BASICS TRACK

What Is A Franchise?

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I. Introduction

What is a franchise? A franchise business model has many components and this paper analyzes a franchise from three different angles. First, Section II of this paper analyzes the legal definition of a franchise. Regardless of what a business arrangement is called, if the three definitional elements of a franchise are met, then the business arrangement is a franchise. Given the state and federal enforcement rights for non-compliance, it is imperative for businesses to understand the legal components of a franchise and to comply with the unique franchise registration and disclosure obligations if their business meets the franchise definition. Section II concludes with a brief discussion of the exemptions to the federal definition of a franchise and an analysis of the business opportunity rule.

Section III of this paper analyzes a franchise from a contractual perspective. Section III focuses primarily on the single-unit franchise agreement and the common contractual provisions governing a single-unit franchise. This section highlights the pressure points and issues a franchisor may want to consider when drafting a single-unit franchise agreement. This section concludes with a summary of the most common forms of franchise agreements including, a single-unit agreement, area development agreement, master franchise agreement and development agent agreement.

Section IV of this paper analyzes a franchise from a relationship standpoint. A franchise is more than a legal definition or a contract. A franchise is a relationship between a franchisor and franchisee. Section IV includes a discussion of the common methods and techniques used by franchisors to strengthen and preserve the franchise relationship.

II. A Franchise is a Legal Definition

Regardless of one’s intent, from a legal perspective a franchise is formed if the business arrangement meets the legal definition of a franchise. The existence of a franchise is not about labels or feelings. It does not matter whether the parties call their relationship a “franchise,” a “license,” or a “distributorship,” or whether they feel like they are in a franchise relationship. From a legal perspective, the existence of a franchise is a matter of definition.

Franchising is a highly regulated business format, regulated at both the federal and state level. Accordingly, it is important for businesses to understand whether their business arrangement meets the legal definition of a franchise and, if it does, to comply with all applicable federal and state regulations. At the federal level, franchising is regulated by the Federal Trade Commission (the “FTC”) under the FTC Rule – 16 C.F.R. §436.1, et seq., which identifies a number of disclosures that a franchisor must provide to a prospective franchisee in a written document called a franchise disclosure document ("FDD"). The FTC Rule applies to franchise opportunities in each of the 50 states, Washington D.C., and all U.S. territories. Thus, a company offering a business arrangement that meets the legal definition of a franchise under the FTC Rule must
present a prospective franchisee with an FDD which contains specific and detailed information about the franchisor and the franchise opportunity. Although a franchisee wronged by the failure to disclose may not have a private right of action, the FTC can bring enforcement proceedings against the franchisor.

In addition to the FTC Rule, certain states also regulate particular aspects of a franchise business arrangement including, requiring disclosure and registration of the franchise opportunity and, in certain states, regulating the parties’ relationship. Accordingly, it is important to understand the definitional elements of a franchise at the state level. In states with their own disclosure laws, a failure to comply with that state’s disclosure law allows a franchisee to seek equitable relief and damages and, in some states, exemplary damages, criminal penalties and fines.

As you can see, understanding whether your business arrangement meets the legal definition of a franchise is important. So, what constitutes a franchise from a legal perspective?

A. The Definition of a Franchise under Federal and State Law.

What qualifies as a franchise under federal law may not meet a state law definition, or vice-versa. Accordingly, it is imperative to understand both the federal and state definitional elements of a franchise and the interplay of federal and state law.

1. Federal Definition

The term “franchise” is defined under the FTC Rule to mean any continuing commercial relationship or arrangement, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

(1) the franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark;

(2) the franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and

(3) as a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.¹

¹ 16 C.F.R. §436.1(h).
In short, a business arrangement meets the FTC Rule definition of a franchise if the business arrangement involves: (i) the grant of a trademark, (ii) the franchisor exerts or has the authority to exert significant control or assistance over the operation of the business, and (iii) the franchisee pays the franchisor or its affiliate a fee. The meaning and application of each of these definitional elements of a franchise are described further below.

a. Grant of a Trademark.

The first definitional element of a franchise requires the grant of a trademark. The trademark element is satisfied if the franchisee is granted the right to operate a business under the franchisor’s trademark, or the franchisee has the right to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark. The FTC Rule defines the term “trademark” broadly to include not only registered trademarks, but any service mark, trade name or other advertising or commercial symbol. Further, it is not necessary that the franchisor own the mark itself for the trademark element to be satisfied. So long as the franchisor has the right to license the use of the mark to others, the trademark element will be met.

The trademark element is the easiest element to identify and, for those business arrangements that wish to avoid the application of the FTC Rule, the easiest element to remove. Specifically, a business can avoid being classified as a franchise if it expressly prohibits the use of its trademark and the business does not use the trademarks. As the court held in Wright-Moore Corp. v. Ricoh Corp., simply prohibiting the use of a trademark is insufficient if, in practice, the third party uses the trademark. The court in Ricoh found the trademark element satisfied even though the dealer was expressly prohibited from using Ricoh’s trademark. Specifically, the court reasoned that a grant of a trademark license existed because the dealer had the right to promote its status as an authorized Ricoh distributor and use Ricoh-supplied advertising. Further, courts have found the trademark element satisfied when the licensee has an obligation to: (i) use best efforts to promote the sale of branded products, (ii) wear uniforms or operate vehicles containing the licensor’s trademarks or logos, (iii) complete special training, (iv) sell unique products which consumers readily associate with a particular manufacturer, or (v) advertise its authorized dealer status locally.

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2 16 C.F.R. §436.1(h)(1).
3 16 C.F.R. §436.1(v).
5 Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128 (7th Cir. 1990).
6 Wright-Moore, 908 F.2d at 135. Despite the distribution agreement prohibiting Wright-Moore from using Ricoh’s name or trademark, the distribution agreement expressly permitted Wright-Moore to state in writing that it was an authorized distributor of Ricoh products. Further, Wright-Moore was provided with advertising materials with Ricoh’s trademark.
7 See, Cassidy Podell Lynch, Inc. v. Snyder General Corp., 944 F.2d 1131, 1139 (3d Cir. 1991) (finding that a trademark license was granted because Cassidy displayed signage bearing Snyder’s trade name at its repair center, was required to maintain yellow pages advertisements designating itself as an authorized Synder seller, and its servicemen wore uniforms bearing Synder’s trade name); Cooper Distrib. Co., Inc. v. Amana Refrigeration, Inc., 63 F.3d 262, 272-73 (3d Cir. 1995) (holding that a trademark license was granted because Cooper’s showroom display the Amana sign, Cooper’s
Accordingly, so long as a purported franchisor is not permitting a third party to use its trademark, service mark, trade name or other commercial symbol, and the third party is in fact not using the trademark, the business arrangement will not satisfy the FTC’s first definitional element of a franchise.

b. Significant Control or Assistance.

The second definitional element requires the franchisor to exert, or have the authority to exert, a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation. The significant control or assistance element exists to acknowledge a franchisee’s reliance on the franchisor’s business experience, and the franchisee’s use of such expertise to reduce business risks and increase its probability of success. The more a franchisee relies upon the franchisor’s control or assistance, the more likely the control or assistance will be considered significant. Generally reliance is found when a franchisee is inexperienced in the business or industry, the franchisee undertakes a large financial risk, or when the controls or assistance provided by the franchisor are unique to a particular industry as opposed to businesses in general. To be deemed “significant,” the control or assistance must relate to the franchisee’s overall method of operation – not merely a small or marginal aspect of the franchisee’s business.

So, what constitutes “significant control or assistance”? In the Franchise Rule Compliance Guide (the “Compliance Guide”), the FTC provided some guidance in this area. According to the FTC, the significant control element may be established by the franchisor having some control over any of the following: (i) site approval or site selection, (ii) site design or appearance requirements, (iii) hours of operation, (iv) production techniques, (v) accounting practices, (vi) personnel policies, (vii) required franchisee promotional campaigns or financial contribution, (viii) restrictions on customers, or (ix) locale or area of operation. Similarly, the FTC noted that the significant assistance element may be established by the franchisor doing any of the following: (i) providing formal sales, repair, or business training programs, (ii) establishing accounting systems, (iii) furnishing management, marketing, or personnel advice, (iv) selecting site locations, (v) furnishing systemwide networks and websites, or (vi) furnishing a detailed operating manual. To a lesser extent, the FTC noted that the following factors will be considered when determining whether significant control or assistance is present in a relationship: (i) a requirement that a franchisee service or

servicemen wore Amana uniforms, Cooper was required to use its best efforts to promote the sale of Amana products, and Cooper advertised itself as an Amana servicer), and Lobdell v. Sugar 'N Spice, Bus. Franchise Guide (CCH) ¶ 7947 (Wash. Ct. App. 1983) (reasoning that a trademark license was granted when the franchisee was granted the right to sell the company’s self-described instantly recognized products in a particular territory).

8 16 C.F.R. §436.1(h)(2).
9 Franchise Rule Compliance Guide at p.2.
10 Id.
11 Id. at p.3.
12 Id.
repair a product, (ii) inventory control, (iii) required displays of goods, and (iv) on-the-job assistance with sales or repairs.¹³

Not all actions by a franchisor will qualify as significant control or assistance. In fact, the FTC has expressly stated that promotional activities alone will not be deemed significant control or assistance.¹⁴ For example, simply furnishing a distributor with point-of-sale advertising displays, sales kits, product samples, or other promotional materials is insufficient to constitute significant control or assistance. Further, the FTC has stated that the following items do not constitute significant control or assistance: (i) trademark controls designed solely to protect the trademark owner’s legal ownership rights in the mark under state or federal trademark laws (such as display of the mark or right of inspection), (ii) health or safety restrictions required by federal or state laws or regulations, (iii) agreements between a bank credit interchange organization and retailers or member banks for the provision of credit cards or credit services, and (iv) assisting distributors in obtaining financing to be able to transact business.¹⁵ The actions noted above, without more, are insufficient to establish the significant control or assistance requirement.

c. Payment of a Fee.

