



# An Introduction to FRANCHISING

## A Collaborative Effort

Minnesota Department  
of Employment and  
Economic Development

Briggs and Morgan, P.A.

### ***An Introduction to Franchising***

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# **An Introduction To FRANCHISING**

Third Edition  
January 2008

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A Collaborative Effort \_\_\_\_\_

Minnesota Department of Employment and Economic Development  
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ISBN 1-888404-48-5

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## THE BUSINESS OF FRANCHISING

Franchising is perhaps one of the most widely misunderstood phenomena in American business. Judging from coverage in the popular media, for every story of wild success – every McDonald’s or Holiday Inn – there seems to be a story of a crashing failure, or even outright thievery, all carried on under the banner of “franchising.”

Franchising is frequently, but erroneously, described as an “industry.” It has been characterized both as the enemy of the American entrepreneur and as the “last, best hope” of American small business to compete against integrated chain retailers.

Can franchising be all of these things? Is it any of them? The answer is “yes.” It has been virtually all of these diverse things, in different times and at different places, and in different manifestations. What franchising really represents is a powerful business tool to distribute goods and services, and to expand a business. It can be a potent investment device for franchisees.

This book provides an overview of franchising as a business tool and the limited public regulation of franchising. It seeks to give the reader a starting point for understanding franchising and evaluating franchise opportunities.

### METHOD OF DISTRIBUTION

Franchising is primarily a *method of distribution* of goods or services. In this sense, franchising is simply a business technique, a means of distributing or providing goods or services to the consumer. Franchising appears in four primary modes:

**Business format franchises for products:**

These are businesses where the franchisor does not actually produce a product but instead dictates to a franchisee how to conduct a business providing a prescribed product to consumers. Examples include franchised quick service restaurants and automotive aftermarket support businesses.

**Business format franchises for services:**

As in business format product franchises, the franchisor does not itself actually produce or provide a service for resale, but dictates to the franchisee how to conduct a business providing prescribed services to consumers. Examples include franchised motels, quick printing shops and home cleaning services. Even nonprofit service organizations can use this form of franchising to expand the reach of their programs into new communities.

**Product franchises:**

In product franchises, the franchisor itself manufactures and distributes a tangible product offered to consumers through franchised retail dealerships, where the franchisor/manufacturer also dictates to the franchisee/dealer how to conduct the dealership business. These may be found not only where the franchisor itself manufactures the product, but also where it has products produced for its account by a third party, or acts merely as a distributor of products whether or not it actually handles the physical distribution of them. Examples include franchised ice cream “dipping shops,” soft drink bottling companies, chain hardware stores, and some specialty merchandise retailing chains.

**Affiliation franchises:**

An affiliation franchise is a uniquely American business phenomenon. The franchisor recruits into its franchise system (in almost any business category, offering goods or services) a retailer who is already engaged, as a successful independent operator, in the franchisor’s line of business. Examples include some of the franchised real estate brokerage chains, some franchised health care providers, and franchised travel agency systems.

## METHOD OF EXPANSION

In addition to being a method of distribution, franchising is also used as a method of expanding an existing business. In this sense, we are simply looking at franchising from a different perspective: namely, that of a business seeking ways to expand the scale of activity in which it is engaged.

Franchising used as a *method of expansion* is an alternative means of capital formation. A business seeking to expand the scale of its operations needs growth capital. Traditional ways of raising such capital include venture capital lenders, various forms of bank and commercial financing, or public or private placement of securities through investment banking channels. Franchising may be thought of as an alternative to these more traditional means of raising growth capital. Using franchising, the business in effect appropriates to its enterprise the capital, as well as the managerial talent and effort, of the franchisee. This is most commonly accomplished by inducing franchisees to invest in additional retail outlets, usually in new geographic market areas, but all in support of and customarily identified by the franchisor's trademarks. The franchisee, therefore, makes a significant capital contribution to the strengthening and expansion of both the scale and the goodwill associated with the franchisor's business enterprise and brand.

To be sure, capital formation through franchising entails some significant equity trade-offs. This is discussed later in "Choosing Franchising as a Method of Distribution."

Franchising as a method of expansion is especially attractive to a business seeking to expand into foreign markets or markets that are geographically or culturally remote from the franchisor. This would be every bit as true for a Minnesota-based company seeking to expand into Texas or California as it would be for expansion into Canada or Europe, or for a foreign business seeking an effective means of penetrating the U.S. market.



Finally, because of its inherent capital and managerial leverage, franchising is often attractive as a means of expanding a business more rapidly than might otherwise be possible. Rapid growth is a goal often cited by firms that elect to expand using franchising.

## **OTHER BUSINESS GOALS**

Franchising sometimes is attractive to a business not as a primary business goal, but as a means to other ends. In this mode, franchising can be a catalyst to the achievement of other, more primary, business goals.

A company may find that for technological, regulatory, or other business reasons, it is desirable for the manufacturer to attain a much higher level of presence or involvement in retail operations involving its products or services than might otherwise be the case. The business, nevertheless, cannot always afford or even desire to vertically integrate its distribution program by owning the retail level of operation. For such companies, franchising can be an attractive compromise. It provides many of the advantages of equity ownership of a retail operation but avoids much of the capital cost and managerial responsibility that can be burdensome to companies lacking unlimited capital.

One example of such a business would be a manufacturer of a high tech product who determines that demonstration, sale, installation, and after-market customer support of its products dictate a more “hands on” presence by the manufacturer than would be possible through the use of unaffiliated, independent wholesalers and retailers. A second example is a company selling products that have significant consumer safety or public regulatory implications. For those reasons, the company might choose not to place its product in the hands of independent and essentially uncontrolled retailers. In both cases, franchising offers an attractive middle ground between merely selling the products to distributors or wholesalers for unconstrained, unsupervised redistribution, or a vertically integrated, “company owned,” retailer network.

## **MULTIPLE FORMS OF FRANCHISING**

Franchising takes many forms. Across the primary modes of business format franchises, product franchises and affiliation franchises, franchising is found in an almost limitless variety of structural arrangements. These include traditional single-unit retail franchises, multiple-unit franchises, franchises with or without exclusive or protected territories, franchises with or without growth options or rights of first refusal, trade area franchises, mobile and home delivery franchises, and one or more tiered subfranchising arrangements. A variety of hybrid ownership arrangements, such as joint ventures and other shared equity business arrangements, also appear in franchise systems.

## **INVESTMENT OPPORTUNITY**

Franchising can be viewed from another major perspective: that of the prospective franchisee, to whom a franchise may represent a shortcut to establish a new business opportunity. For many Americans, the dream of autonomy and financial independence associated with owning and operating one's own business provides a motivating goal, but one of somewhat daunting proportions. Forgoing the relative security and comfort of a salaried position with a larger business entails significant risk.

Franchising offers a middle ground between salaried employment and the essentially open risk of launching one's own independent small business. Again, franchising in this manifestation involves significant trade-offs, discussed later in "Considerations in Buying a Franchise." Nonetheless, it offers the potential to reduce the risk of business failure and loss of investment associated with launching an unfamiliar new business.

Increasingly, even very large business organizations choose franchise investment as a shortcut to entry into an unfamiliar line of business. It provides faster and easier brand recognition than might be possible through internal development of a house-branded line of business. For example, Target Stores might invest in a Subway or McDonald's

franchise, or Marriott in a Pizza Hut franchise. Franchised national brands are increasingly prevalent in institutional host entities such as airports, museums and schools.

## **ECONOMIC IMPACT**

Franchising is a major contributor to the growth of the U.S. and world economies. The International Franchise Association believes that as many as 750,000 franchise businesses operate in the U.S., employing more than 15 million Americans. Franchising generally accounts for as much as 50 percent of all U.S. retail sales (including motor vehicles and motor vehicle fuel). Franchise businesses (again, including motor vehicles and fuel) are now responsible for more than \$1.5 trillion in retail sales. These figures are growing at a steady annual pace, roughly in proportion to the rate of expansion of the U.S. economy as a whole.

In foreign markets, franchising represents a major constituent in the growth of U.S. foreign trade, contributing steadily to stabilizing the nation's foreign trade deficits. Studies indicate that as many as 450 U.S. companies offer franchise programs with more than 35,000 outlets in numerous foreign countries. Many U.S. companies increasingly depend upon foreign franchising for continued growth in sales, earnings and shareholder value.

In this context, it is worth noting again that franchising is one of the best possible tools for U.S. businesses to use to enter foreign markets, and for foreign businesses to enter the American marketplace.

## **NEGOTIATING A FRANCHISE**

While some franchises are offered on a "take it or leave it" form contract, most are negotiable to one extent or another. Franchises offered by smaller or start-up franchisors are usually susceptible to some degree of negotiation to accommodate the franchise offering to the needs and market circumstances of the prospective investor.

## **“BUSINESS OPPORTUNITIES” LAWS**

Anyone interested in franchising must also be aware of public regulation of a distinct but related business phenomenon known as “business opportunities.” This subject is generally outside the scope of this book. Briefly stated, a business opportunity is a business investment program in which the seller of the opportunity offers to provide goods or services to the buyer to enable the buyer to start a business, and the seller assures the buyer that the business opportunity is essentially free of risk, based on a variety of features. For example, the seller may make representations that it will (1) find locations for racks or vending devices for selling the products produced or distributed by the business opportunity buyer; (2) “buy back” the buyer’s output of goods or services produced with materials or assistance provided by the seller; or (3) refund the buyer’s payments or investment if the buyer becomes dissatisfied with the investment. Or, the seller may indicate that a market is assured for the buyer’s output of goods by virtue of a “marketing plan” to be provided by the business opportunity seller.

