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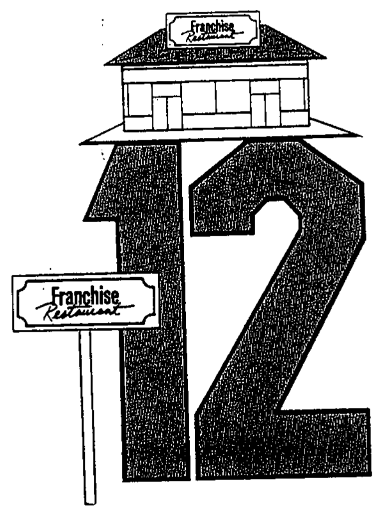


Help your client prosper from a franchise relationship by learning how to analyze the inherent risks of that relationship.

The Twelve Most Important Questions To Ask in a Franchisor-Franchisee Relationship

Fredric D. Tannenbaum

FRANCHISING AS A BUSINESS FORM has enjoyed phenomenal success and acceptance throughout the United States. There are nearly 3,000 franchisors, 500,000 franchisees, and 7 million franchise employees.

Many reasons contribute to the growth of franchising. Franchisors have the ability to distribute their products or services more rapidly and efficiently than with conventional financing. Franchising further limits the risk inherent in rapid growth and expansion. Attracting motivated franchisees who know their geographic and demographic markets also increases the ability to leverage operational talent and dedication throughout a greater area.

Franchisees benefit from a franchise since their business risk is reduced by in effect purchasing a tried and true business method and trademark and receiving access to advice and shared experiences from the franchisor and other franchisees. The cost to a franchisee of devising and implementing a business format and operation may far outweigh the risks associated with engaging in any new endeavor. Empirically, the chances of starting a successful hamburger restaurant pale in comparison to the opportunities for success as a McDonald's franchisee.

Despite all the many positive attributes and advantages inherent in a franchise business, considerable abuse and dominance of franchisees by franchisors precipitated federal franchise disclosure laws and franchise protection laws in 15 states together with franchisee rights on termination laws in 23 states. These legislative initiatives attempt to provide disclosure to franchisees to better evaluate the investment risk.

Notwithstanding the lofty goals of the franchisee disclosure and protection laws, however, a number of areas of contention and conflict still arise between a franchisor and franchisee during the course of their relationship. This article will examine 12 of the most confrontational pitfalls encountered in negotiating a franchise relationship of which both parties should be aware before signing a franchise agreement. Awareness of these issues will better prepare the parties for the realities of franchising.

WHO ARE THE PARTIES? • This basic question is the most overlooked. Franchisees are often enamored by the glamor of being an owner in a large, successful organization or being a participant in the creation of an incipient franchise which they hope to be the next McDonald's. They are frequently smitten by the seduction of a few years' operating histories of the franchisor's few stores and succumb to the temptation to extrapolate those earnings to this franchise.

People Matter

Franchisees should instead obtain a sense of comfort from the credibility and integrity of the franchisor and its operations personnel. Their personal dedication to making the organization and individual franchisee successful is necessary to enable a franchisee to start and operate its business.

Beware of the franchisor who brims all smiles and grandiose talk of "partnership" but in reality is obligated only to collect the franchise fee and royalties. Also avoid a franchisor who owns a small percentage of the total number of outlets. Significant franchisor ownership shows its confidence in its product and creates a commonality of interests between the franchisor and the franchisee. Low franchisor ownership can put the franchisor and the franchisee in an adversarial situation, where the franchisor has lost touch with the market and stands to gain more from royalties than from store earnings.

Is the Franchisee Dedicated?

Franchisors should likewise take a step back and ask "do I want to do business with this person?" Franchisors should avoid the temptation of selling franchises to rich investors who do not understand the hard work required of a franchisee or who are merely investing to provide an occupation for their spouses or children. The franchisee represents the merger of both capital and labor and should be analyzed from both perspectives, not merely the former.