The final FTC Rule definitional element of a franchise is the requirement that the franchisee make a required payment or commit to make a required payment to the franchisor or the franchisor’s affiliate.¹⁶ The term “required payment” is defined broadly to mean:

“all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease.”¹⁷

The definition of a required payment captures all sources of revenue that a franchisee must pay to a franchisor or its affiliate for the right to associate with the franchisor, market its goods or services, or begin operation of the business. “Required payments” go beyond payment of a traditional initial franchise fee. Thus, even though a franchisee does not pay the franchisor or its affiliates an initial franchise fee, the fee element may still be satisfied. Specifically, payments of practical necessity also count toward the required payment element. A common example of a payment made by practical necessity is a charge for equipment or inventory that can only be obtained from the franchisor or its affiliate and no other source. Other required payments that will satisfy the third definitional element of a franchise include: (i) rent, (ii) advertising

¹³ Id. at p. 2-3.
¹⁴ Id. at p.3
¹⁵ Id.
¹⁶ 16 C.F.R. §436.1(h)(3).
¹⁷ 16 C.F.R. §436.1(s).
assistance, (iii) training, (iv) security deposits, (v) escrow deposits, (vi) non-refundable bookkeeping charges, (vii) promotional literature, (viii) equipment rental, and (ix) continuing royalties on sales.  

Simply put, any payment made by a franchisee to the franchisor will satisfy the fee element. For example, a boat dealer’s extensive advertising and its required purchases of promotional materials from the franchisor satisfied the franchise fee requirement under the California Franchise Investment Act. Similarly, a forklift dealer’s payments to a manufacturer for additional copies of a Parts and Repair Manual constituted a franchise fee under the Illinois Franchise Disclosure Act. Finally, required payments for training or services made to the franchisor or its affiliate may satisfy the payment of a fee element.

One key exception to the payment element of the franchise definition is the purchase of a reasonable amount of inventory at the bona fide wholesale price. The rationale underlying the bona fide wholesale price exception is that, as long as the distributor is not forced to buy excessive quantities of inventory, it can resell the goods and recoup its investment and, thus, does not need the protection of franchise laws. The key here is that the inventory purchased must be a “reasonable amount” and not in excess of what a reasonable businessperson normally would purchase for starting or maintaining an inventory or supply. Payment of a fee, however, will be found when the required inventory to be purchased is excessive.

The bona fide wholesale price exemption does not apply to goods such as equipment, ordinary business supplies, or marketing materials that a franchisee must purchase for its own use in the operation of the business. Accordingly, bundling required inventory purchases with equipment, ordinary business supplies or marketing materials may eliminate any attempt to avoid the “payment of a fee” definitional element.

While little guidance exists on what exactly qualifies as a bona fide wholesale price, it is generally understood to mean a price that is greater than the supply source’s

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18 Franchise Rule Compliance Guide at p.5.
20 *To-Am Equip. Co., Inc. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 953 F. Supp. 987 (N.D. Ill. 1997). In *To-Am Equipment*, the court noted that even though the franchisor provided one free manual, the dealer regularly provided on-site service to its customers and, therefore, one manual was insufficient. Although the dealer could have copied the manuals or purchased additional copies from another dealer, the court held that this did not take the purchase of additional manuals from the manufacturer outside the definition of a franchise fee.
21 *Metro All Snax v. All Snax, Inc.* Bus. Franchise Guide (CCH) ¶ 10,885 (D. Minn. 1996) (finding that Metro All Snax’s payment of $34,500 for training constituted payment of a fee under the Minnesota Franchise Act) and *Lobdell*, Bus. Franchise Guide (CCH) ¶7947 (holding that payments for the cost of finding retail locations for their racks and for advertising constituted payment of a fee under the Washington Franchise Act).
cost to manufacture the goods, but less than a retail price. The burden of proving that the price qualifies as a “bona fide wholesale price” remains the burden of the supply source.

2. State Definition

As noted above, certain states have franchise acts that govern business arrangements meeting the state definition of a franchise. The state legal definition of a franchise largely resembles the FTC Rule’s definition of a franchise in that most require the combination of three basic elements. Specifically, the federal “grant of a trademark license” and “payment of a fee” elements are fundamentally the same at the state level. State franchise laws, however, replace the middle definitional element of substantial assistance or control either with the requirement that there be a marketing plan prescribed in substantial part by the franchisor or a community of interest between the parties. The marketing plan and community of interest definitional elements are described more fully below.


Most state franchise acts employ a marketing plan definition of a franchise. Generally, the marketing plan element is satisfied if the franchisee is granted the right to engage in the business of offering goods or services under a marketing plan or system substantially prescribed by the franchisor. The marketing plan element is evaluated both on the language of the contract, and also on the parties’ course of dealing. Similar to the FTC Rule’s significant control or assistance requirement, the marketing plan element is defined by the degree of control exercised by the franchisor over the franchisee and the amount of assistance the franchisor offers to the franchisee.

Further, whether a marketing plan is prescribed in “substantial part” depends on a variety of factors including the extent of control over the franchisee’s business operations and strategy, the existence of minimum purchase requirements, the grant of an exclusive territory, and the types and degree of assistance offered or promised by the franchisor. No factor is dispositive, but the combination of any of these restrictions may amount to a marketing plan.

While there is no standard definition of what constitutes a “marketing plan,” generally, a marketing plan exists where advice or training is given regarding the operation of the business or the sale of the franchisor’s products or services. For example, Illinois, Rhode Island and Washington view the following types of assistance and control as relevant in determining whether a marketing plan is present: (i)
specification of price, (ii) use of particular sales or display equipment, (iii) use of specific sales techniques, (iv) use of advertising or promotional materials or cooperation in advertising efforts, (iv) operations or management training, and/or (v) operation, managerial, technical or financial guidelines or assistance. Likewise, in California a marketing plan may be found if the franchisor does any of the following: (i) gives detailed instructions concerning operating techniques, (ii) assigns an exclusive territory, (iii) provides training sessions, (iv) prescribes or limits resale operations, (v) restricts use of advertising, and/or (vi) provides for uniformity of appearance. In fact, in California the mere suggestion that a franchisee follow the franchisor’s marketing plan may be sufficient to satisfy the marketing plan element, even if the franchisee ultimately chooses not to follow that plan.

b. Community of Interest.

Four states define a franchise or dealership as including a community of interest between the grantor and the grantee in the marketing of goods and services. Unlike the marketing plan approach, the community of interest element is not directly related to the amount of control exercised by the franchisor, but rather focuses on the interdependence of the parties as shown by shared goals, cooperative effort, and any shared financial interest in the operation of the franchised business or the marketing of goods and services offered by the franchisee.

The Wisconsin Fair Dealership Law defines a community of interest as a continuing financial interest between the grantor and the grantee in either the operation of the dealership business or the marketing of such goods or services. Wisconsin applies a 10 factor “totality of the circumstances test” when determining whether the community of interest element has been satisfied. Specifically, the totality of the circumstances test includes an analysis of the following factors: (1) the duration of the parties’ relationship, (2) the extent and nature of the parties’ obligations, (3) the percentage of time or revenue devoted to the grantor’s products or services, (4) the percentage of the grantee’s growth proceeds or profits derived from the grantor’s products and services, (5) the extent and nature of the grantee’s territory, (6) the use of the grantor’s trademarks or logos, (7) the grantee’s financial investment in the inventory, facilities, and goodwill of the alleged dealership, (8) the personnel devoted to the alleged dealership, (9) the amount of money and time spent on advertising and promotions for the suppliers products and services, and (10) the extent of supplemental services provided by the grantee to purchasers of the grantor’s products or services.

28 Hawaii, Minnesota, New Jersey and South Dakota all include a community of interest element in their definition of a franchise.
In determining whether a community of interest exists under the New Jersey Franchise Act, courts have focused on the extent of the alleged franchisor’s control over the alleged franchisee, the franchisee’s economic dependence on the franchisor, the relative bargaining power of the parties, and the presence of franchise-specific investments by the franchisee. A primary factor in this equation is interdependence, which generally arises when the franchisee invests heavily in the franchise business such that its economic health hinges on the continuation of the business. The percentage of revenues or sales attributable to the franchisor’s products is not dispositive of the interdependence issue, but franchisees and dealers whose revenues attributable to a supplier’s products are relatively small generally have a hard time establishing interdependence and a community of interest.

Minnesota courts use a rather nominal threshold, finding a community of interest present whenever parties derive fees from a common source, a standard that describes nearly every distributorship and licensing arrangement.

3. What Types of Relationships are not Covered.

Business opportunities are not covered by the FTC Rule. As described in greater detail below, business opportunities are governed by separate federal and state laws.

Additionally, the FTC Rule applies to franchise opportunities in each of the 50 states, Washington D.C., and all U.S. territories. The FTC Rule does not cover the sale of franchises to be located outside the United States and its territories.