Although business opportunity regulation was an outgrowth of a number of often fraudulent “business” scams, such as chinchilla ranches, worm farms, “work-at-home” schemes and other dubious arrangements promoted to naive and unsophisticated consumer investors, the law now sweeps in a much broader array of business and distribution programs. Today, many legitimate businesses use structured business arrangements that are classified as “business opportunities” under one or more states’ laws. Business opportunity regulation is discussed further in a later section.

## HOW TO RECOGNIZE A FRANCHISE

### WHY THIS IS IMPORTANT

Franchising is a regulated form of doing business. Under Minnesota law, a franchisor may not *offer* or *sell* a franchise until the offering is registered with the Minnesota Department of Commerce, or qualifies for an exemption from registration. Once the offering is registered (or if it is exempt from registration), the franchisor may sell a franchise only if it first provides a comprehensive presale disclosure document to each prospective franchisee. The disclosure document historically has been called an “offering circular” or “UFOC” (for “Uniform Franchise Offering Circular”), or “franchise disclosure document.” Under a 2007 change in a Federal Trade Commission rule on franchise disclosure (discussed later), the “franchise disclosure document” (or “FDD”) terminology will come into wider use.

Minnesota law also provides an umbrella of protection to franchisees by prohibiting certain listed “unfair practices.”

Failure to comply with the law — by failing to register; by providing a false, misleading or incomplete offering circular; or by violating the unfair practices rules — exposes the franchisor to substantial penalties and civil liability to an injured franchisee. Any entity engaged in distribution of goods or services, or licensing of any kind, should learn the reach of this law to avoid a costly and embarrassing violation.

For someone buying into a business promotion of any kind, awareness of the existence and scope of the franchise laws assures access to both important investment information and strong laws protecting franchisee investors.

Consequently, people involved in business from almost any perspective should learn to recognize franchise arrangements. Discussion of the four most important reasons follows.

### **Receiving Pre-Sale Disclosure**

A prospective franchisee is entitled under Minnesota and federal law to receive comprehensive pre-commitment disclosure of material investment information from the franchisor. The investor should always consider whether or not the business is a franchise when contemplating investment in a business promoted by another. This will alert the investor to a variety of important considerations, including his or her entitlement to receive this comprehensive pre-commitment disclosure.

Investment commitments to a franchise offering should not be made until the required pre-commitment disclosure information has been received, studied carefully, and reviewed with a professional advisor.

Pre-commitment registration and disclosure of franchise offerings is covered in much more detail below. For now, simply note that even for companies that have recognized and properly treated their business promotion as a franchise, the quality of disclosure information varies significantly between offerings. For many other types of business promotions, the investor can recognize a critical danger signal if he or she can recognize that a particular business proposition does (or could) constitute a franchise under Minnesota state law, but the promoter has not treated the offering as a franchise.

Thus, investors have a meaningful incentive to watch for business opportunities that may constitute a franchise even if the seller does not realize that its proposal constitutes a franchise.

### **Protecting a Business Relationship**

Franchise law can provide recourse for a party already in a business relationship with another party which the other party proposes to terminate or to alter significantly to the detriment of the investor. If the

investor whose interest is being threatened recognizes that the business relationship fits within the statutory definition of “franchise,” the investor sometimes can rely on these powerful legal tools to protect the relationship against unwarranted termination or certain other disadvantageous changes in the relationship.

This happens because in Minnesota (as well as Iowa, Wisconsin and about 14 other states), legislation provides a range of remedies to investors in franchises. These remedies protect against practices including termination without good cause and refusal to allow the investor to exercise a renewal or extension option. In some states, including Minnesota, the law prohibits a wide variety of additional “unfair practices.”

Invoking these legal rights requires the assistance of an attorney to interpret the law and its possible application to your particular facts and circumstances. But investors should be aware that state law may provide a means to resist an unwanted termination or a material, adverse alteration of the business relationship.

Oftentimes, dealership or distributorship-type relationships are created by parties who are unaware that the relationship might be governed by state franchise law. When this occurs, the franchisee may be able to use statutory remedies afforded to the franchisees, long after the relationship was established, even though it never occurred to anyone earlier that the business arrangement constituted a franchise.

### **Escaping a Business Relationship**

Conversely, franchisees sometimes can use state franchise laws to escape a business relationship that proves to be unsuccessful or materially different from what had been anticipated.

If the business arrangement was treated as a franchise from the outset, the franchisee will be well aware of the applicability of state franchise laws. If the nature of the business established by the franchisee, the level of support services provided by the franchisor, or the amount

or type of investments required to establish and operate the business turn out to be materially different from what was represented in the offering circular, the franchisee may have a claim for damages. The franchisee also may be able to rescind the sale of the franchise based on the misdisclosure. Similarly, investors in business arrangements that later prove to be franchises, but weren't treated as such at the outset, may invoke the franchise laws to rescind the relationship even if an otherwise binding contract is in place, or to recover damages and other appropriate relief.

The law also provides that the franchisee may recover its legal fees in certain cases.

Evaluating such an action involves the application of a complex statutory scheme to infinitely variable sets of facts and circumstances. This requires the assistance of a legal advisor. Awareness of these remedies, however, always must begin with the operator of the business.

### **Avoiding the Creation of Inadvertent Franchises**

A business seeking to expand, or seeking outlets for its products or services through distributors or dealers, may *inadvertently* create a franchise relationship. This happens when a party enters into an arrangement with another that meets the statutory definition of "franchise" but fails to recognize that franchise law applies to the transaction. Indeed, many business people in Minnesota and elsewhere mistakenly perceive franchising as limited to quick-service restaurants and perhaps a few other familiar industry sectors. Nothing could be further from the truth.

Businesses in virtually every sector of the economy use franchising as a distribution method or to achieve other business goals. According to U.S. Census Bureau data, approximately 6,000 U.S. companies offer franchises in at least 75 different industrial sectors. More are added every week – most by design, but some by inadvertence.



The statutory definition of a “franchise” (detailed in the following section) reaches *any* business in *any* industry that either offers to or in fact does enter into a business relationship or contract containing the elements defined in the statute (subject to a handful of narrowly defined exceptions and exemptions). If the business fitting the role of the franchisor has neither recognized that the law applies nor taken the many steps necessary to comply with it (or to qualify for exemption from it), it will have “sold” an unregistered franchise in violation of the law. The title on the document is of no importance, as a franchise can easily be created in a contract entitled “Lease,” “Purchase Agreement,” “License Agreement,” “Joint Venture Agreement,” “Dealership Agreement,” “Marketing Agreement,” or the like. This, in turn, exposes the business to a wide range of potentially serious civil or even criminal sanctions for failing to comply with the law. Thus, a basic awareness of the scope and content of the Minnesota Franchise Act is essential for any person seeking to distribute goods or services through other persons or businesses.

Anyone seeking to learn whether or not a particular franchise program is registered in Minnesota may inquire with the Department of Commerce in St. Paul. Franchise registration files and the master registration lists are public record documents open to inspection by anyone and for any reason. It is good practice (although not strictly required) to call the Department in advance to arrange an appointment to review a registration file.

## **STATUTORY DEFINITIONS**

### **Minnesota Law**

The Minnesota Franchise Act appears at Chapter 80C of Minnesota Statutes. Section 80C.01, Subd. 1 contains the technical definition of the word “franchise” under this statute.

Rather than attempt to analyze fully this lengthy and technical definition, we will offer a paraphrase of the definition in terms understandable to most businesspeople:

A “franchise” is created when one person or business grants another the right to offer, sell or distribute goods or services, using the trademark, trade name, commercial symbol or advertising of the grantor; the grantee pays consideration for the right to enter into or maintain the relationship; and there is an ongoing “community of interest” between the parties relative to the distribution of the goods or services.

The statute does not apply solely to written contracts for ongoing business relationships. A purely oral arrangement or even a single transaction can also satisfy the statutory definition if it contains all of the required elements.

That said, it is still necessary to elaborate upon the meaning of some of those terms in this context. To understand this definition, recognize that the law has four essential elements:

- The “grant” element
- The “trademark” element
- The “community of interest” element
- The “franchise fee” element.

All four elements must be satisfied to create a franchise. Take away any one of them, and no “franchise” is present.

The “grant” element means that one *person* grants another the *right to offer, sell or distribute* goods or services. The meaning of this element is straightforward.

The grantee need only be allowed (not necessarily required) *to use the grantor’s trademark, logo, trade name or advertising* in connection with the distribution of goods or services. For a transaction or business relationship to avoid satisfying the “trademark” element, it is not enough that the agreement is silent as to the grantee’s use of the grantor’s

trademark or other commercial identification; the agreement must affirmatively prohibit the grantee from “using” the grantor’s trademark, trade name, logo or advertising.

What does “using” the grantor’s trademark mean? The answer is not entirely clear under Minnesota law. While the Minnesota courts have held that a franchisee need not “hold itself out as the franchisor” to establish “use” of a trademark, “using” the grantor’s trademark probably means using the mark (or other form of trade identification) in a way that leads a customer to think that the grantee, the dealer or distributor, is part of the grantor’s business organization or part of a chain of affiliated businesses – rather than an independent merchant simply reselling someone else’s branded product or service. Minnesota courts have not ruled clearly on this point, but “using” a trademark, logo or trade name probably means more than a dealer merely offering a branded product or service and identifying the product by its brand. To illustrate this concept, consider the example of “Smith Hardware Company” advertising or placing banners in its windows to advise the public that it has “Wilson” brand sporting goods available for sale. Smith Hardware is probably not “using” the “Wilson” trademark in the sense required by the Minnesota Franchise Act. Similarly, if Best Buy advertises that it has “Sony” brand televisions available for sale, it is probably not “using” the “Sony” trademark within the meaning of the statute. Again, our courts have not ruled definitively on this point.