WHAT IS THE FRANCHISOR PROVIDING? • Franchisees should carefully evaluate the two most important items that the franchisor licenses through the franchise agreement—the trademark and other trade secrets (such as recipes), and the marketing plan. Franchisees should consider:

- The strength of the trademark;
- Possible confusion or similarity with other trademarks;
- The genuineness of the trademark;
- The extent to which the trademark has acquired a secondary meaning; and
- The overall image connoted by the trademark.

Stand by Your Mark

Franchisees should also attempt to require a franchisor to stand behind its trademark. In so doing, the franchisor should be obliged to indemnify, defend, and hold franchisees harmless from any intellectual property claim or litigation challenging the validity or use of the mark. Franchisors should also agree to compensate franchisees if the trademark is held invalid and required to be changed. Franchisors may be willing to reimburse franchisees for their out-of-pocket costs in replacing signs and printing new supplies.

Franchisees invariably demand more compensation because of their increased advertising expenditures to promote the new trademark and lost revenues during the transitionary period before customer acceptance of the new trademark. Some franchisees further seek the right to terminate the franchise agreement since an essential element of their bargain has been terminated.

Franchisors usually counter that the business or marketing plan is the key to the franchisee's success and is the essential element that developed the trademark in the first place. Franchisees should, therefore, carefully evaluate the reasonableness of the franchisor's business strategy including:

- Hours;
- Target demographic groups;
- Promotional techniques;
- Uniforms;
- Store layout and decor;
- Products; and
- Suggested retail prices.

WHAT IS THE FRANCHISEE PAYING? • Obviously, franchisees can read the offering circular and franchise agreement and discern the charges they must pay the franchisor. Franchisees should compare these royalties and fees to those charged by other franchisors.

Danger of High Royalties

Franchisees should not be misled, however, by franchisors who charge a small, up-front franchise fee but impose high monthly royalty obligations. Assume two identical hamburger franchises. One franchisor charges a franchise fee of $5,000 and monthly royalties of eight per cent (in addition to advertising royalties). The other charges a franchise fee of $20,000 and monthly royalties of five per cent (not including advertising). Assume annual net sales for each franchise of $500,000. At first glance, the former franchise appears less expensive to the franchisee. In reality, after the first year of operation, each franchisee will have paid an aggregate of $45,000 to his franchisor. In the second and succeeding years, the first franchisee will pay $40,000 each year to the franchisor, while the second franchisee will pay $25,000 each year. The first franchisor may argue that the higher royalties will assure a more interested and dedicated franchisor. The franchisee must then evaluate whether the franchisor's "added dedication" is needed or warranted and what percentage of operating income is in effect being shared with the franchisor.

Does the Advertising Help?

Franchisees should evaluate the success of the present marketing campaigns and try to determine whether any of the advertising royalty fees will directly benefit each franchisee.

For example, if a franchisor has 10 franchises in Illinois and is selling one in California, the California franchisee needs to evaluate whether any of the advertising will benefit it or will be spent promoting the 10 "clustered" franchises. The franchisor will insist on its need for control over all advertising royalties and will invariably promise fairness and sensitivity to the California franchisee. Whether that fairness and sensitivity result in a specific dollar or percentage commitment, a relaxation of royalty obligations until more California franchisees appear, or permission to spend all or a portion of the fee locally instead of remitting it nationally is a matter of negotiation.

Hidden Costs

Franchisees should also be aware of other hidden costs (accounting fees, lease location expense, construction supervision fees, etc.) and sources of revenue for the franchisor (e.g., rebates from suppliers for arranging for bulk purchases and rent received as landlord or sublessor of the franchise location to franchisee). As the franchisor enjoys more revenue sources outside of traditional royalties, the franchisee should be cautioned to question where the franchisor's true loyalties or interest lie. Does the franchisor view itself as the franchisee's franchisor or landlord?

WHERE CAN THE FRANCHISEE SELL? • When the parties negotiate the franchise agreement, the geographic scope of the franchisee's territory is often fiercely contested. Both parties should conduct marketing studies, traffic pattern evaluations, and other analyses to evaluate the potential customer reach in the territory. For example, would you prefer a territory to own a frozen yogurt franchise on four main blocks of Rodeo Drive in Beverly Hills, California, the entire 5-mile diameter city limits of a southeastern U.S. city with a population of 30,000, or a 500-square mile area in western Nebraska?