4. Exemptions.

Some business arrangements satisfy the three definitional elements of a franchise but are expressly exempt from the FTC Rule. It is important to understand that some, but not all of these same exemptions have been adopted by states with state franchise acts. Each of the FTC Rule exemptions is described further below. Before relying on any of the exemptions noted below, it is important to confirm that the same exemption applies at the state level.

a. Minimum Payment

Exempt from the FTC Rule are franchise sales where the total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operations of

31 Neptune T.V., 462 A.2d at 601(holding that the community of interest factor was not met because the arrangement lacked "both the symbiotic character of a true franchise arrangement and the consequent vulnerability of the alleged franchisee to an unconscionable loss of his tangible and intangible equities").
32 Metro All Snax, Bus. Franchise Guide (CCH) ¶ 10,885.
the franchisee’s business is less than $500.\textsuperscript{33} A franchisee commences operation when it first makes goods or services available for sale. A commitment entered into during the first six months that requires a payment later than six months after commencing operation does not count towards the $500 minimum payment exemption.

**b. Fractional Franchises**

The FTC Rule also exempts from the definition of a franchise the sale of a fractional franchise.\textsuperscript{34} A fractional franchise relationship is created when the following two elements are present at the start of the relationship: (i) the franchisee, any of the franchisee’s current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business, and (ii) the parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee’s total dollar volume in sales during the first year of operation.\textsuperscript{35}

The same line of business means selling competitive goods, or being in a business that would ordinarily be expected to sell the type of goods to be distributed under the franchise.\textsuperscript{36} When considering the second required element – whether the increased sales volume from the fractional franchise relationship exceeds 20% of total sales – the parties may measure incremental sales resulting from the fractional franchise against total sales at all stores owned by the franchisee. The store owner should measure the increase in sales attributed to the new product against the aggregate total sales volume for all products sold through his or her businesses.\textsuperscript{37}

**c. Leased Departments**

A business arrangement meeting the definition of a leased department is exempt from the definition of a franchise.\textsuperscript{38} A leased department means an arrangement whereby a retailer licenses or otherwise permits a seller to conduct business from the retailer’s location and the seller is not required to purchase any goods, services or commodities directly or indirectly from the retailer, an affiliate of the retailer, or a person designated by the retailer.\textsuperscript{39} Leased department arrangements usually occur in the merchandising of footwear, optometry, tobacco, cosmetics, and jewelry. This exemption is only available if the independent retailer is not required to directly or indirectly purchase its goods or services from either the larger retailer or from suppliers required or approved by the larger retailer.

\textsuperscript{33} 16 C.F.R. §436.8(a)(1).
\textsuperscript{34} 16 C.F.R. §436.8(a)(2).
\textsuperscript{35} 16 C.F.R. §436.1(g).
\textsuperscript{36} Franchise Rule Compliance Guide at p.8.
\textsuperscript{37} Id. at p.9.
\textsuperscript{38} 16 C.F.R. §436.8(a)(3).
\textsuperscript{39} 16 C.F.R. §436.1(l).
d. Oral Agreements

The FTC Rule exempts purely oral relationships that lack any written evidence of a material term of the franchise relationship or agreement. This exemption does not apply when there is any writing, even if unsigned, with respect to a material term, such as a purchase invoice for goods or equipment.

e. Petroleum Marketers & Resellers

The FTC 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 station franchises. The PMPA exemption is intended to be read broadly. It covers not only gasoline stations, but other services and products — such as repair centers, car washes, or convenience stores — sold to a prospective franchisee under the same, unified, franchise agreement as the gasoline station itself. However, the offer or sale of a convenience store or other franchise to an existing gasoline station franchisee under a separate franchise agreement is not exempt, and is, in fact, no different from the ordinary sale of a franchise to an existing franchisee.

f. Large Franchise Investment

Any franchise sale that qualifies as a large franchise investment is exempt from the FTC Rule’s definition of a franchise. A large franchise investment occurs when the franchisee’s initial investment is at least $1 million, excluding the cost of unimproved land and any franchisor (or affiliate) financing, and the franchisee signs an acknowledgement, acknowledging the grounds for the exemption. The acknowledgment must contain the following prescribed statement:

The franchise sale is for more than $1 million — excluding the cost of unimproved land and any financing received from the franchisor or an affiliate — and thus is exempt from the Federal Trade Commission’s Franchise Rule disclosure requirements, pursuant to 16 C.F.R. §436.8(a)(5)(i).

40 16 C.F.R. §436.8(a)(7).
41 Franchise Rule Compliance Guide at p.9.
42 16 C.F.R. §436.8(a)(4).
43 Franchise Rule Compliance Guide at p.10.
44 Id.
45 See, 16 C.F.R. §436.8(a)(5).
46 16 C.F.R. §436.8(5)(i). This exemption focuses on the level of the initial investment not the number of outlets or the type of outlets begin sold. The exemption will apply where the total projected initial investment is reached whether for a single unit or multiple units. At the same time, it is possible that the large investment exception may apply to some, but not all, of a franchisor’s franchise sales.
47 16 C.F.R. §436.8(a)(5)(i). The franchisor has the burden of proving that the acknowledgment was furnished to and signed by the prospective franchisee.
A franchisee’s initial investment is limited to the type of expenses that would ordinarily appear in an Item 7 disclosure – expenses paid through the opening of the outlet and any additional expenses paid through the three-month initial period thereafter. It does not reach all possible payments to the franchisor made over the life of the franchise agreement. Accordingly, future obligations to pay rent, royalties, or advertising fund contributions to be made over the life of the franchise agreement do not count toward the initial investment. Additionally, in order to qualify for the large franchise investment exemption at least one individual must invest at the $1 million level for the exemption to apply. The large investment exemption is premised on the assumption that a franchisee’s ability to pay a large sum equates with sophistication. That assumption fails when no one investor standing alone is investing at the requisite threshold level.

Additionally, the FTC Rule exempts franchise offers and sales to large entities – such as airports, hospitals, and universities – that have been in business for at least five years and have a net worth of at least $5 million. To qualify for the exemption, the large entity must have five years of prior business experience, but there is no requirement that this experience be in franchising, or even in the business being franchised.

To qualify for the large franchisee exemption, the prospective franchisee-entity must have a net worth of $5 million. When determining the prior experience and net worth of a franchisee-entity, franchisors may consider the prior experience and net worth of the prospective franchisee’s affiliates and parents.

g. Insider Exemption

The insider exemption applies to franchise sales to the officers, directors, general partners, managers and owners of a franchisor. The insider exemption applies in the following situations:

(1) One or more purchasers of at least a 50% ownership interest in the franchise has, within 60 days prior to the date of the sale, been for a period of at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor’s franchises or the administrator of the franchised network, or

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48 Franchise Rule Compliance Guide at p.10.
49 16 C.F.R. §436.8(a)(5)(i), footnote 11.
50 Franchise Rule Compliance Guide at p.12.
51 Id. (noting that a husband and wife can be considered a single investor).
52 16 C.F.R. §436.8(a)(5)(ii).
53 Franchise Rule Compliance Guide at p.12.
54 16 C.F.R. §436.8(a)(5)(ii).
55 Franchise Rule Compliance Guide at p.13 (noting that commonly-owned franchisee assets may be combined to reach the large entity exemption requirements).
(2) One of more purchases of at least a 50% ownership interest in the franchise has, within 60 days prior to the date of the sale, been for a period of at least two years, an owner of at least a 25% interest in the franchisor.56

5. Exclusions

The following relationships are excluded from the FTC Rule. Although each of these relationships may have some similarities with a franchise relationship, none of them meet the definitional elements of the term franchise.

a. Employer-Employee Relationship

Traditional employer-employee relationships are excluded from coverage under the FTC Rule. The traditional right of control test will apply in determining whether an employment relationship exists. Specifically, in determining whether an employer-employee relationship exists, the following factors will be considered: (i) whether the employer pays a salary or definite sum of money as consideration for the work, (ii) whether the employee can be discharged or his employment terminated without liability on the part of the employer, and (iii) whether the employee must invest money in the business before being hired.57

b. General Partner Relationship

Bona fide relationships among general partners are excluded from the FTC Rule. All partners in the partnership must be general partners to qualify for the exclusion.58

c. Cooperative Associations

Two types of cooperative associations qualify for exclusion: (i) agricultural cooperatives authorized by the Capper-Volstead Act, 7 U.S.C. § 291, and (ii) retailer-owned cooperative chains. Retailer-owned cooperatives are those operated by and for independent retailers on a cooperative basis. The members must be independent retailers, and the organization must furnish services or goods primarily to its members.59

56 16 C.F.R. §436.8(a)(6).
57 Franchise Rule Compliance Guide at p.15.
58 Id.
59 Id. at 16.
d. Certification or Testing Services

Relationships that are created solely by arrangements with bona fide certification or testing services, such as those offered by Underwriters Laboratories and similar organizations are excluded from the FTC Rule.60

e. Single Trademark License

The grant of a single trademark license is excluded from the FTC Rule. This exclusion includes: (i) a one-on-one licensing arrangements – i.e., the license of a trademark to a single licensee who manufacturers the trademarked goods according to the licensor’s specifications, (ii) collateral product licensing – i.e., the practice of licensing a trademark that is well-known in one context for use in another, and (iii) licensing agreements entered into in the course of settlement negotiations in trademark infringement litigation, when the licensor grants the infringing party a license to use the trademark for a specified period.61

B. Legal Implications of Meeting the Franchise Definition

If a business arrangement meets the FTC Rule definition of a franchise, the franchisor must ensure that when offering or selling the business arrangement – i.e., the franchise, the franchisor complies with the disclosure obligations and requirements set forth in the FTC Rule. Additionally, if any state franchise act applies to the offer and sale of the franchise, the franchisor must ensure it complies with any additional disclosure and registration obligations promulgated by applicable state law.