If, however, the Olson Widget Company appoints the Jones Company to operate a retail widget dealership where the name over the door of the dealer’s shop is “Olson Widgets,” the dealer is certainly “using” the “Olson” trademark in the sense meant by the Minnesota Franchise Act. It may also be “using” the “Olson” trademark even if the Jones Company operates an Olson Widget dealership under its own trade name, “Jones Company,” but its sole or primary business activity is the promotion and sale of “Olson” brand widgets. (*See, Martin Investors, Inc. v. Vander Bie*, 269 N.W.2d 868 (Minn. 1978) and *Unlimited Horizon Marketing, Inc. v. Precision Hub*, 533 N.W.2d 63 (Minn. 1995).)

Another potentially tricky part of the “trademark” element is its reference to using the grantor’s *advertising* to satisfy it. This aspect of the definition has never been tested in the Minnesota courts. Nonetheless, if the other basic elements of a “franchise” are present in any particular contract or transaction, the use of common advertising or advertising provided by or closely associating the dealer with the grantor may be enough to throw the arrangement over the line into the category of a “franchise.” This occurs by creating the appearance to the public that the dealer or distributor is part of an affiliated group of businesses.

It is also noteworthy that the “trademark” element can be satisfied by a single contract or transaction, or a single offer to enter into one. It does not depend upon either a widespread pattern of public offerings of such arrangements or even an ongoing business relationship.

The *community of interest* element is difficult to analyze because its meaning is not particularly clear. Virtually any commercial arrangement for the distribution or resale of goods or services involves some shared economic interest between buyer and seller, even if only in increasing the volume of sales. Thus, it is not at all clear what this element adds to the definition. Another way to think of this is that it would be extremely rare for a distribution relationship to be excluded from the franchise definition due solely to the absence of a “community of interest” in the distribution of the goods or services. In one early case in the mid- 1970s, a transaction was found not to be a franchise because the supposed “franchisee” was a subcontractor who sold back to the “franchisor” the goods the “franchisee” had received and reprocessed. It therefore did not have a community of interest in the *distribution* of the goods. (But note that this kind of arrangement might constitute a “business opportunity.”)

Courts in other states have struggled with similar concepts under other states’ laws. They have concluded that a “community of interest” requires more of a shared interest in a business relationship than exists in a single, arm’s-length sale transaction. Thus, courts have tended to look at such factors as the duration of the relationship, the dependence of the dealer

upon the relationship for its commercial success, the percentage of the dealer's sales derived as a consequence of the relationship, the scale of investment required of the dealer to satisfy the arrangement, the proportion of the dealer's investment that is usable only for the business associated with that relationship, the extent to which the dealer's day-to-day business activities are directed by the franchisor, the existence of any pooled or shared advertising obligations or participation in profits, and similar factors in deciding whether a "community of interest" exists in the distribution of goods or services.

In Minnesota, the courts have interpreted "community of interest" very liberally; it takes very little in a business relationship to satisfy this element. Wisconsin courts have construed a similar phrase in the Wisconsin Fair Dealership Law more narrowly.

The *franchise fee* element is what most often separates "ordinary dealership" or distributorship type relationships from franchises. This is because in most cases a dealer or distributor does not pay separate consideration for the right to enter into or maintain the relationship, at least in combination with a grant of rights to use the grantor's trademark or other trade identification as described previously. The "ordinary" dealer buys inventory but does not pay separate consideration for the privilege of becoming a dealer in those goods either in the form of fees or required ancillary purchases of equipment, training or services.

In many cases where a dealer is trying to resist termination by a manufacturer or is seeking to escape a relationship that had not been recognized or treated as a franchise, finding a "hidden" or "indirect" payment of a franchise fee can bring what the parties had theretofore considered an ordinary dealership arrangement within the scope of the Minnesota Franchise Act. This means the dealer may have remedies against an unwanted termination or the tools to break out of the unwanted relationship. This outcome always comes as a considerable shock to the careless or unfortunate company that created the inadvertent franchise.

The after-the-fact classification of a business relationship as a “franchise” comes about because of the broad scope of the statutory definition of a *franchise fee*. The statute very simply defines a franchise fee as any payment made, directly or indirectly, in consideration for the right to enter into or maintain the relationship, subject to a few narrow exclusions. This applies to payments for goods or services and applies whether or not other valuable consideration is received in exchange for the payment. It applies to all payments for intangibles, including services provided by the grantor and even tangible products – unless specifically excluded by one of the exclusions spelled out in the statute.

For example, if a manufacturer, in establishing a distributorship arrangement, requires the distributor to attend a two-week training program for which the manufacturer charges a \$600 fee, the training fee is clearly a franchise fee. Similarly, if a manufacturer requires its dealers to contribute to a pooled advertising program or to subscribe to a bookkeeping or accounting service sponsored by the manufacturer, those payments clearly constitute a franchise fee. This is the case even though perfectly sound and valuable training, advertising, or bookkeeping services are provided in exchange for the payments.

The test is whether the manufacturer would authorize the dealer or distributor to enter into and maintain the relationship wholly without reference to whether or not the fees are paid. If fees for such collateral services are genuinely optional and paid as a matter of truly free choice by the dealer or distributor, they are not franchise fees because they are not required in order to obtain or maintain the position as a dealer or distributor. But if the payment is required by contract or practical necessity, then they will be treated as franchise fees. Some other states’ franchise laws define “franchise fee” even more broadly than Minnesota by providing fewer exclusions or exceptions from the “any payment” provision.

One significant exclusion under Minnesota’s law is for the payment of the *bona fide* wholesale price of inventory merchandise, in reasonable quantities. Thus, if the dealer or distributor pays no more than the bona fide wholesale price of the inventory goods handled, and no other fee or payment is made to obtain or keep the dealership, then no franchise fee is present. A *bona fide* wholesale price is the price paid by others for comparable goods in a free market environment. If a manufacturer is selling unique goods for which it is the only source, then there is no external market by which the reasonableness of the purported wholesale price can be measured. Thus, a disgruntled dealer could easily attack even payments for inventory of such products as an indirect or hidden franchise fee.

Even if a manufacturer charges only a *bona fide* wholesale price, but imposes unreasonably large inventory obligations on the dealer or requires that the dealer acquire that inventory prematurely relative to true market demand for the items, then an indirect franchise fee is probably present by virtue of the front-end loading required by the manufacturer. These situations obviously present very fact-intensive issues that require a careful and professional application of the law to the particular facts and circumstances. Sometimes, these disputes must be resolved by the courts.

Other exclusions from the definition of a franchise fee include repayment of a *bona fide* loan, providing real estate, fixtures or facilities at their fair market value, and other similar exclusions spelled out in the statute.

A franchise fee is not limited under Minnesota law to payments made to the “franchisor.” If a company requires its distributor or dealer to make payments (other than those payments specifically excluded from the definition, like payments for inventory) to a third party, then a franchise fee may still be present. Some courts have indicated that they would not consider payments, required or not, to be “franchise fees” if they were made to third parties for business essentials that *any* business would purchase – like business permits, office operating supplies, insurance, or basic marketing costs. Nonetheless, this issue is not fully resolved.

## **Exemptions from the Registration Requirement**

Before leaving the Minnesota definition of “franchise”, we must note the existence of a number of exemptions from registration under the statute. An exemption means that even though the transaction or relationship fits the definition, the arrangement need not be registered with the Department of Commerce before it is offered or sold. These include: sale of a franchise by the franchisee-owner; a sale to a bank or insurance company; sales of registered securities; a single isolated sale of a franchise under specified conditions; sale of a franchise to a franchisee with specified experience in the business and who derives 80 percent or more of its total sales from other sources; sale of a foreign franchise to a nonresident of Minnesota under specified conditions; and sales exempted by order of the Commissioner of Commerce.

For the most part, these exemptions are of relatively limited use either to a franchisor or franchisee, as they exempt the franchisor only from compliance with the registration required before a franchise may be offered to the public. They do not exempt the franchisor either from the requirement to make pre-commitment disclosure or from the antifraud and other remedial sections of the statute. That said, these exemptions can be very useful in a narrow range of circumstances where a producer or manufacturer may be able to structure a particular transaction so as to be able to take advantage of an exemption. Needless to say, these planning initiatives require the close assistance of an experienced franchise lawyer to assure that the transaction does not violate the statute.

## **Federal Trade Commission Rule - 16 C.F.R. § 436**

Franchise sales are also regulated by federal law. In 1979, the United States Federal Trade Commission joined the 15 states that then regulated the offer and sale of franchises. It did this by promulgating a Trade Regulation Rule on Franchising and Business Opportunities Ventures, commonly referred to as the “FTC Rule.” In 2007, the Federal Trade Commission amended the FTC Rule to reduce inconsistencies with state franchise disclosure laws. The FTC Rule is a self-implementing precommitment disclosure mandate that preempts any contrary or less- protective



state disclosure requirements. Unlike state law, however, there is no requirement under the FTC Rule that a franchise offering be registered, nor is there any federal review of franchise offering circulars.

The definition of a “franchise” under the FTC Rule is conceptually similar to the state definition previously outlined, but not identical. The FTC definition may be paraphrased as follows:

A “franchise” is a continuing commercial relationship in which (i) a franchisee redistributes goods or services which are identified by the trademark, commercial symbol or advertising of the franchisor, or where the franchisee operates its business under a name using the franchisor’s trademark, commercial symbol or advertising, and (ii) the franchisor provides significant assistance to or imposes significant controls over the franchisee’s method of operation, and (iii) the franchisee is required to pay the franchisor (or its affiliate) \$500 or more (except for the *bona fide* wholesale price of inventory goods) at any time through the first six months after the franchisee commences business.