Shifting Populations

Both the franchisor and the franchisee should also consider the impact of potential population and demographic changes in negotiating the geographic scope of the exclusive territory. Although one can hardly predict the nature and extent of change in a territory during the term of the franchise agreement, the parties should at a minimum contemplate such changes. Contrast a franchise territory granted in the Silicon Valley before the high technology boom of the late 1970s-early 1980s with a franchise territory awarded in the oil patch in Texas during the oil boom in the late 1970s-early 1980s. Although some attempt to negotiate provisions dealing with changes in population and demographics should be made, such clauses and permutations are too numerous and cumbersome to be workable.

Geographic Exclusions

The franchisor may further attempt to limit the geographic exclusivity of the territory. The two most common means of limitation are through franchisor-owned stores or performance standards for the franchisee. The franchisee should strongly resist any attempt by the franchisor to limit an exclusive geographic territory.

Performance objectives also prevent a lazy franchisee from "resting on its laurels" and reaping the benefit of its past success or the success of other franchisees.

Performance standards are too subjective, easy to manipulate, difficult to verify, arbitrary given the length of the term of the agreement, and unfair to the franchisee since it enjoys no rewards if the standards are met.

Some franchisors insist that the standards provide an objective criterion for all franchisees to meet and are a necessary device to maximize distribution of the franchisor's products or services and overall operating efficiency of all franchises in the network. Performance objectives also prevent a lazy franchisee from "resting on its laurels" and reaping the benefit of its past success or the success of other franchisees. Franchisors further point to conventional manufacturer-distributor or licensor-licensee relationships, which often contain minimum sales obligations to justify these provisions.

WHAT ARE THE FRANCHISEE'S MANAGEMENT RESPONSIBILITIES? • Tension often arises between the parties regarding the degree of a franchisee's day-to-day managerial involvement. Franchisors prefer on-site, involved owner-managers as franchisees. Doctors, for example, who are delivered sales reports by their accountants once a week do not contribute the necessary time or dedication to enhance the business. Once again, franchisors prefer their franchisees to contribute both labor and capital.

Hired Management

Franchisees profess that hands-on, day-to-day management is not necessary if a qualified manager, trained by the franchisor, is hired. Since franchisees have an incentive to protect their investment, they feel that direct management of the franchise can be delegated, especially if a franchisee owns and operates more than one franchise location. Although franchisees may represent the merger of capital and labor, they will agree that those roles may be played by two different people within the franchise organization.

HOW LONG IS THE FRANCHISE TERM? • Although many franchise agreements are "at will" and may be terminated upon the franchisor's written notice, franchisors typically grant terms of five to 15 years. A franchisor understands that a franchisee needs sufficient time to establish a business, recover its capital costs, and integrate as part of an overall network operation.

Franchisors Want Flexibility

Some franchisors are reluctant, however, to grant longer terms and automatic renewal terms even to franchisees who are in substantial compliance with their franchise agreement. Franchisors are naturally hesitant to perpetually commit the future of their business, especially if the first term is lengthy. The previous example of the franchisor who granted a territory in the then-backwater Silicon Valley in the late 1970s may have essentially licensed away its future. If the Silicon Valley franchisee is not economically strong enough to or desirous of opening additional franchises in the area, the franchisor cannot recoup those lost potential revenues unless it can terminate the franchisee's agreement for good cause (or at least not be required to renew the agreement).

Concomitantly, if the franchisee is operating the franchise well, but not producing the same level of revenues as other franchisees in similar locations, the franchisor would naturally desire the flexibility to change its source of distribution. Franchisors again justify a shorter initial term and no automatic right of renewal of the term by analogizing to a Sony–Al's TV Store or IBM–Bob's Computer relationship where Sony and IBM use the retailer to develop their respective products' awareness and loyalty and then eliminate certain marginal dealers to enable existing dealers to raise prices and service or to provide the retailing service themselves. Franchisors granting renewal may seek a "most favored franchise" provision. This provision would condition renewal on increasing (but not decreasing) the franchise fee and royalties to the levels then paid by new franchisees at the time of renewal.

Loyalty Rewarded?