1. Disclosure Requirements

Under the FTC Rule, all franchisors must prepare an FDD containing certain disclosure items regarding the franchisor and the franchise business.62 Further, the FTC Rule requires the franchisor to provide the FDD to a prospective franchisee at least fourteen calendar days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale.63

2. Registration Requirements

In addition to the disclosure obligations required by the FTC Rule, certain states require franchisors to register their FDD with the applicable state agency prior to offering or selling a franchise to a prospect. In particular, franchisors must register their franchise business in the states of California, Florida, Hawaii, Illinois, Indiana, Maryland,

60 Id. (noting that franchising involves a distribution of goods or services whereas certification or testing services merely involve the use of a trademark by parties meeting their standards).
61 Id.
62 16 C.F.R. §436.2.
63 16 C.F.R. §436.2(a).
Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Utah, Washington and Wisconsin.

C. What is a Business Opportunity  If a commercial arrangement is not a franchise under the FTC Rule or applicable state laws, businesses must be aware of the business opportunity laws and analyze whether their business arrangement meets the federal or state definition of a business opportunity. Similar to the regulation of franchises, business opportunities are regulated at both the federal and state level.

1. Federal Regulation

a. Definition of a Business Opportunity

The FTC currently defines a “business opportunity” as any continuing commercial relationship created by any arrangement or arrangements whereby:

(1) A person (hereinafter “business opportunity purchaser”) offers, sells or distributes to any person other than a “business opportunity seller” (as hereinafter defined), goods, commodities, or services which are:

   (i)(A) Supplied by another person (hereinafter “business opportunity seller”); or

   (B) Supplied by a third person (e.g., a supplier) with whom the business opportunity purchaser is directly or indirectly required to do business by another person (hereinafter “business opportunity seller”); or

   (C) Supplied by a third person (e.g., supplier) with whom the business opportunity purchaser is directly or indirectly advised to do business by another person (hereinafter “business opportunity seller”) where such third person is affiliated with the business opportunity seller; and

   (ii) The business opportunity seller:

   (A) Secures for the business opportunity purchaser retail outlets or accounts for said goods, commodities, or services; or

   (B) Secures for the business opportunity purchaser locations or sites for vending machines, rack displays, or any other product sales displays used by the business opportunity purchaser in the offering, sale,
or distribution of said goods, commodities, or services; or

(C) Provides to the business opportunity purchaser the services of a person able to secure the retail outlets, accounts, sites, or locations referred to in paragraphs (a)(ii)(A) and (B) of this section; and

(2) The business opportunity purchaser is required as a condition of obtaining or commencing the business opportunity operation to make a payment or a commitment to pay to the business opportunity seller, or to a person affiliated with the business opportunity seller.64

b. Business Opportunity Disclosure Requirements

If a business arrangement meets the definition of a “business opportunity,” the FTC’s Business Opportunity Rule requires the offeror to make certain disclosures to a prospective purchaser prior to the sale.65 Many of the disclosures required by the FTC’s Business Opportunity Rule are similar to the disclosures required by the FTC Rule.

c. Exemptions and Exclusions

Similar to the FTC Rule governing franchises, some business arrangements satisfy the definitional elements of a business opportunity but are expressly exempt or excluded from the FTC’s Business Opportunity Rule. Specifically, the following business arrangements are exempt from the FTC’s Business Opportunity Rule: (i) a fractional business opportunity, (ii) a leased arrangement, (iii) when the total of payments made during the first 6 months of operation are less than $500, (iv) when there is no written evidence of the relationship, and (v) when the business arrangement complies with the franchise disclosure requirements set forth under the FTC Rule.66

Likewise, the following business arrangements are expressly excluded from the FTC’s definition of a business opportunity: (i) employer-employee relationship, (ii) members in a bona fide cooperative association, (iii) a license for certification or testing services, and (iv) a single trademark license agreement.67

64 16 C.F.R §437.2(a).
65 16 C.F.R. §437.1.
2. State Regulation

a. Definition of a Business Opportunity

In addition to the federal regulation of business opportunities, twenty-six states have enacted some form of business opportunity laws which define and regulate business opportunities within the state. The following states have enacted business opportunity laws: 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.

Primarily, state business opportunity laws require pre-sale disclosure and registration. Failure to comply with any applicable state business opportunity law may result in both common law and statutory remedies. In addition, the regulatory authority can impose administrative sanctions, including administrative fines, stop orders, and orders placing the seller on probation for a period of time.

The statutory definitions of a business opportunity vary from state to state, but typically have the following common elements:

(1) Any contract for a seller to provide products, equipment, supplies, or services to enable the purchaser to state a business; and

(2) The seller makes certain representations to the buyer, for example: the seller will provide locations or assist the purchaser in finding locations for the business; the seller will purchase any or all of the products produced; the seller guarantees the purchaser will derive income from the business which exceed the price paid; or the seller will refund all or part of the price paid if the purchaser is unsatisfied with the purchase.

While the states’ definition of business opportunities are broad and can reach a wide range of businesses, the states’ statutes contain certain exemptions and exclusions from their requirements. Since many sellers would like to avoid classification as a business opportunity, it is important to be aware of the available exclusions and exemptions and to analyze whether one of the exclusions or exemptions may apply. Below are some of the common state exclusions and exemptions:

(1) The sale of a sales program or marketing program made in conjunction with the licensing of a registered trademark or service mark.

(2) The sale of a franchise as defined by the FTC Rule – 16 C.F.R. §436.1. If a franchisor is relying on the franchise

68 The following states have enacted business opportunity laws: 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.
exemption, several states require the franchisor to file a notice of the exemption with the state regulatory body.

(3) The sale of an ongoing/established business.

b. Disclosure and Registration Requirements

Similar to the definition of a business opportunity under state law, the disclosure and registration requirements of business opportunities vary under state law. In general, state laws regulating business opportunities require business sellers to prepare a disclosure document which includes certain information regarding the business opportunity and the business seller.

Additionally, states regulating business opportunities also typically require a business opportunity seller to provide the business opportunity purchaser with the prescribed disclosure document in advance of the sale.

III. A Franchise is a Contract

A. The Single-Unit Franchise Agreement

A single-unit franchise agreement grants franchisees the right to open and operate one franchised business, typically at a franchisor-approved location or within a franchisor-approved area. The agreement licenses to franchisee the right to use franchisor’s marks and business system in connection with the franchised business, and outlines franchisee’s rights and obligations. Drafted broadly to encompass numerous scenarios, the franchise agreement is supplemented with the operations manual when the need for specificity and detailed standards arise.

While each franchise agreement is drafted with the intent to create a franchise relationship between franchisor and franchisee, no two agreements are exactly alike. Different system structures, business models, customer demands, target franchisees, etc. shape the way a franchise agreement is drafted. The following paragraphs will navigate through typical provisions included in franchise agreements, and discuss some of the considerations franchisors should take into account when drafting these provisions.

1. The Grant Clause

The grant clause is typically one of the first sections included in a franchise agreement. It defines, as precisely as possible, exactly what rights are being granted to franchisee and often also includes rights reserved by franchisor. Most commonly, this clause gives franchisee the right to use franchisor's trademarks and system, as it may be defined, in connection with the operation of a single franchised business. This business may be confined to one approved location, to a specified territory, or a combination of both, depending on the franchise offering.
Burger King Corporation's ("BKC") grant clause, for example, specifically outlines franchisee's rights with respect to a single location:

"BKC grants to Franchisee and Franchisee accepts a franchise to use the BURGER KING System and BURGER KING Marks only in the operation of a BURGER KING Restaurant at [address], more fully described in Exhibit A (the "Franchised Restaurant")... This franchise is for the specified location only and does not in any way grant or imply any area, market or territorial rights proprietary to Franchisee."

On the other hand, Sears Carpet and Upholstery Care, Inc. includes a more territory-based grant clause in its franchise agreement:

"... Subject to the provisions of this Agreement, the COMPANY hereby grants to FRANCHISEE a franchise ("Franchise") to operate a BUSINESS in the Territory described in Exhibit 1 to this Agreement ("Territory"), and to use the Marks in the operation thereof..."

Also in the grant clause, franchisors enumerate specific rights not granted to franchisee. These franchisor "reserved rights," as they are often called, might include: 1) the right to operate, or grant others the right to operate, a franchised business under the same trademarks outside of franchisee's territory (if any is granted), or at any location other than franchisee's approved location (if the grant of the franchise is limited to a single location); 2) the right to operate, or grant others the right to operate, any business under different trademarks within or outside of franchisee's territory; 3) the right to distribute goods or services identified by franchisor's trademarks through alternate channels of distribution, which may include such channels as the Internet, catalogues, telemarketing, and supermarkets; and 4) the right to be acquired by a business providing products and services similar to those offered through the franchised business, regardless of whether the acquired business operates or franchises competitive businesses in franchisee's territory.

a. Drafting Considerations

The grant clause is, in essence, licensing language. It licenses franchisor's trademarks and system to franchisee for its use in connection with the franchised business. For this reason, and to allow franchisor to retain control over its brand, the grant clause should be drafted as narrowly as possible, while at the same time fulfilling franchisee's need to successfully operate the franchised business. In order to achieve this balance, a thorough understanding of a franchise system's structure is necessary.

In addition to complementing the structure of the franchise system and meeting franchisee's basic need to operate the franchised business, a grant clause should also consider rights franchisor specifically desires to retain for itself (as listed above).
2. Territorial Rights

Territorial rights, as defined and granted in a franchise agreement, are rarely confined to a single provision. Instead, such rights and limitations surface throughout the agreement, often beginning in the grant clause. Territorial rights vary widely and are tailored to the type of franchised business being offered.