The FTC Rule then exempts a number of types of transactions from the disclosure requirement. These include:

- Relationships that involve a leased department within a general merchandise store;
- A franchise granted to a franchisee with prescribed levels of prior experience in the business and where more than 80 percent of the franchisees’ total sales will be derived from other sources;
- Franchisees making initial investments of more than \$1 million, excluding unimproved land and amounts that are financed by the franchisor;
- Sales to franchisees that have been in the business for at least five years and have a net worth of \$5 million or more;

- Certain “insider” sales where the franchisee is an owner of a certain percentage of the franchisor’s equity, or an officer, director, general partner or other person with at least two years management responsibility for sales in the franchise system; or
- Where there will be no written document describing the relationship.

Petroleum marketers and resellers covered by the Petroleum Marketing Practices Act also are exempt from the disclosure requirement. Exemption under the FTC Rule takes a transaction entirely out of the Rule’s coverage, but does not determine whether the franchise is or is not exempt from Minnesota’s or any other state’s franchise law.

### Other States

In addition to Minnesota, 19 other states regulate the offer and sale of franchises. These states are:

California	North Dakota
Florida	Oregon
Hawaii	Rhode Island
Illinois	South Dakota
Indiana	Texas
Kentucky	Utah
Maryland	Virginia
Michigan	Washington
Nebraska	Wisconsin New York

The Canadian provinces of Alberta, New Brunswick, Ontario and Prince Edward Island also regulate offers and sales of franchises, as do a small but growing number of foreign countries.

The pattern of definition in these other state laws (*i.e.*, the description of the types of business transactions covered) is remarkably similar to Minnesota law. Most of these laws contain the “granting”, “trademark” and “franchise fee” elements. Some states replace the “community of interest” element with the question of whether the grantee is required

to operate under a “marketing plan” prescribed in substantial part by the grantor. A marketing plan exists when the grantor prescribes significant restrictions on the grantee in the conduct of the grantee’s business, or provides significant assistance to the grantee in operating the business. Examples of business arrangements that can constitute a “marketing plan” include providing a mandatory training program, prescribing the appearance of the grantee’s business premises, prescribing a territory or location, dictating hours of operation, or exercising controls over the grantee’s advertising. Any of these provisions could also be used in Minnesota to show the existence of a “community of interest.” It is worth noting that some states do have different requirements. For example, in the franchise relationship laws in Arkansas and New Jersey, the definition of “franchise” does not include a requirement that the franchisee pay the franchisor a fee.

For all practical purposes, an arrangement that would be a franchise under any one of these laws is highly likely to be covered by all of them. It is sometimes useful in a multi-state transaction, therefore, to be aware that more than one state’s franchise laws may apply. This may give the franchisee a broader range of possible remedies should a problem arise with the transaction or relationship.

## **COMMON CHARACTERISTICS OF FRANCHISES**

Fortunately, we can distill the many technical definitional issues into a simple definitional concept that any businessperson can use to determine whether franchise laws might apply. This shorthand definition of a “franchise” is:

Does one party pay something extra for the privilege of distributing goods or services, using a brand, trade identification or advertising other than that person’s own name or advertising, where the parties have an ongoing common interest in their shared enterprise, or one party dictates to the other how to run its business?

If the answer to that question is “yes” or even “maybe,” further scrutiny into the possible application of franchise laws would be prudent.

In some cases, business transactions become subject to franchise or other laws where a distribution arrangement takes on a structure that is unusually or needlessly complex. This is common in some multilevel distribution schemes, or pyramid schemes, where parties to the relationship are obligated by contract or economic necessity to recruit others into the distribution scheme in order to profit from it themselves.

## **BUSINESS OPPORTUNITIES LAWS**

Business opportunities have been mentioned several times in earlier sections. They are a curious phenomenon in American business. When the scam artists and crooks were run out of franchising by the franchise registration and disclosure laws, some turned to closely related forms of “business” promotions aimed at novice or unsophisticated consumer-investors. These ranged from questionable deals at best to outright frauds at worst. Examples included “worm farms,” chinchilla breeding deals, some work-at-home schemes, and various vending machine and rack jobber route deals. This kind of promotion came to be characterized as “business opportunities” schemes. Between the late 1970s and 1984, these schemes led about 25 states to enact laws to control and eliminate them.

Deciding what constitutes a “business opportunity” is even more complicated and varied from state to state than deciding what constitutes a “franchise.” Nonetheless, for our purposes, these definitions can be paraphrased into the following concept:

A business opportunity exists where a seller provides goods or services to a buyer to enable the buyer to start a business; the buyer makes any payment in excess of a stated threshold (usually \$100 or \$500; payments for “inventory” are not excluded); and the seller makes any of a number of prescribed representations to the buyer to the effect that the buyer’s investment is safe because the seller

(i) will find locations for vending machines or racks to be serviced or stocked by the investor, (ii) will buy back the buyer's output of goods produced using whatever the seller initially provided, or refund the buyer's money if the buyer becomes dissatisfied with the deal, (iii) represents that the buyer will derive income from the scheme greater than what was paid for it, or (iv) represents that a market is assured for the buyer's output due to a marketing plan to be provided by the seller.

Business opportunities are somewhat closely related to many product-oriented franchise arrangements. They differ from them largely in the representations made by the promoter or seller indicating that the buyer's investment is safe or secure for any of the reasons listed in the various definitions. They are, therefore, characterized less by a "get rich quick" theme than by a "you can't lose" assurance.

In most states (including Minnesota), business opportunities are regulated in a manner similar to franchising: the law requires that a business opportunity offering be registered with a state administrative authority and that prescribed disclosures be made to prospective investors before any commitment can be made. Bonds or other forms of financial assurance often are also required. Curiously, under the Minnesota Franchise Act, business opportunities are defined as an alternative type of "franchise." As a result, the regulatory consequences are identical for the two different types of business promotions.

Other states have separate regulatory procedures for business opportunities, including detailed regulation of various features that they either must or may not contain. Before its amendment in 2007, the FTC Rule, like Minnesota, treated business opportunities as an alternative definition of the word “franchise”. The 2007 amendment to the FTC Rule removed “business opportunities” from the franchise Rule into a separate regulation. The Federal Trade Commission will adopt a new, separate, Business Opportunity Rule, 16 C.F.R. Part 437, to regulate business opportunities. The Business Opportunity Rule would require a shorter, one-page disclosure of five topics: explanation of any earnings claims being made; a list of criminal or civil actions brought against the seller or its representatives that involve fraud, misrepresentations, securities, deceptive or unfair trade practices; a description of the seller’s refund or cancellation policies; the number of purchasers in the last year and how many of those purchasers have sought a refund or to cancel the agreement; and a list of references.

Business opportunities generally are beyond the scope of this book. Expert legal advice should be sought and great care exercised before offering or selling such an arrangement or buying into one.

It should be noted in passing, however, that although many of the business opportunity promotions that led to the enactment of business opportunities laws included highly questionable or fraudulent deals, many legitimate, mainstream businesses have employed techniques to distribute their products that come within the scope of the state business opportunities laws. As a result, many legitimate business offerings today are made under the coverage of a business opportunity law. One reputable business magazine even published an annual listing of 500 leading “business opportunities.”

# FRANCHISE REGULATION

## HISTORY

Franchising in its current form evolved in the United States predominantly in the 1950s and 1960s. During that period, franchising experienced explosive growth in terms of the number of companies using franchising and the number of different industry sectors in which franchising was used, and in the variety of ways that franchising was used to pursue a wide array of business objectives. Unfortunately, much of this growth occurred as a result of franchisors promoting their franchise offerings with very little regard to the investment information needs of their prospective franchisees. Few franchisors provided meaningful pre-commitment investment information, and many sold franchises on the basis of claims and representations that lacked meaningful substantiation. In addition, several noteworthy outright frauds were perpetrated on naïve or unsuspecting investors.

In the late 1960s, several states attempted to address these problems by using state securities regulation laws and unfair trade practices laws to regulate abuses in the offer and sale of franchises. These efforts were largely unsuccessful.

In 1970, California's legislature became the first in the nation to adopt a law aimed directly at the offer and sale of franchises. The California Franchise Investment Law became effective January 1, 1971. It was modeled after the California Securities Law and required that franchise offerings be registered with the Department of Corporations before any offer could be made to sell a franchise in California. It also dictated that a lengthy pre-commitment disclosure document be delivered to each prospective franchisee at a prescribed time before the franchisee could make any payment or sign any binding agreement related to the franchise.

Over the next five years, 14 other states enacted similar laws. The Minnesota Franchise Act became effective August 1, 1973. In 1979, the Federal Trade Commission joined the 15 states that then regulated the offer and sale of franchises by enacting a Trade Regulation Rule on Franchising and Business Opportunities Ventures. In 2007, the Federal Trade Commission updated the FTC Rule. The amended Rule reduced inconsistencies between federal and state franchise disclosure requirements, and moved business opportunities into a separate Rule.

The franchise laws were generally effective in achieving their intended results to provide prospective investors in franchises a substantial body of information to allow the investor to compare offerings, and to make an informed judgment as to the suitability and merits of the franchise opportunity presented. The laws are also intended to provide franchise investors with legal remedies against those franchisors that fail to make the prescribed disclosures, misstate important information in the Franchise Disclosure Document, or leave out important information necessary to make what was disclosed fully accurate. The laws were never intended to, and do not, protect investors from making bad investment judgments, or to protect investors against franchise programs run by companies that are incompetent, arrogant or simply unsuccessful.

Another common misconception about franchise laws is that they prevent crooks from using franchise opportunities to defraud people. The laws do not and cannot prevent such activity. The most they can offer is the slim prospect of an after-the-fact remedy if the crook can be identified and tracked down. Dishonest people and companies tend not to comply with registration and presale disclosure laws in the first place.



## **REGISTRATION AND DISCLOSURE**

As in most states that regulate franchise sales, the heart and soul of Minnesota franchise sales regulation is the requirement that a franchise offering be registered with a state administrative official before it may be offered to anyone, and that the franchisor provide to each prospective investor a comprehensive set of disclosure information in the form of a prospectus on the franchise offering. This is known as the Franchise Disclosure Document (or FDD).