Franchisees, on the other hand, typically seek longer terms and automatic renewal terms. Franchisees claim that they should be rewarded for their loyalty in the franchisor's early years. They further state that it is unfair, inequitable, and discouraging for them to build up a business and establish customer loyalty in a particular location just to have their business snatched away by some "fair-haired" franchisee or franchisor who, in fact, may not run the business any better than the franchisee. If a franchisee is complying with the terms of the franchise agreement, moreover, the franchisee will feel it is unfair not to continue the agreement after the expiration of the initial term.

Franchisees who are not granted automatic renewal terms seek, at a minimum, to limit the franchisor's right to require alterations and improvements to the franchise. They reason that the cost cannot be recovered if the remaining length of the term is too short. As is discussed below, many states' laws prohibit early termination of a franchise without good cause and some laws even require renewal of a franchise unless good cause exists not to renew.

WHAT HAPPENS IF THE FRANCHISEE DIES OR WANTS TO SELL? • A franchisor will often want to terminate the franchise agreement upon the franchisee's death (or the death of the major or controlling stockholder of a corporate franchisee). The franchisor posits that its relationship with the franchisee is a personal one and, like a partnership, should expire upon the death of the franchisee. The franchisor is also concerned about the immediate transition and running of the franchise in the days following a franchisee's death and will often want the right to appoint a transitionary or temporary manager.

Death Isn't the End

Franchisees counter that the decedent's managerial skills are readily transferable (and perhaps had already been delegated to a day-to-day manager) to another family member with whom the franchisor could feel equally comfortable. A compromise is usually reached so that the franchisee's surviving heir (spouse, child, etc.) receives some period of time (90 to 270 days) to elect to keep the business and satisfy the franchisor's training requirements.

Selling Out

Franchisors often obtain a right of first refusal for some period of time to purchase the franchise on the same terms and conditions as a bona fide offeror proposes to the franchisee. Franchisors desire this right to regain control of the franchise location, increase their percentage ownership of the franchises, or perhaps find a more preferable franchisee for that location. Should the franchisor decline to purchase the franchise, the franchisor often seeks a transfer fee. This fee has been justified as necessary to discourage turnover and trafficking in franchises and to compensate the franchisor for the administrative costs involved in a new franchise relationship.

Franchisee Freedom To Sell

Franchisees contend, on the other hand, that their franchises should be as marketable as the franchisor's franchises and business. The right of first refusal diminishes the marketability of the franchise, they argue, since the prospective buyer may be reluctant to be used as a pawn to set the price of the franchise and may desire to close quickly. The transfer fee is also frequently negotiated as too high and arbitrary. Franchisees will concede that the franchisor should be reimbursed for its out-of-pocket costs associated with the transfer.

WHAT HAPPENS IF THE FRANCHISOR DIES OR WANTS TO SELL? • Usually nothing. Franchisors have historically been free to transfer their interests in franchise agreements with impunity. In recent years, however, franchisees have organized to voice displeasure with and objections to a franchisor's sale.

Burger King franchisees, for example, while not enamored with the franchisor's managerial direction, were concerned that the new proposed transferee-franchisor would be so debt-ridden from its leveraged buyout that it would cut costs and services to franchisees. Carvel franchisees, while welcoming the expansion and new product goals articulated by the franchisor purchaser, expressed anxiety about the loss of the founder's vision and direction.

CAN THE FRANCHISOR SELL COMPETITIVE PRODUCTS? • The franchisor's license typically permits franchisees to sell particular products through specified means of distribution under a marketing plan. The license does not extend to the marketing of the same or repackaged product through other sources of distribution or pursuant to a different marketing plan. Pillsbury, for example, licenses its franchisees to sell Haagen Dazs ice cream at the franchised locations. At the same time, Pillsbury sells hard-packed Haagen Dazs ice cream in supermarkets and other retail stores.

Different Markets, Different Sellers

Franchisors often argue that these sales satisfy completely different markets. The grocery store purchaser in the above example is not the same customer of a franchisee. The customer purchases at grocery stores for convenience and in connection with other, more substantial purchases. The consumer buys at franchises for a treat and in connection with a night out on the town. The dollar spent at the market is not as discretionary as the dollar spent at the franchise.