As we saw above with BKC, some franchisors elect not to grant territorial rights to franchisees. The only right franchisee is granted in such circumstances is the right to operate a single approved franchised location. This does not mean, however, that franchisor is permitted free-reign with respect to the placement of corporate or franchised units in franchisee’s vicinity. In the case of Scheck v. Burger King Corp., the court found that although Burger King’s franchise agreement did not constrain Burger King from opening another unit near an already-existing unit, it was a breach of the franchise agreement’s implied covenant of good faith and fair dealing to place a new unit about two miles from an existing location. While courts have distinguished their cases from Scheck, or chosen not to follow the precedent set, franchisors should nonetheless heed the warning this case issues. In essence, franchisors should not assume that simply because a right is not expressly reserved by franchisor in its franchise agreement, that it is not limited by the covenant of good faith and fair dealing.

As a direct result of Scheck, franchisors began including a section in the franchise agreement expressly reserving certain territorial rights (as discussed in the "grant" section above).

Some franchisors, however, do choose to grant limited territorial protections, perhaps the most popular of which is franchisor's agreement not to operate, or grant others the right to operate, a same or similar business under franchisor's trademarks within franchisee's territory. Still other franchisors, typically those with territory-based businesses, allow franchisees to operate only within a specified territory, where territorial protection, if any, can greatly vary.

An example of a provision involving a territory-based business structure can be found in the Jimmy John's franchise agreement. Jimmy John's sandwich shops are famous for fast deliveries to surrounding areas, which might explain franchisor's desire to retain full control over franchisee's delivery area:

"You must provide delivery services in compliance with our System Standards but only in the delivery area we specify for you (in an email or other communication) after you find the Restaurant’s site. You acknowledge and understand that we may, at any time and from time to time, and for any or no reason, change the definition of the delivery area and, in particular, reduce its size... The delivery area is nothing more than the geographic boundaries in which you may deliver the Restaurant’s products. It confers no other rights on your whatsoever."

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The Snap Fitness franchise agreement, on the other hand, provides the following limited territorial protections to franchisees:

“During the term of this Agreement, neither we nor our affiliates will develop or operate, or grant to anyone else the right to develop or operate a SNAP FITNESS® Club in the Designated Area (other than at Special Sites).”

b. Drafting Considerations

In light of the numerous territorial disputes which arise regularly in the franchise context, franchisors define both their own and franchisee’s territorial rights with specificity, leaving no room for ambiguity and individual interpretation.

When contemplating what territorial rights to grant franchisee, franchisor should consider: 1) the structure of the franchised business; 2) the minimum territory required for franchisee to succeed; and 3) limitations and exceptions to territorial rights.

The structure of the franchised business should influence what territorial rights are granted to franchisee. For example, if the franchised business is a restaurant where franchisee is required to deliver goods and/or provide catering services, franchisor may wish to grant franchisee a protected area in which only franchisee has the right to deliver and cater. For franchise systems whose business structures rely heavily on direct marketing efforts to attract customers, if franchisor does not grant a certain amount of territorial protection, customer confusion and franchisee disputes may arise. In such cases, franchisor may elect to grant franchisee the right to market and provide goods and services within its defined territory and, at the same time, prohibit franchisee from marketing and providing goods and services outside of its defined territory.

In addition to taking into account the business structure of the franchise, franchisor should consider what reasonable territorial rights should be granted to franchisee in order to facilitate and protect the success and growth of the franchised business. To use an example in the beauty industry, one might compare a nail salon to an eyelash extension services salon. Where most customers may not be willing to travel 15 miles from home or work for a manicure, they may be not only willing, but required, to do so for the more rare eyelash extension services. Still in its relative infancy, eyelash extension service salons currently draw customers from much larger areas than nail salons. As such, a franchisor for a nail salon may not grant franchisees any territorial protection or, if it does, may only agree not to place a company or franchised salon within a very limited area surrounding franchisee’s location. On the other hand, a franchisor for eyelash extension services salons should recognize that, in order to sustain the franchised business, franchisee will need a greater area to draw customers from. As a result, such franchisor might consider offering greater territorial protection to its franchisees.

The limitation of territorial rights is just as important as the grant of territorial rights. Franchisor may consider specifically limiting franchisee rights to a certain
territory, and not beyond, in order to encourage franchisees to focus marketing efforts and business development within its own area. Franchisor may also desire to limit any territorial protection granted to franchisee by: 1) explicitly reserving certain territorial rights for itself (a typical list of which may be found in the above grant section), 2) excluding any closed or captive markets from franchisee's territory (which may include department stores, supermarkets, shopping malls, amusement parks, airports, train stations, public facilities, college and school campuses, arenas, stadiums, ballparks, hospitals, office buildings, convention centers, military bases, etc.), or 3) by establishing, or reserving the right to establish, a national account system.

3. Initial Term

The initial term is the length of time, typically expressed in years, for which the franchise agreement remains in effect, and during which franchisee has the right and obligation to operate the franchised business. While there isn't a great amount of variation in the technical drafting of the initial term provision, the initial term clause does contain two common variables which often differ from franchise agreement to franchise agreement.

The first variable found in the term clause is the commencement date of the initial term. Under many franchise agreements, the term will begin on the date of execution. Other franchisors, however, may choose to begin the term on the date franchisee executes its lease, on the lease commencement date, or on the date the franchise opens for business. The second variable in an initial term provision is the length of the term. Such lengths vary widely from franchise system to franchise system.

a. Drafting Considerations

The more prevalent considerations franchisors account for when setting the length of their initial term include: 1) initial investment and financing considerations; 2) real estate lease and purchase considerations; and 3) industry stability and changing business model.

For franchises requiring a high initial investment, franchisee will want sufficient time to operate the franchised business in order to earn a sizable return on their investment. For these larger investment franchises, franchisees are also more likely to obtain sizeable loan amounts which may be amortized over longer periods of time as compared to smaller loans obtained to start franchised businesses with more moderate initial investment requirements. Therefore, the higher the initial investment, the more seriously franchisor may consider granting a longer initial term. For example, both Burger King and Blockbuster, each requiring a significant initial investment, offer twenty year initial terms.

For franchises contemplating a retail lease, conventional wisdom dictates that the franchise term run concurrently with the lease term. Also, if franchisees will be purchasing real estate for the development of the franchised business, franchisor may want to adopt a longer initial term length.
For franchise systems offering primarily new products and services, that is, products and services which have not yet gained public and cultural recognition, franchisor may want to offer a shorter initial term. For these types of systems, vast changes will often take place very quickly, and franchisor may not want its first generation franchisees on the initial form of franchise agreement for a period of ten or more years. Even should franchisor and counsel intelligently draft the franchise agreement to anticipate system changes, some considerations, such as protected territories, are difficult if not impossible to amend mid-term. On the other hand, if the industry is stable and well-established, franchisor should feel more comfortable offering a longer initial term.

4. Renewal

Most every franchise agreement will include a renewal provision. This renewal provision serves to grant franchisee the right to continue operating the franchised business, typically under franchisor's then-current franchise agreement, for an additional set length of time. Franchisor may choose to grant anywhere from one to an infinite number of renewal terms. Regardless of how many renewal terms a franchisee is granted, however, franchisor will typically condition renewal on a laundry-list of conditions, as discussed below.

c. Drafting Considerations

Renewal terms in franchise agreements differ with respect to: 1) the length and number of renewal terms granted, and 2) franchisor's conditions for renewal.

With respect to the length of each renewal period, franchisor might consider providing, as with the initial term, a period of years that would run concurrently with any lease options. If, for example, the leases for a franchise system's prototype location tend to include five-year lease options, franchisor may want to set its renewal period at five years. The number of renewals granted is truly within the discretion of franchisor, however, there are certain concerns which should be taken into account should franchisor desire to offer perpetual renewal terms. For one, some states have adopted a rule of construction which disfavors continuous contracts.70 Also, because certain state laws prohibit franchisor from refusing to renew a franchise agreement without "good cause," franchisor may be powerless to refuse renewal to franchisees in these states, even to franchisees who may be operating in default of their franchise agreement.71

71 The following states have statutes pertaining to franchise renewals: Arkansas, California, Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island, South Dakota, Washington, and Wisconsin.
Conditions-precedent, required to be met before franchisor will approve a renewal, are commonplace in franchise agreements. Franchisor’s conditions for approval to renew often include most of the following terms under which franchisee must:

- Provide notice to franchisor of its intention to renew within a specific number of days or months before expiration of franchise agreement;
- Before the expiration of the franchise agreement, update or replace all décor, fixtures, furnishings, equipment, and signage, to conform to franchisor’s then-current standards;
- Sign franchisor’s then-current form of franchise agreement, which may materially differ from franchisee’s previous form of agreement, including additional or increased fee amounts;
- Pay to franchisor the determined renewal fee;
- Cure all defaults under the franchise agreement;
- Be current on all payments to franchisor, franchisor’s affiliates, and franchisee’s suppliers;
- Along with franchisee’s guarantors, if any, execute a general release in favor of franchisor;
- Provide proof to franchisor, that franchisee has the right to possession of the franchised business’ premises for the renewed term of the franchise agreement; and
- Attend additional training, if required.

5. Royalty Fees

Royalty fees represent franchisor’s main source of income and are paid by franchisee to franchisor for the ongoing right to operate under franchisor’s system and trademarks. There are multiple ways of structuring the ongoing royalty fee payments due to franchisor. Typically, royalty fees are calculated as a percentage of gross sales, where gross sales are net of sales tax. Some franchisors elect to charge a flat fee royalty fee, and still others a creative hybrid of both the percent and flat fee structures (sometimes accomplished by imposing a minimum or maximum royalty fee requirement). Royalty fees are also, in some systems, calculated as a percent of product purchased or sold.