Both the FTC Rule and Minnesota law require that the Franchise Disclosure Document provide information in 23 separate categories. Franchisors are required to make known various facts about the franchise including the name of the franchise, business address of the franchisor and any parent companies, the nature of the franchise offering, the competitive market circumstances in which the franchised business will be operated, background information on the franchisor and its officers and directors, litigation and bankruptcy history for the franchisor and its principals, a summary of fee and initial investment information, restrictions on the franchisee's purchasing discretion, financing information, trademark information, whether the franchisor does or does not provide any kind of earnings or financial performance ("track record") information, and statistical information about the franchise system. The Franchise Disclosure Document also contains the audited financial statements of the franchisor, a specimen of the franchise agreement and related agreements, and a list of existing franchisees.

Franchise Disclosure Documents can often run to 100 pages or more. The information they contain is usually quite detailed and technical. The quality and depth of information provided can vary significantly from one offering to another. In reviewing and interpreting the information contained in the Franchise Disclosure Document, a prospective franchisee should always obtain independent professional advice from either an experienced franchise lawyer or perhaps a certified public accountant with significant franchise experience.

In multi-state transactions – such as a situation where a prospective franchisee may be a resident of one state but considering purchasing a franchise to be located in another state – more than one state’s FDD may have to be delivered to the prospective franchisee to satisfy the requirements of each state’s laws.

Before offering a franchise in any of the registration states, the franchisor is required to register that offering with the state franchise law administrator. In Minnesota, the administrator is the Department of Commerce. Registration is accomplished by filing with the administrator a proposed form of the FDD, together with certain additional forms and other information prescribed by law and by state regulations.

The Department reviews the FDD and certain related information also required to be filed. It often requires additional or restated information in the proposed FDD. The Department will issue an order of registration when it is satisfied that the FDD addresses the required areas of disclosure. The order of registration then entitles the franchisor to make offerings to prospective investors in Minnesota for a limited period of time.

The Department of Commerce does not assess the merits of the offering or determine the accuracy or completeness of information in the FDD. At best, staff employees of the Department check that each category of information called for by the FDD requirements has at least been addressed in the FDD. Prospective franchisees should not rely upon the fact of registration or the fact that an FDD has been reviewed by the Department as a substitute for making their own comprehensive investigation of the proposed franchise.

Registration orders are valid for up to one year. A franchisor has an obligation to amend the FDD promptly upon the occurrence of any material change in the information contained in the FDD, but franchisors are generally under no obligation to make disclosure retroactively to persons who have already purchased a franchise.

If a prospective franchisee has received an earlier FDD and is still considering the investment when a material change occurs, the franchisor must make an updated disclosure to the prospective franchisee before completing the sale.

The franchisor is required to file an annual report with the Minnesota Department of Commerce which updates the information in the FDD. It must do so no later than 120 days after the franchisor's next fiscal year end or by the first anniversary of the registration order, whichever occurs first. In most cases, new audited financial statements are required in connection with the annual report.

The other registration states follow essentially the same regulatory pattern, with a couple of exceptions. Michigan and Wisconsin require a notice filing with a state agency but do not review FDDs. Oregon, like the FTC Rule, mandates disclosure but does not require filing or registration. Hawaii conducts a cursory review of FDDs but not a full registration scrutiny. A few states (including Florida, Kentucky, Nebraska, Texas and Utah) require an administrative notice filing with a state agency to claim an exemption (for franchise offerings) under the state business opportunities law, but do not otherwise register or review FDDs.

In most of the other registration states, the review process is essentially identical to that in Minnesota. Variations in specific items of state law may result in slightly different versions of FDDs for use in the various states. Consequently, in some multi-state transactions, franchisors may be required by the various laws to deliver more than one state's FDD to the prospective franchisee whether or not those offering circulars differ slightly from state to state. The state statutes have never adequately dealt with that problem, and any inconsistencies within the FDDs are usually sorted out on a case by case basis. Many FDDs address multi-state inconsistencies or unique disclosure requirements of single states by adding one or more "state addendums" to the FDD.

One of the more important features of pre-sale disclosure that prospective franchisees should be aware of is the minimum time in which the prospective franchisee is entitled to obtain disclosure before being asked

to make any commitment. Under the FTC Rule, the franchisor is required to deliver the FDD to the prospective franchisee at least 14 days before the prospective franchisee makes any payment to the franchisor, or 14 days before the prospective franchisee signs any binding agreement relating to the franchise, whichever occurs first or, if earlier, at the “reasonable request” of the prospective franchisee.

Franchise Disclosure Documents may be delivered in paper format, on a CD, or electronically by email or download from a web site, provided the franchisee is informed of the right to request and receive a paper (or “hard copy”) version.

The effect of the pre-commitment disclosure obligation is to provide the FDD to the prospective franchisee long before the prospective investor may be required to make any financial or binding contractual commitment to acquire the franchise. This is intended as a cooling off period to enable the prospect to consider carefully all of the FDD information, and to enlist the assistance of a lawyer, CPA or other trusted business advisor to assist in interpreting the information provided.

The prospective franchisee will be asked to sign a “Receipt,” which is the last page of the FDD. This document merely indicates that the prospective franchisee did in fact receive the FDD on the date indicated. It does not otherwise obligate the prospective franchisee in any way, but investors should be careful to read the Receipt before signing it to be certain that it does not contain factual inaccuracies.

The law also requires that the prospective franchisee be furnished with a complete copy of the FDD (including a duplicate of the Receipt), without charge.

The philosophy of the franchise registration and disclosure requirement is to provide prospective franchisees with pre- commitment information so that relatively informed investment decisions can be made. The purpose is not to prevent prospective franchisees from making imprudent or unsuitable investment commitments.

The information in the FDD is intended to give the prospective franchisee a clear sense of what he or she is being asked to invest in. It provides a basis upon which the prospective investor can compare one franchise offering to another – sometimes even across industry lines – to weigh the cost and benefits of, for example, a doughnut shop franchise as compared to a dry cleaning franchise. It provides a starting point for the prospective franchisee to conduct his or her own investigation into the suitability of the investment, the track record of the franchisor, and prospects for success.

The information in an FDD by itself is never enough information for a prospective franchisee. While it is true in some senses that a prospective investor in an independent small business can never have too much information about the proposed investment, it is worth noting that the FDD should be thought of only as a starting point in conducting a pre-commitment investigation into the proposed business arrangement. For example, the FDD rarely contains sufficient information about the competitive environment and long-term trends in the business sector in which the franchise will be operated. It is up to each individual investor to ascertain whether the business prospect being investigated might be vulnerable to rapid technological obsolescence, unusually intense competitive pressure, trends towards consolidation at the level of either franchisees or the franchisor, or might itself have regulatory requirements with which the prospective franchisee is not equipped to cope. Many FDDs carry little if any of this information.

FDDs sometimes do not disclose the identity of the *ultimate* controlling parties behind the franchisor.

FDDs also do not provide sufficient information for a franchisee to compile a complete operating budget for the business, even though initial, pre-opening capital outlay requirements are spelled out. The assistance of a skilled accountant should be sought to develop a one- year and five-year operating plan.

The most glaring omission from most FDDs is disclosure of the financial performance history of the franchisor's other franchisees. For odd historical reasons, this crucial bit of information is still not a required disclosure.

The FDDs for many franchise programs leave it entirely to the prospective franchisee to locate his or her own sources of financing, find and acquire a site, and perform other similar critical start-up requirements.

The composition and quality of franchise offerings varies significantly from one industry sector to another, and even within sectors. Prospective franchisees owe it to themselves to shop aggressively before making a commitment to any particular industry sector or a specific franchise organization.

Other good sources of information to help find or evaluate a franchise offering are available to prospective franchisees. These sources include the following:

A given franchisor's FDD	State agencies (in Minnesota, Department of Commerce)
A competitor franchisor's FDD	Better Business Bureau American Franchise Association (Chicago)
Federal Trade Commission (Washington D.C.)	American Association of Franchisees Dealers (San Diego)
Franchisees of a given franchisor (listed in the FDD)	International Franchise Association (Washington, D.C.)
Professional advisors, such as an attorney or CPA	Public library

## **Cooling Off Provisions**

Because the law requires that the FDD be delivered no later than 14 days before the prospective franchisee signs a contract or makes any payment with respect to the franchise being offered, a franchisor cannot require its prospective franchisees to sign contracts, make deposits, pay earnest money, or make any other payment or commitment with respect to the franchise until the prescribed cooling off period of 14 days has elapsed. Once that time has passed and the franchisee has committed to acquire a particular franchise, the franchisor may then, if the practice is properly disclosed in the FDD, require the payment of deposits or prepayments of all or part of the initial franchise or other fees in conjunction with the execution of the franchise agreement, or perhaps a preliminary agreement governing the parties' working relationship until the franchise agreement itself is issued. Some franchisors will then ask the prospective franchisee to sign a confidentiality agreement. These practices vary significantly from one franchise offering to another, and the requirement that such a deposit or prepayment be made or preliminary contract be signed is not necessarily an indication that the franchise offering involves a high level of risk.

## **Financial Conditions to Registration**

In many cases, the Department of Commerce will condition the registration of franchise offerings by small, start-up, or otherwise undercapitalized franchisors upon the franchisor establishing an escrow account in a bank in Minnesota. Under such an "impound order," the franchisor is required to deposit all initial franchise fees into the prescribed escrow account under a three-party agreement between the franchisor, the bank and the Minnesota Department of Commerce. The initial fees are held in the escrow account until the particular franchisee has opened the franchise for business. The franchisor may then petition the Department of Commerce for permission to obtain a release of that franchisee's initial franchise fee from the escrow account. The Department contacts the prospective franchisee to ascertain whether all of the promised pre-opening services have been provided. If they have, the franchise fee will be released to the franchisor. But if the franchisee is dissatisfied with the level of support

service, the Department may intervene to investigate, or simply to freeze the escrow account until the franchisee consents to its release or until the franchisor can satisfy the Department that the franchisee is being unreasonable in refusing to allow the release of the funds.