A franchisor usually attempts to restrict its franchisees from competing in similar businesses anywhere while the franchise agreement is in effect and for several years after the termination of the agreement.

Franchisee Efforts Go Unrewarded

Franchisees argue, on the other hand, that their efforts have built up or enhanced the image and reputation of the franchisor's product. Franchisees' advertising expenses on behalf of the trademark directly stimulate consumer awareness and demand for the product. The consumer may find it easier or more desirable to purchase the product in the supermarket if the shopper perceives no difference between the quality and service of the supermarket and franchise. Franchisees, therefore, frequently believe that their sales decline as a direct result of such sales by the franchisors. This point is intensified if the franchisee's sales preceded the franchisor's sales in grocery stores.

Many franchisors are inflexible and unwilling to compromise on this point, requiring the franchisee to factor this risk into its decision whether to purchase the franchise. Some franchisors will offer their franchisees a percentage of the franchisors' sales in the grocery stores, an agreement not to market in grocery stores for a certain number of years, or a covenant to consider the impact of such sales on the franchisees.

MAY THE FRANCHISEE COMPETE WITH THE FRANCHISOR DURING AND AFTER THE TERM OF THE FRANCHISE AGREEMENT? • A franchisor usually attempts to restrict its franchisees from competing in similar businesses anywhere while the franchise agreement is in effect and for several years after the termination of the agreement.

The geographic and temporal scope of the post-termination, noncompete clauses have been frequently litigated. The general rule regarding enforceability of these covenants is that courts will enforce restrictive covenants that are reasonable in time and geographic scope. Many permutations of this general rule exist, however. A two-year non-compete provision in a franchise agreement terminated for no reason by the franchisor after one year is not as likely to be enforced as the same clause in a franchise agreement that was terminated by the franchisor without cause after 10 years. A restrictive covenant extending only to the franchisee's exclusive territory and the exclusive territories of other franchisees within a 100-mile radius of the franchisee's location is more likely to be upheld than a clause prohibiting the franchisee from competing anywhere.

The Courts Balance

Courts will typically balance the interests of the franchisor and the franchisee in determining whether to enforce these provisions. Franchisors are concerned with protecting their trade secrets (which protection may be enforced perpetually without geographic limitation), business methods, customers, and from "creating a monster" to be unleashed against other franchisees. Franchisees want to be able to earn a living and practice some of the principles they gained through experience. Courts in some states will rewrite an overbroad restrictive covenant to make it fair. In this author's opinion, the noncompetition provisions of many franchise agreements are overbroad and subject to being nullified or rewritten by a court of equity.

WHAT ONGOING SERVICES DOES THE FRANCHISOR PROVIDE? • The franchisee pays a royalty not only for the license of the trademark but

Sixteen states have enacted legislation limiting the right of a franchisor to unilaterally terminate a franchisee.

also to gain access to the franchisor's marketing plan and strategy. The latter, therefore, requires the franchisor to monitor and maintain a pulse of the marketplace, constantly refining and improving the business plan.

What Have You Done for Me Lately?

The franchisee should carefully evaluate the types of franchisor services to be provided after the initial training session. Will the franchisor periodically visit the franchise and provide site-specific comments (display of merchandise, signage, cleanliness of the site, appearance of employees, etc.)? Is the franchisor required to arrange for inventory purchases at a reasonable price or is the franchisee adrift to fend for itself with suppliers? Does the franchisor commit itself to periodically update its operating manual based on improvements to and experience with the system?

Naturally, the franchisor has a vested interest in providing many of these services to its franchisees to assure quality control, consistent performance of the franchised locations, and desired growth of the product sales. However, franchisees should try to get a sense of whether the franchisor considers its role to be active or passive.

ON WHAT GROUNDS MAY FRANCHISOR TERMINATE? • Many franchise agreements allow a franchisor, regardless of the years remaining in the term of the agreement, to terminate the agreement for any reason. This right is justified by the notion that a franchisor needs maximum flexibility in devising the optimum marketing and distribution of its product.