An example of the flat fee royalty fee structure can be found in the Regal Nails Salon & Spa franchise agreement, where franchisor imposes a flat “monthly franchise fee” directly related to the size of franchisee’s salon location:

“… we will debit your ACH account a minimum of $500 plus $1 per sq. ft. of your salon premises over 500 sq. ft. to pay your Monthly Franchise Fee.”

72 In this section, the term “royalty fee” is used for ease of reference. While the term “royalty fee” or “royalties” is the most popular term used to refer to the ongoing fee imposed on franchisees, franchisors may use any other preferred term.
d. Drafting Considerations

In the crafting of its royalty fee and related provisions, franchisor must determine: 1) how to structure its ongoing royalty fee (i.e. whether as a percent of gross sales, flat fee, or otherwise); 2) at what percent rate or what amount franchisor should set its fee; and 3) through what method of payment franchisor will collect the fee.

Today, one of the primary factors influencing how royalty fees are structured is the method by which franchisee captures sales. If franchisor desires to implement a royalty fee as a percent of gross sales, for example, franchisee will typically be required to purchase and use a point-of-sale software system that allows independent access of data to franchisor and grants franchisor the ability to monitor franchisee sales and help detect underreporting. If such software is neither a requirement nor practical for a franchisor's particular system or, for example, franchisor's business model is a cash-based business, a flat-fee royalty fee structure may be more desirable. A flat fee royalty fee structure avoids reporting requirements and excuses franchisor from having to police royalty payments. Finally, if franchisee is limited to one or few suppliers from which to purchase products sold to customers, franchisor may find data from suppliers (which, at times, may be franchisor itself) the kind of reliable data on which to base its ongoing fee structure.

A franchisor should not rely on its initial fees to provide or supplement financial support for its operations. The primary revenue stream on which franchisor builds its operations is the ongoing royalty fees. As such, when determining what to charge franchisee as a royalty fee, franchisor must consider both its own revenue stream needs and franchisee's ability to meet its expenses and earn a profit.

When determining what rate to set the royalty fee, or how much to charge franchisee as a royalty fee, franchisor should also look to industry standards. One reason for this consideration is how a royalty fee rate higher than industry standards will affect franchise sales. After all, most franchisees will compare several competing franchise systems before deciding on which, if any, to purchase. Sandwich shops, for example, tend to set royalty fees at about 6%. Jimmy John's, Firehouse Subs, Schlotzky's Deli, and Which Wich all charge a royalty fee of 6%, although Subway charges an 8% royalty fee.

Franchisor should also consider franchisee's probable gross sales when determining the royalty fee rate or amount. While 5% of gross sales is common, where probable gross sales are in the millions, franchisor may elect to lower the royalty fee rate to 4%. For example, Applebee's, Denny's, Golden Corral, and On the Border all charge a 4% royalty fee.

6. Advertising

a. National Advertising

In addition to the royalty fee, most franchise systems impose a contribution requirement for national and/or regional advertising and marketing activities. The idea
behind this contribution is that a combined amount can be used to greater effectiveness in promoting the system and brand than if franchisees spent their contributions independently. Through the collection of an advertising contribution, the franchise system might have sufficient funds to spend on larger advertising projects such as the production and airing of television and radio commercials. In turn, this type of large-scale advertising creates brand exposure that benefits all franchisees in the system. Also, when advertising is controlled by franchisor on a national and/or regional level, the message communicated to consumers is consistent and unified.

Advertising contributions are typically calculated as a percent of gross sales, usually net of any sales tax. In general, the percent of gross sales required to be contributed falls between one and four percent. As with the royalty fee, however, the franchisor may also set a flat fee advertising contribution amount, or may elect not to impose one at all.

Franchisor must also decide how to manage national advertising contributions. The management of contributions will depend greatly on whether franchisor has imposed an advertising fee under the franchise agreement, or an advertising fund.

With an advertising fund, the more popular of the two national advertising contribution structures, contributed funds are not income to franchisor. Typically, these funds are either kept by a separate business entity or in a separate account. Also, expenditures are limited to what franchisor has contractually promised to spend such monies on under the franchise agreement. Franchisor may also be required to provide Franchisees, upon request, an (unaudited) accounting of fund income and expenditures. As compared to an advertising fee, the structure of the advertising fund is much more transparent and franchisors are held accountable to franchisees with respect to fund activities and expenditures.

Under an advertising fee, contributions are considered income to franchisor. Franchisor need not sequester the funds in a separate account, but franchisor may nonetheless want to keep an accounting as to income and expenditures concerning the fee. Depending on how the related provisions are drafted, usually there are no obligations to keep franchisees informed as to expenditures made, and no contractual limitations on franchisor expenditures on advertising, marketing, or promotional activities. As such, franchisees have no basis on which to hold franchisor liable with respect to advertising fee expenditures.

b. Local Advertising

Local Advertising Expenditure Requirement

In addition to national advertising fee contributions, franchisors also usually require that franchisee spend a certain amount on local advertising activities. Imitating the national advertising fee structure, franchisor may require that franchisee spend a certain percent of gross sales or a flat fee amount on local advertising.
To ensure that the local advertising requirement is met by franchisee, franchisor may require that franchisee submit, for franchisor's approval, a marketing plan. Others, in order to ensure that franchisee has spent the required amount, demand that franchisee submit to franchisor a list of advertising activities and associated costs and even receipts for a certain period of time (i.e. monthly, quarterly, or yearly).

In order to monitor the use of its marks and to ensure that all advertising and marketing activities are being conducted pursuant to franchisor's standards and specifications, franchise agreements require that franchisee submit all materials to be used for such purpose to franchisor for approval.

i. Regional Advertising Cooperatives

Franchisor may reserve the right to require multiple franchisees within a regional area to join together and form an advertising cooperative. If formed, franchisees are required to contribute funds to the cooperative, which then uses the collected amounts on local marketing and advertising activities. A cooperative is typically required to function under organizational documents agreed to by cooperative members, which may also include franchisor. Franchisor may also want to consider whether to give franchisees contributing to cooperatives a credit in their contribution amount to any local advertising expenditure requirement, if any.

c. Drafting Considerations

National Advertising

In the drafting of its national advertising provisions, franchisor must determine: 1) the amount and structure of franchisee contributions to national advertising, 2) whether to implement an advertising fund or fee, and 3) should franchisor elect to implement a fund, how to define the parameters of permitted expenditures under the fund.

The amount and structure of franchisee contributions to national advertising often take into account franchisor’s royalty fee amounts and structure. Whether as a percent of gross sales, flat fee, or otherwise, both fees are likely to be structured the same. Also, advertising contributions are typically less than franchisee royalty payments and, as with royalty considerations, take into account industry standards, franchisor revenue needs, and franchisee's ability to earn a profit.

If franchisor elects to implement a national advertising fund, all advertising, marketing, and promotional activities on which fund monies may be spent must be enumerated in the franchise agreement. As franchisor must give itself the contractual right to spend fund monies on certain specified activities, this provisions is likely to be a very long list of broad and forward-thinking advertising and promotional activities.

Local Advertising

While franchisor has full control over how national advertising funds are spent, it gives up a certain amount of control with respect to franchisee's local advertising efforts.
In drafting provisions regarding local advertising requirements, franchisor should determine how involved it would like to be in franchisee’s local advertising efforts. If franchisor desires greater approval and monitoring power, reporting requirements and submission requirements may be more frequent and stringent. Franchisor must balance the administrative burden such requirements might impose to the benefits of maintaining consistency of its brand image throughout the system.

A local advertising provision might impose requirements on franchisees with respect to: 1) marketing plan submissions; 2) franchisor’s right to approve, reject, or consult with franchisee on marketing plan submissions; 3) marketing expenditure reporting; 3) submission of franchisee’s marketing materials; 4) franchisor’s right to approve or reject franchisee’s submitted materials; 5) franchisee’s obligation to participate in gift card programs, sweepstakes or contests, coupons, or other franchisor-imposed promotional activities; and 6) territorial limitations on franchisee’s local marketing activities.

Regional Advertising Cooperatives

Certain considerations franchisor should evaluate when drafting the advertising cooperative section of the franchise agreement include: 1) whether the franchise agreement should place a limit on franchisee contributions to cooperatives; 2) whether franchisee contributions to cooperatives should be credited to any local advertising expenditure requirement; 3) whether franchisor must participate in a cooperative if company-owned units are within the cooperative’s territory (and, if franchisor must contribute, whether it will be at the same amount or rate as cooperative franchisees); 3) who is responsible for the administration of the cooperative; and 4) under what document the cooperative will operate.73

7. Franchisor’s Trademarks

All franchise agreements place restrictions on franchisee’s use of a system’s trademarks. Brand consistency, unity, and maximization demand that franchisor have control over the brand’s presence in the marketplace. These days, however, with online coupon and discount websites, social media outlets, and more opportunities than ever before for franchisees to influence a brand’s message and presence, franchisors must take into account whether they would like to leverage these and other future opportunities through its franchisees, while minimizing any potential negative impact and liability.