The existence of an impound order requiring the creation of such an escrow account is not always properly disclosed in the FDD. Franchisees dealing with small, start-up or thinly capitalized franchisors should ask the Department of Commerce whether such an order is in place.

Instead of escrowing initial franchise fees, some franchisors facing an impound order may choose instead to post a bond with the State of Minnesota assuring compliance with the terms of the offering. These arrangements are not always properly disclosed in FDDs, so a prospective franchisee should ask the Department of Commerce whether such a requirement has been established in a particular offering.

A third alternative, which the Department of Commerce sometimes accepts, is for the franchisor to agree in writing to defer the franchisee's payment of the initial franchise fee until the franchised unit opens for business.

Impound orders or bonding obligations are meant to assure satisfactory completion only of pre-opening support services. They may not be relied upon for financial assurance in respect to ongoing operating support promised by a particular franchisor.

### **Other Contracts**

Each contract that a franchisee may be required to execute with the franchisor or the affiliates of the franchisor must be in the FDD. This allows cautious and comprehensive review of those legally binding contractual obligations in advance of making a commitment. If a franchisee later finds that the franchisor is requiring the franchisee to sign some other agreement beyond those set forth in the FDD, the franchisor may be acting in violation of the law.



## **Material Changes to the Form Agreement**

If the franchisor unilaterally makes changes to the Franchise Agreement or other contracts that are attached to the Disclosure Document which the franchisee will be required to sign, a final copy of the franchise agreement and/or other contracts must be disclosed to the prospective franchisee at least seven calendar days before execution. This requirement does not apply to changes initiated and negotiated by the franchisee, or to clerical entry of information such as names and addresses into blanks in a form contract.

## **Negotiating a Franchise**

A curious nuance of the franchise registration and disclosure process is the question of whether a franchise may be negotiated before it is signed. Unfortunately, state administrators in some states (other than Minnesota) have taken the position that once registered, a franchise offering is essentially locked in to precisely that form of agreement and that it is illegal for the franchisor to negotiate the terms of the franchise with prospective franchisees before signing the agreement.

This interpretation is not supported by the law. Prospective franchisees should consider themselves perfectly entitled to request modification of a franchise offering to deal with the particular business circumstance or needs of that prospective franchisee. This is certainly the case in Minnesota. There is no assurance that a franchisor will agree to negotiate the terms of a franchise; indeed, many do not. In most states, franchisors are under no legal duty to bargain over the terms. But there is no legal reason why a prospective franchisee should not at least ask whether the franchisor is willing to make appropriate modifications either to fine tune a franchise to the particular market or other circumstances faced by a prospective franchisee, or to remove or mitigate objectionable or overreaching terms of the form contract.

Ordinarily, even if a franchisor might be willing to make concessions in some areas, prospective franchisees should not expect any franchisor to modify the basic terms of the franchise, including the initial fee, royalty rate, and other fundamental or structural components of the franchise offering.

Except in California and North Dakota, a franchisor is not required to disclose or register subsequent changes in an existing franchise.

### **Additional Franchises**

A person who is already a franchisee in most cases is also a *prospective* franchisee in respect to an additional franchise in the same system or even a renewal franchise offered to him or her, even if the franchisee has had a long-term franchise relationship with that franchisor already. As a prospective franchisee in respect to the new or renewal franchise, the franchisee is entitled to the full benefit of the disclosures and cooling-off period required for any other franchise transaction.

### **Sales by Franchisees**

A franchisee selling its own franchise for its own account on an isolated basis (*i.e.*, neither as agent for the franchisor nor as part of a pattern of such sales) is exempt from the registration requirement. A buyer from that franchisee is **not** entitled to receive an FDD before or after closing on the sale. The buyer should request voluntary disclosure of a current FDD from the franchisor for background information even if the franchise agreement being transferred is on an older and different form of contract than the most current contract described in the current FDD. Only if the franchisor is closely involved in the transfer does it become a “seller” of the franchise, requiring it to make disclosure to the existing franchisee’s transferee. This can happen if the franchisor acts as a “broker” for the sale by advertising for the buyer, participates in the negotiation of the terms of the sale, or issues a new or replacement franchise agreement to the buyer.

## **FRANCHISE RELATIONSHIP REGULATION**

In addition to requiring registration and pre-sale disclosure for franchise offerings, Minnesota and some other states regulate to a limited extent the content of the franchise agreement and the conduct of the ongoing relationship between franchisor and franchisee. These regulations focus largely on the ending of the franchise relationship – whether by assignment, expiration or termination. Minnesota’s franchise relationship regulation is found in Sections 13 and 14 of the Minnesota Franchise Act and the regulations adopted thereunder. The advice of an expert franchise lawyer should be sought before trying to apply these regulations to particular facts and circumstances.

Like the registration and disclosure requirements, Minnesota’s relationship regulations reflect market circumstances that existed in the 1960s and 1970s. As such, they are somewhat out of date. Much of what they cover is no longer a concern in most sectors of franchising, and they fail to cover many of the areas that more recently have become matters of concern to many franchisees. These include encroachment, abusive sourcing restrictions, or management of system advertising funds. For instance, the relationship regulations prohibit termination of a franchise without “good cause,” substantial advance notice, and (in most cases) ample opportunity to cure a default. The need for this regulation is reduced given that arbitrary or abusive terminations of business format franchises are rare today, even in the large number of states that have no such laws on the books. But this prohibition still has considerable value to franchisees trying to resist what they perceive as an unjustified termination.

The franchise relationship laws and regulations do not assure franchisees of the competence, integrity, leadership, financial health, or survival of their franchisors. Thus, thorough “due diligence” in investigating a proposed franchise investment is always prudent. Nevertheless, the “unfair practices” sections of Minnesota’s relationship regulations do provide an unusually strong statement of a minimum set of rules by which the game of franchising is to be played.

Roughly seventeen states have laws and regulations that govern the franchise relationship. A handful provide comprehensive codes of regulations like Minnesota's, while most provide only limited protection in one or two specific areas, such as by simply prohibiting termination of a franchise without "good cause."

The FTC Rule does not regulate franchise relationships beyond the presale disclosure mandate.

### **Other Franchise Classifications**

Another matter that is outside the scope of this book but warrants brief mention is that Minnesota and many other states have special franchise and other related statutes that apply to a wide variety of industry classifications. Under the Minnesota Franchise Act itself, special sets of regulations are in force with respect to motor vehicle fuel franchises, burglar alarm franchises, hardware franchises, distributorships for beer and alcoholic beverages, farm implements, heavy industrial equipment, and motor vehicles. Manufacturers' representatives are also protected by a law that assures timely payment of earned commissions.

## **CHOOSING FRANCHISING AS A METHOD OF DISTRIBUTION**

### **PLANNING A DISTRIBUTION PROGRAM**

Businesses can choose among a wide range of distribution and expansion strategies. Sometimes, the choice is obvious. At other times, the choice is the consequence of an analytical process.

Every business faces core structural decisions: form of business organization, definition of strategic business goals, capital structure, and basic tax planning. Equally critical to any business or service organization is the choice of a method of distribution. Often subordinated to other issues, this decision has significant implications for the organization's allocation of resources, staffing needs, regulatory burdens, and ultimate success or failure. The need for careful analysis applies equally to product and service providers.

The characteristics, resources, and strategic objectives of a business sometimes dictate its method of distribution. Firms with ample capital resources may choose a vertically integrated system. Firms with sharply constrained capital often cannot afford vertically integrated systems or the regulatory and managerial costs of highly structured, regulated methods such as franchising. Firms with highly bureaucratic or autocratic decision making systems should not rely upon a distribution method that uses delegated entrepreneurial centers such as franchising or independent dealers. Firms in sensitive industries (health care, high tech, etc.) often try to avoid the risks associated with autonomous resellers such as independent dealers.

For most business organizations, the selection of a method of distribution turns on an analysis of the entity's goals and resources, and cost-benefit-burden trade-offs of the available alternatives. In some cases, the analysis may lead to a particular method only because other alternatives are less feasible or desirable. Franchising may be especially attractive if the business calls for rapid expansion, a structured or highly integrated distribution system, or expansion into a foreign or geographically remote area. Other choices that meet the same goals within the same resources (such as a "business opportunity" program, or costly debt financing for a vertically integrated approach) often appear decidedly less attractive than franchising.

If the choice is to use franchising, based on the factors outlined below, an enormous number of structures are available to establish a franchise program, affording a great deal of flexibility in tailoring a franchise distribution program to the exact goals and resources of that business. The more commonly used franchise structures include:

- Single unit franchises for a single location, or defined market area.
- Multiple unit franchises to develop a series of individual retail locations, usually in a defined market area, over a prescribed period of time.
- An area franchise in which a franchisor grants another the right to carry on the licensed business within a defined geographic market area.
- A franchise sales agent relationship, where a licensee solicits sales of franchises to others, but the resulting franchise runs directly from the franchisor to the retail operator.
- An area subfranchise relationship granting the right, within a specified geographic territory, to grant subfranchises to others to establish individual retail operations.

- Dual distribution systems in which the franchisor itself engages in distribution and retail sale of the goods or services that are also being offered by franchisees, either in adjacent market areas or sometimes even in the same market areas, but usually through a separate channel of distribution.