The harshness of this result prompted pro-franchisee legislation in recent years. The federal Automobile Dealers Franchise Act, for example, requires automobile manufacturers to act in "good faith" before any termination of a franchisee. Under this statute, however, a franchisee needs to prove the franchisor's coercion and intimidation. These elements are difficult to prove and therefore dilute the protection of the Act. The Petroleum Marketing Practices Act similarly requires gasoline marketers to terminate their dealers only for "good cause," which is also ambiguously defined.

Good Cause

Sixteen states have enacted legislation limiting the right of a franchisor to unilaterally terminate a franchisee. These statutes typically require the presence of "good cause" before any such action. Good cause typically has been defined to include the franchisee's failure, after reasonable notice and opportunity to cure, to comply with any lawful requirement of the franchise agreement. Some states require repeated or persistent failure of compliance with the franchise agreement to constitute good cause.

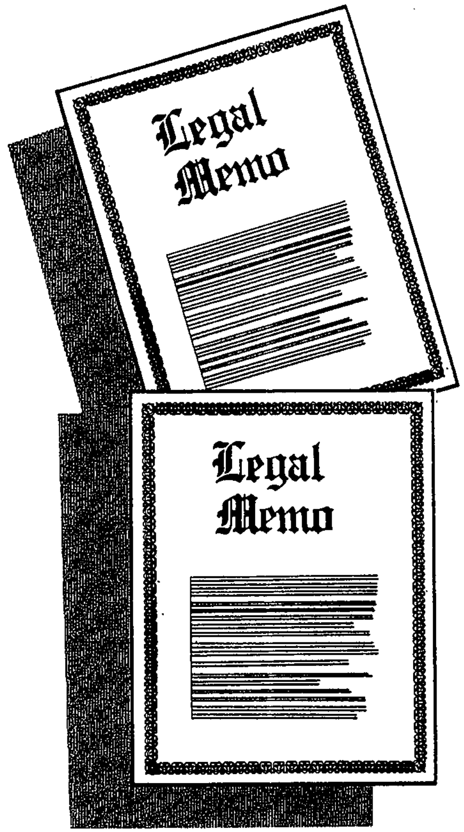
In recent years, the common law in a few states has implied a fiduciary duty between the parties and declared it unconscionable to terminate a franchise relationship unilaterally until the franchisee has at least recouped its investment. This position is a minority one, however. Most courts and authorities still consider the franchisee-franchisor relationship to be that of businessmen each acting on his own behalf, with no fiduciary obligations.

Upon termination of a franchise, the restrictive covenant discussed above would be in effect. Frequently, a franchisor will also seek an assignment of a franchisee's lease to enable the franchisor to control the location. If the franchisor is the landlord or sublessor, the termination of the franchise agreement should constitute a default under the lease or sublease, which default will also enable the franchisor to obtain the use of the franchise location.

Inventory Acquisition

Additionally, some states require the franchisor to acquire the franchisee's inventory in various termination situations. Arkansas requires repurchase of inventory (not equipment, leasehold improvements, or signs) upon any termination without good cause. California requires repurchase of inventory upon either termination or non-renewal if the relationship is not ended in accordance with the law. Both Connecticut and Wisconsin require repurchase upon any termination and Hawaii requires repurchase upon any termination or non-renewal. Illinois, on the other hand, requires repurchase upon non-renewal because of the "diminution in value of the franchised business caused by the expiration of the franchise" if the franchisee either cannot, after expiration of the franchise, conduct substantially the same business under another trademark in the same area or has not been notified at least six months before the expiration date of the franchisor's intent not to renew.

CONCLUSION • Both parties to a franchise agreement may prosper from the unique and special benefits inherent in a franchising relationship. Franchisors and franchisees must carefully evaluate and analyze all of the business and legal risks, however, before proceeding on this route. At a minimum, both franchisor and franchisee should consider the 12 questions presented in this article.



An Easy Way To Write Good Legal Memos

Roland A. Paul

Here's how to use "chicken-scratching" to cure your writer's block.

MOST PEOPLE HAVE some degree of writer's block whenever they sit down to write anything longer than a grocery list. That is true for legal memoranda and letters as much as for any other form of writing. Moreover, the two usual ways of getting documents onto paper—writing them