While the restrictions under already-existing franchise agreements may well grant franchisor the right to control Internet usage of franchisor’s marks through general prohibitive language, franchisors should consider adding Internet advertising and social media provisions to their franchise agreements on a going-forward basis. In general, these provisions tend to have extensive and broad restrictions, but allow for exceptions

73 These and other considerations are also found in 16 CFR 436.5(k)(4)(iv) of the FTC Rule.
An example of just such a provision can be found in Snap Fitness’ franchise agreement:

“You may not use the Marks or any part or derivative thereof on the Internet, except as we expressly permit in writing. Without limiting the generality of the foregoing, you may not use the Marks or any part or derivative of the Marks as part of any URL or domain name, and may not register the Marks as part of any user name on any gaming website or any social networking website… or as part of any unauthorized email address. You also may not display on any website (including commercial websites, gaming websites, and social networking websites) any of our copyrighted or proprietary works, which include the design portion of our Marks, or any collateral merchandise identified by the Marks.”

a. Drafting Considerations

In general, as demonstrated in the above example, provisions governing trademark use should allow franchisor maximum control. As such, provisions governing franchisee's use of the marks are designed to be extremely limiting.

If franchisor desires to allow franchisee some freedom with respect to trademark use on the Internet (for example, if franchisee is permitted to have its own website), these freedoms should not be enumerated in the franchise agreement. Rather, these additional uses of franchisor's trademarks should be characterized as policies permitted only if franchisee conducts the activity in compliance with franchisor's written directives.

Franchisor considerations as to how much to limit franchisee's use of its marks may depend to what degree system franchisees need, or benefit from, online exposure. A serviced-based business, for example, may rely on Internet use of franchisor's trademarks significantly more than a retail establishment.\footnote{John Fitzgerald, Douglas Kordel, Melissa Rothring, Kimberly Toomey,“Top Five Changes to Consider Making to Your Franchise Agreement,” 43rd Annual Legal Symposium (May 2010).}

With greater online freedoms granted to franchisees, franchisors face additional work and responsibility. In addition to the policies franchisor must craft and implement, monitoring trademark use is also a concern. The policing of trademark use can be an administrative burden on franchisor if franchisor doesn't have the staff to ensure franchisee compliance.

Finally, franchisor must decide whether or not it will defend franchisee with respect to trademark infringement claims. Although seemingly an expensive proposition, franchisor's interest in its trademarks, and its obligation and right to protect the foundation on which the franchise system is built, tends to outweigh the monetary cost of assuming the responsibility to direct all litigation concerning the system’s...
8. System Standards

For a franchise system to be successful, uniformity and consistency must be its hallmarks. After all, multiple businesses operating under the same trademarks create a consumer expectation of uniformity. Meeting these expectations requires that franchisees follow a single set of standards which may govern everything from the location and build-out of the franchised business, to its décor, equipment, and the products and services offered. System standards are conveyed and taught through franchisor’s training programs and confidential operations manual.

The provisions in the franchise agreement that govern system standards are numerous and strewn throughout the agreement. It is beyond the scope of this paper to compare the variation of each provision across franchise agreements, some of which include provisions governing site and build-out, training, sourcing, and upgrade requirements. Many franchise agreements, however, will include a broad "catch-all" provision requiring that franchisee follow all system standards.

The Mr. Clean Car Wash franchise agreement, for example, includes the following provision:

“You acknowledge and agree that operating and maintaining the CAR WASH according to System Standards are essential to preserve the goodwill of the Marks and all Mr. Clean Car Washes. Therefore, you agree at all times to operate and maintain the CAR WASH according to all of our System Standards, however communicated to you in writing or another tangible form (for example, as presented in the Operations Manual or via the Franchise System extranet or Website) and as we periodically modify and supplement them, even if you believe that a System Standard, as originally issued or subsequently modified, is not in the Franchise System’s or the CAR WASH's best interests. Although we retain the right to establish and periodically modify System Standards that you have agreed to maintain, you retain the right to and responsibility for the day-to-day management and operation of the CAR WASH and implementing and maintaining System Standards at the CAR WASH.”

a. Drafting Considerations

It is unrealistic to include all system standards and operating requirements in a franchise agreement, especially as they evolve significantly over time. For this reason, several broader provisions with respect to operation standards are included in the franchise agreement, and more particular information is supplemented by franchisor’s confidential operations manual.

Just a few of the broader provisions incorporated in franchise agreements imposing system standards include:
• The requirement to purchase proprietary or other products and services from franchisor or its designated suppliers;
• The requirement to offer and sell only certain specified products and services;
• Training requirements (initial and ongoing);
• The purchase and use of specific computer hardware and software systems;
• Restrictions as to franchisee’s use and display of franchisor’s trademarks;
• Insurance requirements;
• Adoption of all processes and procedures developed by franchisor with respect to the operation of the franchised business;
• Employee qualification, training, dress, and appearance standards; and
• Franchised business operating hours and staffing levels.

It is clear that each of the provisions listed above require additional specificity. The proper venue for expanding on these broad operation standards is in franchisor’s operations manual. As system specifications are bound to change, franchisor should reserve the right to modify its confidential operations manual on a going-forward basis.

Finally, franchisor should consider how it will monitor compliance with system standards. Whether through reporting, on-site visits, standard evaluations, or otherwise, franchisor should reserve these rights in the franchise agreement.

9. Default and Termination

Franchisor must grant itself the right to terminate the franchise agreement. This right to terminate, however, may only be exercised after franchisee defaults under the terms of the franchise agreement. There are three categories of franchisee defaults: 1) defaults which result in automatic termination of the franchise agreement without notice from franchisor; 2) defaults which result in termination immediately upon franchisee’s receipt of notice from franchisor; and 3) defaults which may be cured within a set number of days upon franchisee’s receipt of notice.

Before terminating a franchise agreement, franchisor should determine whether a state relationship law applies. State relationship laws will supersede the franchise agreement and may impose a longer notice or cure period. For example, New Jersey requires that franchisor give franchisee 60 days notice before termination; and Minnesota and Wisconsin require that franchisor give franchisee 60 days notice to cure a default, except in certain circumstances.

75 Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Washington, and Wisconsin all have franchise relationship laws.
Defaults which typically result in automatic termination include: 1) filing for bankruptcy protection; 2) admissions of insolvency; 3) final judgments entered against franchisee which remain unsatisfied for 30 days or more.

Defaults which typically result in termination upon receipt of notice by franchisee include: 1) abandonment; 2) transfer in violation of the agreement; 3) franchisee and required personnel's failure to complete training requirements; 4) failure to open the franchised business within the time allotted; 5) material misrepresentations made in the acquisition of the franchised business; 6) conviction of crimes involving fraud or moral turpitude or convictions or pleas of no contest to a felony charge; 7) underreporting or knowingly maintaining false books or records; 8) offering unauthorized products or services; 9) failing a certain number of quality assurance inspections within a certain time period (i.e. failing two or more quality assurance inspections within a rolling 12-month period); 10) receiving a certain number of written notices of default within a set time period (i.e. three or more notices of default within any calendar year).

Third are the list of defaults for which franchisor must give franchisee an opportunity to cure before exercising its right to terminate. This list might include: 1) failure to pay franchisor or suppliers; 2) violations of the franchise agreement’s provisions as to the use of franchisor’s trademarks or copyrighted materials; 3) failure to obtain or maintain insurance as required; 4) failure to submit plans or reports; and the extremely important “catch-all” provision; and 5) the violation of any other provision in the franchise agreement.

Some franchise agreements also grant franchisee the right to terminate the franchise agreement. Franchisor may allow franchisees the right to terminate, for example, if franchisor is first notified of any alleged default of its obligations under the franchise agreement, and is provided an opportunity to cure.

a. Drafting Considerations

When drafting the default and termination provisions, franchisor must consider: 1) which defaults should result in immediate termination (usually upon notice to franchisee) and which may be cured by franchisee; 2) the length of each cure period; and 3) whether franchisor wishes to grant franchisee the right to terminate the agreement.

Typically, incurable defaults, or defaults which can irreparably and severely damage franchisor’s brand and reputation, are those defaults which will result in the immediate termination of the franchise agreement, upon franchisee’s receipt of notice. Franchisor should also consider reviewing the franchise agreement to ensure that all material terms are included in specific default provisions. Relying on the catch-all default provision may grant franchise a longer cure period than franchisor would have otherwise chosen to give.

When setting cure periods, franchisor should consider the urgency with which the default must be cured. For example, if a health or safety violation is discovered, the
cure period may be as short as 24 hours. On the other hand, if franchisee has failed to obtain and implement an upgraded version of franchisor’s required software, the cure period may be as long as 30 days.

Finally, franchisor must consider whether to give franchisee the right to terminate the franchise agreement. If franchisor is considering granting termination rights to franchisee, franchisor should make its decision only after having closely reviewed its contractual obligations under the franchise agreement. If franchisor has created burdensome obligations on its behalf, such as billing or collections requirements, franchisor may not want to grant franchisee the right to terminate, even if franchisor grants itself the right to cure the default.

10. Obligations upon Default and Termination

Once franchisor has exercised its right to terminate the franchise agreement, the process of severing all ties between franchisor and franchisee begins. To this end, a franchise agreement will include certain post-termination obligations. Some or all of these post-termination obligations may include: 1) noncompetition and confidentiality covenants; 2) de-identification of the franchised business; 3) cancellation of all fictitious names; 4) return of all confidential materials (including, most importantly, the operations manual) and materials bearing franchisor’s trademarks; 5) transfer of the franchised business’ telephone number to franchisor; and 6) payment in full of all amounts owed to franchisor and affiliates.

a. Drafting Considerations

Apart from the usual laundry list of post-termination obligations imposed on franchisees, franchisor should also consider whether additional obligations should be imposed due to the structure or unique characteristics of the franchise system.