## **SUITABILITY OF FRANCHISING**

A business considering franchising in its analysis of alternative methods of distribution or expansion must assess the suitability of its choice for the product, service or business format it intends to distribute. The business should choose a method that advances its marketing goals. If the company is primarily involved in manufacturing and selling a product, even under a brand identification that is important to the manufacturer, franchising may not be the most appropriate method. In many such cases, the commercial goals and distribution needs of the producer do not require, or justify, the level of involvement and control (and the resulting regulatory costs and burdens) of franchising. A franchise might be appropriate, however, if the marketing plan entails a relatively high degree of control of or participation in retail operations, greater brand prominence as an identification device at the retail level, or a more closely integrated product support function at the retail level.

Franchising is more likely the appropriate choice if the prospective franchisor's main goal is to prescribe a business format – even if the franchisor intends to supply goods or services to the franchised businesses. In those cases, alternatives are available such as providing consulting services or licensing intellectual property rights apart from any brand identification.

## **ADVANTAGES AND DISADVANTAGES OF FRANCHISING**

Franchising affords significant benefits, but also brings considerable costs and risks compared to other methods of distribution. The costs and regulatory burdens associated with franchising make it a poor choice for a very small-scale program or short duration efforts.

It is very difficult to test market a franchise program. Entry barriers in the form of regulatory hurdles are high, and exit barriers in states with harsh anti-termination laws are extremely challenging.

### **Advantages of Franchising**

Franchising allows the *rapid expansion* of a distribution network. Because franchising entails the application of capital, managerial talent, and personnel resources of independently owned franchisees, it permits growth of a distribution system more rapidly than would be possible if the manufacturer relied on its own capital and personnel resources. Regulatory compliance may slow this effort down, but it may still be a faster growth vehicle than a vertically integrated business or a system comprised of unaffiliated distributors or dealers.

Franchising requires the commitment of *lesser amounts of capital* to a distribution system than methods such as vertically integrated schemes, joint ventures or other forms of shared equity arrangement. This can help a manufacturer's own financial and capital structure and allows a greater proportion of its resources to be devoted to its manufacturing, marketing, and administrative needs. Less structured methods (dealerships, sales agents, etc.) may require much less capital investment than a franchise program. Lesser capital requirements do not mean low or no capital. Indeed, startup franchise programs often require \$50,000 to \$100,000 or more in capital on their own.

Franchising involves application of the *management skill and loyalty* of a dedicated owner-operator. The franchisee has a direct, substantial, and continuing personal and financial stake in the success of the franchised business. This is not always true of hired managers, and is unpredictable in independent dealers who may have other interests. A franchised business therefore often reflects a greater level of intensity of management at the retail level. In many lines of business, the reduced labor cost that results from personal managerial involvement by a franchisee can be the difference between the commercial success or failure of the franchised business.



The franchisee's personal stake and involvement also has a downside if the franchisee's expectations and aspirations are not met. If that occurs, the franchisee may experience an intense disaffection for the franchisor and its program, which may exceed that of a fired manager or terminated dealer. The personal and financial stake of the franchisee-investor thus can be a two-edged sword. This risk can be a serious barrier to an organization discontinuing the use of franchising. It definitely represents an ongoing administrative and managerial challenge to the franchisor, sometimes on a daily basis.

Franchising usually reduces the **cost of compliance** with the myriad local legal requirements for operating a retail business, such as payroll taxes, foreign corporate qualification, sales and use tax permits, employment laws, environmental compliance, zoning laws, local licensing requirements, and local consumer protection rules. These compliance obligations can be a significant burden to companies engaged in multi-state or international distribution. Unlike some other methods such as vertical integration or use of sales agents, franchising shifts the cost and responsibility for compliance with these requirements to the local franchisee. Ordinary dealership and distributorship programs can also shift these burdens and risks, and at a lower cost to the producer than through franchising.

Franchising also offers significant **advantages to the franchisee**. This can make a franchise a more attractive investment vehicle to the franchisee-investor. Franchising offers the franchisee instant trade identification through use of the licensed trademark. It also generally offers professional training, marketing assistance, a proven operating system, on going system support functions, and enhanced resalability compared to running an unaffiliated business.

Downsides of a franchise to the investor, as compared to some of the other alternatives, include higher costs associated with franchise fees, the risk of encroachment by other outlets of the franchisor, sourcing restrictions that may impose supra- competitive costs, and vulnerability to mandatory reinvestment in the franchised business. Further, many

franchise programs are characterized by an overbearing intrusiveness in entrepreneurial decision-making. Other choices, even acting as an independent dealer, can combine some degree of equity appreciation and hedging of business risk without the costs and hassles that accompany a franchise. The choice is an entirely subjective one for the franchisee.

Other characteristic disadvantages include the cost of the fees paid to the franchisor; the difficulty associated with relocating or reformatting the business; significant hurdles to selling the business; risks associated with highly restricted, or non-existent, renewal rights; costs associated with restricted sourcing of equipment and supplies; and a panoply of other problems flowing out of often one-sided contracts favoring the franchisor.

On balance, however, these considerations suggest that franchising can be an exceptionally effective means of expansion – especially into a foreign or geographically remote market, and even for a foreign enterprise entering the U.S. market.

### **Disadvantages of Franchising**

Franchising also has several distinctive disadvantages. These include certain risks and cost factors not found in some other methods of distribution. Industry propaganda about franchising rarely addresses these features, which are not always apparent to or carefully analyzed by inexperienced franchisors or their attorneys.

The manufacturer's or distributor's *managerial discretion is more limited* than in a vertically integrated system with respect to controlling retail pricing, redistribution of products, tie-in and full-line marketing, and exclusive dealing. For companies that believe that retail pricing, controlling redistribution of their output, or other highly restrictive marketing techniques are indispensable aspects of their marketing plan, franchising is probably not an appropriate method. This is partly due to the risk of violating state and federal antitrust and trade regulation laws by imposing such controls on independent franchisees.

Franchising is an increasingly **regulated form of business** activity. Franchise regulation is expected to grow, not diminish. Franchise registration in some states may be conditioned on compliance with unpublished, undiscoverable regulations imposed as “policies” by franchise law administrators. Courts have not developed an entirely consistent and predictable body of common law dealing with franchise business relationships. Regulation and occasional litigation, however, are not unique to franchising, and this is rarely a dispositive consideration. Certainly, many hundreds of franchisors have navigated these waters successfully. Because of state laws governing termination and renewal rights, however, franchising is an awkward choice if the producer’s intent is to enter into a short-term program or a “test” program of any kind, or if the producer anticipates the possibility of discontinuing a franchise program in one of the many states with franchisee- protective anti-termination laws. The overhead and ongoing administrative costs of franchising can be a significant problem for firms that are unfamiliar with the area. These concerns, both regulatory and scale, often suggest that franchising, despite its advantages, is simply not worth the “price” to some prospective franchisors or for particular marketing efforts.

Franchising can be relatively **inflexible over longer periods** in rapidly changing competitive, regulatory or technological environments. Because of the nature of the franchise relationship, the long-term contracts that govern the relationship, and the investment commitments and legal independence of franchisees, it can be difficult for a franchisor to make significant or rapid changes in the trade identification, operational method, product mix, retail image and marketing strategy that constitutes the franchise program at its inception.

Franchisors may find themselves subject to **concerted** and sometimes hostile **franchisee actions**. This can be expressed through various means including independent franchisee associations, franchisee- sponsored advisory councils, franchisee- operated cooperative buying associations and private labeling programs, franchisee bargaining groups, franchisee legislative advocacy, or class action lawsuits.

Franchisors must be especially vigilant of **trademark infringements** and misuse by their own licensees and others. Business format franchisors in particular must be aware of the ongoing legal steps necessary to protect their trademarks against misuse, infringement and dilution. Experienced professional trademark advisors must be engaged in this effort.

Franchisors have a growing exposure to **vicarious liability** for the torts of their franchisees. While this risk ordinarily can be insured, usually at the expense of the franchisee, it is a phenomenon that many franchise programs are not economically structured to reflect. It is also a risk to which some other forms of distribution arrangements are not subject, especially to the same degree.

Only certain **“personality types”** make good franchisors, whether as individual entrepreneurs or mature corporations. A successful franchisor recognizes the collaborative nature of the franchise relationship, and respects the investment objectives and aspirations of its franchisees. Dictatorial command-oriented firms will not succeed in franchising.

**Public disclosure of sensitive information** can be a strong disincentive to franchising. Much inside information can become available to competitors. Companies with weak financial statements, unfavorable litigation histories, a record of a past bankruptcy or reorganization (or involvement in management by individuals with an unfavorable litigation or bankruptcy history), a poor track record of getting franchisees open for business, or a history of termination and non-renewal of franchises may find it difficult to draft an FDD, or, having done so, to sell their franchises. The FDD is disclosed on the public record once it is registered in one of the registration states. This includes the financial statements of the franchisor together with all the other information required by the FDD guidelines, including information concerning the structure and method of operation of the company’s distribution program.

Historically, public regulation of the offer and sale of franchises has not meshed well with other (and usually much older) public **regulation of substantive business activities**. This is most notable in such fields as mortgage banking, optometry, real estate brokerage, law, medicine, accounting, and securities. Franchised distribution systems in these and other licensed or regulated trades are challenging to plan and implement safely and effectively.

A similar disincentive to franchising can occur in particular industry segments which either have had a **previous bad experience** with franchising or have had no prior experience whatsoever with franchising. In these sectors, prospective investors may regard franchising with suspicion.

## FRANCHISEE CONSIDERATIONS IN EVALUATING A FRANCHISE

### ADVANTAGES AND DISADVANTAGES OF A FRANCHISE

The “turn key” nature of many franchise offers can be quite alluring to a prospective investor.