For example, if franchisees enter into contracts with customers, franchisor may want to ensure that the termination of a franchise agreement does not adversely affect the former franchisee’s customers. As such, franchisor may require that franchisee assign any existing contracts to either franchisor or another franchisee for fulfillment.
B. Contracts Relating to the Franchise Relationship

While the single-unit franchise agreement is the agreement that creates the franchise relationship, other related agreements also affect the franchise relationship. These agreements may create an obligation to enter into one or more single-unit franchise agreements, to conduct franchise sales activities, or to provide support services to system franchisees. Each such agreement, as described below, provides franchisors with different mechanisms for franchise expansion, although, not every agreement is suitable for each franchise system. Franchisor's target franchisee, the franchise opportunity's initial investment range, and the franchised business' market area, for example, should all be considered when determining what combination, if any, of the following agreements are suitable for franchisor's system.

1. Area Development Agreement

An area development agreement grants developer the right to open two or more franchised businesses within a specified territory. Each franchised business opened under an area development agreement should be documented by franchisor. Depending on the structure of the area development agreement, each additional franchised business opened may be documented in one of two ways. First, developer may be required to execute an amendment adding the new location to an already existing franchise agreement. Second, developer may be required to sign a new franchise agreement for each additional unit opening under the development agreement.

The benefit to this second method is that each time developer opens an additional unit, they will be required to sign franchisor's then-current franchise agreement, typically an agreement whose language has been improved and updated. Also, requiring developer to execute franchisor's then-current franchise agreement each time developer is prepared to open an additional unit allows developer to sign each agreement on behalf of an affiliate. For liability, tax, accounting, and business reasons, franchisors generally allow developers to form affiliate entities under which to enter into each additional franchise agreement.

A typical area development agreement will include a development schedule pursuant to which developer must open and continuously operate a set number of franchised businesses by each date set in the schedule. If developer is unable to meet its obligations under the schedule or the development agreement, franchisor reserves the right to modify or reduce developer’s territory, remove any territorial protections granted, or terminate the agreement. In such cases, however, developer may continue operating any then-existing franchised businesses, unless of course the agreements include cross-default provisions.

2. Master Franchise Agreement or Subfranchise Agreement

A master franchise agreement, or subfranchise agreement, grants master franchisee or subfranchisor the same rights and obligations a franchisor has, although
limited to a specified territory. Under this agreement structure, master franchisee typically has the obligation to sell franchises within its territory and may be required to meet minimum sales targets pursuant to a schedule. Once a franchise sale is made, it is the master franchisee who must sign the franchise agreement with franchisee. As the one bound under the agreement, it becomes the obligation of master franchisee to provide all pre-opening and post-opening training and support, and to meet all other obligations franchisor would typically be responsible for under the franchise agreement. In return, master franchisee collects ongoing fees from its franchisees.

This agreement structure is not generally recommended for use within the United States, but is typical of agreements entered into for international franchise expansion.

One reason franchisors distrust the use of this structure in the domestic arena is because of enforcement issues. As master franchisee, and not franchisor, is the signatory on each franchise agreement, franchisor itself cannot enforce franchisee compliance under each franchise agreement. This responsibility falls to master franchisee, and franchisors are not typically willing to give up such control over enforcement of its brand and system standards.

This agreement structure has, however, successfully been used domestically in the cleaning industry. Some concepts who utilize this structure include Jani-King and Coverall franchise systems.

3. Development Agent Agreement

Sometimes a franchisor will elect to outsource sales, training, and operational support services to a third party, who may be called a development agent, an area director, or by some other name. The development agent arrangement resembles a master franchise arrangement, in that the development agent performs functions typically performed by the franchisor in the franchisor-franchisee relationship. Unlike a master franchisee, which contracts directly with franchisees in the master franchise territory, a development agent has no contractual privity with the franchisees and, therefore, no direct responsibility to them. The development agent is only responsible to the franchisor for providing the agreed services.

The development agent typically is charged with soliciting and screening potential franchise candidates (like a franchise sales broker), as well as meeting established sales goals. In exchange for franchise sales-related services, the development agent receives a commission, which typically ranges from one third to one half of the initial franchise fee.

In addition to franchise sales services, the development agent also performs many of the franchisor’s training and support obligations to franchisees located in the development agent’s area of responsibility. These services sometimes include initial training, and almost always include onsite assistance and operational visits. In exchange for operational services, the development agent receives a percentage
(typically ranging from 33% to 40%) of royalty fees collected from franchisees located in the development agent's area of responsibility.

The development agent arrangement also typically has characteristics of a joint venture agreement in that the parties may share (or the development agent may be required to contribute to) the franchisor's administrative, operational, and legal expenses.

IV. A Franchise is a Relationship

While the law establishes what businesses must be classified as franchises and the contract details all the rights and obligations of the business, the relationship between franchisor and franchisee is the true definition of franchising. In fact, many franchisors would say they have reached success when neither they nor their franchisees ever have to read the law or reach for the contract. They choose instead to resolve problems by addressing the concerns directly and relying on their strong relationship to find a workable solution.

Franchise contracts generally last an extended period of time, often up to 20 years. Because the relationship lasts that long, it is important to have trust between the franchisee and franchisor that all parties are taking steps to protect and improve the brand and system.

In a typical franchise system, the interests of the franchisor and the interests of the franchisee largely align. For instance, all parties want to protect the brand and uphold brand standards. To do this, the franchisor creates a system of rules and procedures to ensure consistency throughout the brand. Franchisees are expected to follow this system, and the value of the system is enhanced if all the franchisees act the same.

When the relationship between the franchisor and its franchisees is strong, the franchisee works hard to comply with system standards and appreciates the franchisor's efforts to enforce them. Franchisees want to make sure their investment is being protected through enforcement of the system in all the restaurants. If other franchisees are not meeting the standards, then an active franchisor will be prompt to act.

One particular sign of strength in a franchise system is when the franchisees rely on each other for support, and the franchisor relies on the franchisees to support each other. When a new franchisee enters a system, there is no better way to acclimate to the system than to hear and see how another franchisee succeeds within it.

Both franchisors and their franchisees have a responsibility to work to improve this relationship. Below are some ideas and examples that affect this relationship.
A. Franchise Advisory Councils

One very common technique used to improve franchise relationships is the institution of a franchisee advisory group. This is typically a group of franchisees elected by their peers. They meet periodically with representatives from the franchisor to offer insight on business issues and new ideas.

Franchise advisory councils are beneficial to both franchisees and franchisors. The benefit to the franchisor is that it gets to hear hands-on advice about the practical implications of ideas or programs. For instance, the franchisor may come up with an idea for a new product that seems wonderful from the main office, but the franchisees can share how it would not work for an individual unit or owner. The franchisees, on the other hand, gain the perspective of what it takes to apply an idea across an entire system. For instance, one franchisee might use a certain training method in their restaurant or think a new item should be added to the services offered. But, that franchisee does not always consider what it would take to start using that method or adding that new item for every unit across the entire system. They often are ideas that work in a certain region or work when applied only on a small scale.

One area frequently covered by an advisory group is advertising and media. In most franchise systems, advertising is largely funded by an advertising fund that is funded by a percentage of sales from each unit in the system. Because each franchisee is required to contribute to the fund, it is logical that franchisees want to have a voice in how it is managed. Advertising advisory councils often view media before it is approved and also advise on how the advertising fund is spent. Other common types of advisory groups are ones that advise on building issues, purchasing, training, and other aspects of the business that affect the franchisor and franchisees.

Franchisors must be explicitly clear about the roles and rights of such advisory councils. KFC Corporation is currently in the midst of a lawsuit with an association of its franchisees over a dispute about the rights of their franchise advertising advisory board. The franchisees have sued KFC Corporation for violation of the advertising board’s bylaws. The franchisees contend that they have the right to vote on marketing materials as well as the right to make changes to the materials. KFC Corporation argues that the advisory board only has the right to vote on approved advertising plans that KFC proposes to the board.

B. Franchisee Associations

In addition to franchisor-created advisory councils, franchisees also frequently create their own association that is not tied to the franchisor, often with assistance of a third party. These are commonly referred to as “franchisee associations.” Franchisee associations can be utilized to provide services to franchisees that the franchisor is either unwilling or unable to provide. For instance, a franchise association might pool its franchisees’ buying power to purchase insurance for the franchisees. When franchise relations are not strong, franchisee associations can also be seen as a means
of protecting the franchisees’ united interests. This can leaned to a strained relationship between franchisors and franchisees.

C. Communication

A key element of the franchise relationship is communication. Throughout the length of the complex franchise relationship, there is obviously a need for frequent communication. Those franchisors that value their franchisees and understand their business really appreciate the importance of good communication.

For example, franchisees are often facing a wholly different set of business issues, as small business owners that are following a system created by another company, and franchisors need to be able to speak to these issues when communicating news from the corporate headquarters. It is important to explain to franchisees why news is relevant to them. Franchisors should give the business justification for changes and new requirements in order for franchisees to accept them willingly.

Franchisors can also use communication as a means of strengthening the relationship. Most importantly, franchisors not only communicate to the franchisees but also listen to their concerns. Franchisors can implement ideas like internal blogs and online idea boards, which allows franchisees a forum to share information and feedback both with the franchisor and with each other. In a strong system, franchisees can even use media like this to monitor each other and mediate when there are issues. When the relationship is a priority, then franchisees step up to support the franchisor and its ideas.

D. Frequent Franchisee Contact

Another important aspect of franchise relations is to have frequent contact between the franchisor and its franchisees. This can be achieved by having annual conventions with all franchisees, regional field meetings, visits to individual franchisees in the field or bringing franchisees in to the corporate headquarters. Such personal contact and individual attention to listen to a franchisee’s particular concerns and celebrate their successes shows a franchisee that they are appreciated in the system. When corporate representatives take time to visit a franchisee’s locations in person, it goes a long way to establish positive relations for the future.