Franchise industry propaganda paints a rosy picture of franchise investment opportunities. A franchise program may provide the franchisee with potentially significant advantages compared to the start-up of an independent small business. That said, there are also several distinct disadvantages and risks in owning a franchised business. There is no business sector in which a person must buy a franchise in order to start a business. If one chooses to cook hamburgers for a living, one need not pay substantial amounts of money to one of the recognized national hamburger restaurant franchisors to do so. Still, many well-informed and intelligent investors line up for the opportunity to do so based on their perception that there is a *quid pro quo* – a true trade-off of values to be derived from the franchise that justifies the fees and other burdens involved. This section summarizes some of those advantages and disadvantages from the prospective franchisee’s perspective.

#### Advantages

By investing in a franchise of an established chain, a franchisee acquires access to the ***distinctive trade identification*** of the franchisor in the form of the licensed trademark or other commercial identification used by the franchised business. In most circumstances, this provides an advantageous head start on acquiring goodwill in the marketplace (*i.e.*, trade recognition by potential customers). In many cases, however, especially when dealing with franchisors who are themselves in a start-up mode or perhaps just newly entering the Minnesota marketplace, the shared trade identification will be of limited value (at least until that particular brand establishes itself in the marketplace).

Trade identification, however, is a two-edged sword. In rare cases, a brand identification carries negative goodwill in the marketplace, which actually can be a strong disadvantage to the franchise. A new franchise may thus be in trouble from day one if the brand is declining through age or mismanagement, or it has acquired a justified bad reputation in a particular market based on bad performance by the franchisor or by earlier franchisees. Prospective investors should always engage in careful pre-purchase investigation of a franchise offering in their intended market area, as well as generally.

The synergism that results from ***being part of a larger chain*** of merchants carrying common trade identification can sometimes provide an additional competitive edge for the investor that is not obtainable from an independent small business. But chains can pull in two directions. As such, if public recognition of the chain turns unfavorable, the chain identification and synergism can work to the franchisee's detriment.

Most franchise programs provide the franchisee with the ***developed expertise*** of the franchisor. This occurs both in the business being franchised and in some of the areas of common support services described later. At its best, this expertise will provide the franchise investor with a roadmap for getting the franchised business up and running. This will help the investor avoid many of the trial-and-error mistakes that an independent, small business operator might otherwise commit due to the learning curve associated with starting up a new business.

An advantage promised by most franchisors and delivered by some is ***expert site evaluation*** and site selection assistance. Many first-time business investors lack real estate and marketing expertise sufficient to enable informed selection of suitable site locations for a new business. A capable franchisor may be able to provide that assistance, in some cases going so far as assisting in the negotiation of acquisition terms or lease terms. A small minority of franchisors will go further still, providing financial assistance relative to site selection by agreeing to acquire or lease the site for the franchised business.

A major value of many franchises is a ***proven operating system*** shared with the franchisee, presumably mastered by the franchisor through its own or its franchisees' efforts and experience. The operating system is usually conveyed to the investor in a pre-opening training program, an operations manual and other communications from the franchisor. Operating systems in franchised businesses vary significantly from one franchisor to another in their sophistication, scope and value.

Most franchise programs also offer ongoing ***operational support*** from the franchisor. Support may include pooled purchasing of inventory, supplies, insurance, or other inputs into the franchised business, as well as various research and development functions. Operating support almost always includes various forms of advertising and marketing assistance. As with many other features of a franchise, the composition and quality of operating support services varies greatly from one franchisor to another. This occurs even within a single industry sector and certainly between different industry sectors. Again, careful investigation and aggressive shopping are both required for a prospective franchisee to identify a suitable franchise program offered by a franchisor with a successful track record. Not every franchisor consistently delivers what it promises, and not every support service is worth its cost to the franchisee.

A franchised start-up business may be ***more "bankable"*** than an independent business start-up. A growing number of banks and other financing sources are showing greater willingness to finance franchised businesses. When a franchisee sells the franchised business, a prospective buyer may be more willing to buy a business that is part of a recognized and successful franchise organization than an independent operation (which may be highly dependent upon the personality and public recognition of its individual owner for its success).

### **Disadvantages**

In spite of the many advantages a franchise promises its owner, almost every franchise also has a number of features that are disadvantageous to the franchisee as compared to the independent small business owner. These include the following factors.



Every franchise is **part of a controlled group**. Many of the entrepreneurial management decisions that would be within the discretion of the independent business owner, in a franchise are reserved and exercised by the franchisor. The franchisee is part of a team, not an entirely independent business. While the capital investment, managerial effort, and the ultimate risk or reward of the investment still lie with the franchisee, many of the important decisions at both a strategic and tactical level will be made by someone else. That creates a potentially substantial vulnerability on the part of the franchisee to the insight, research, wisdom and judgment of the franchisor.

Investors who can't function well as team players generally do not make successful franchisees. Individuals who depend upon others to make decisions are generally better off working as employees in a traditional corporation, while individuals who are so independent or free-spirited that they cannot accept important decision-making by others are probably better advised to seek out their own independent business opportunities.

A growing proportion of franchise organizations afford member franchisees an institutionalized **role in system governance**. Such a role entails participating in decisions regarding the franchise system which can affect the outcome of the franchisee's investment in the system. These mechanisms are highly beneficial to the franchisee and the system as a whole. The prospective franchisee should inquire about the existence of an independent franchisee association within the system and how it interacts with the franchisor. Inquiry should also be made regarding the existence of independent purchasing or advertising cooperatives, which may be available to system franchisees. The FDD may or may not report information concerning co-ops or independent franchisee associations.

**Cost** is another disadvantage to franchising. Franchises almost always entail substantial fees, which constitute both an ongoing cost burden and often a structural competitive disadvantage. No one is under any legal obligation to pay fees to a franchisor in order to start up an independent business in any particular line of business. Before committing to pay

substantial fees to a franchisor, a prospective franchise investor should satisfy himself that the value to be derived from the franchise offering is commensurate with the fees to be paid over the life of the franchise.

A franchise is also a relatively **immobile business**. Because the franchisor has a legitimate interest in controlling where its retail outlets will be located and in what markets they will operate, definition of the site or market boundaries of the franchised business is rarely left to the discretion of the franchisee. This can become an especially acute problem if the franchisee decides that the business should be relocated for any reason. Relocation may or may not be possible in a franchise system, or may be allowed only with burdensome conditions.

The **ability to resell** the franchise also may be impaired by the terms of the franchise agreement. A proposed transfer of the franchise or of its business assets ordinarily draws close scrutiny by the franchisor before the business may be sold to another. The facility may have to be upgraded to current system standards. Franchisors also have a legitimate interest in regulating who their franchisees will be, and usually reserve the right to require that their consent be granted before a transfer may occur. Consent may depend on subjective factors such as the experience or financial qualifications of the proposed transferee. Transfer fees, sometimes sizeable, are imposed in many franchise offerings. Franchisors also frequently reserve a right of first refusal to match an offer by a third party to acquire the franchised business. This can be a significant impediment or deterrent to some prospective purchasers. Some franchise contracts do not allow the seller even to assign his or her own franchise, but require the buyer to sign a new, different, and possibly less advantageous franchise contract.

A franchisee suffers from **vulnerability to factors beyond his or her control** in areas that can have a profound impact on the success of the business or the satisfaction or profit the franchisee derives from it. These areas include vulnerability to the other franchisees' performance and the quality and value of the franchisor's operational performance. This factor is often missed altogether or downplayed by inexperienced prospective franchisees.

The ***shared brand identification*** of the franchisee's business can have negative implications. If others in the system in the same or nearby markets do a poor job, the public ill will that ordinarily attaches to such performance may be transferred to the franchisee despite his or her own good efforts in running his or her own business. Bad publicity from another franchisee's breakdown (or the franchisor's), such as a food contamination issue, can severely injure the business of an innocent franchisee in the same brand.

Many franchise agreements allow for ***competitive encroachment*** by the franchisor or its affiliates through new nearby outlets, or distribution of competitive products through other channels of distribution under the same brand identification used by the franchisee. This can be a very severe risk to a franchisee because its own franchisor can become a primary competitive threat to the franchised business. For the most part, courts have not protected franchisees against this very serious problem.

In the long run, every franchisee is extremely vulnerable to the overall commercial performance of their franchisor. If the franchisor fails financially, the consequences can be catastrophic for system franchisees.

This vulnerability extends both to the conduct of the business that is being franchised and to the franchisor's skills in administering its franchise relationships. These are two entirely separate but closely linked areas of concern. Franchisees have no assurance that personnel shifts will not occur in the franchisor, which can result in the loss of people upon whom the franchisee relied in making the investment commitment.

Ownership of a franchisor also can transfer unexpectedly. A founder may decide to sell out, perhaps by making a public offering of stock or by selling out to a larger conglomerate organization. A publicly traded franchisor may be taken over by another business. It is not unheard of for a franchisor to be acquired by one of its key competitors. These types of change in control may result in significant changes in level or quality of service support, levels of capital appropriated to the business, competence of the personnel assigned to franchisee service functions,

or redefinition or redirection of the business. It may result in diverted or nonexistent loyalty if the new franchisor already owns a competitive business (whether franchised or not).

In some franchise systems, franchisors have been unresponsive to **changes in market circumstances**, or have created contractual arrangements that do not enable the system as a whole to change in response to changing market circumstances. This may result in inflexibility to changing competitive, technological, or regulatory circumstances that can harm the success of the franchisee's business.

The franchisee's **purchasing discretion** is likely to be restricted in most franchise systems. If this power is abused or used opportunistically by the franchisor, a material adverse impact on the franchisee's financial results can occur. Franchisors have a legitimate interest in controlling the nature and quality of goods and services provided under the franchisor's brand identification. Most systems express this by means of restrictions as to the type, brand, or origin of products and services purchased by the franchisee for use in the franchised business. Some franchises go beyond this to control the sources from which franchisees obtain equipment and supplies for the franchised business. This may deprive the franchisee of the benefits of shopping aggressively for various types of equipment and supplies used in the franchised business. This concern is alleviated in systems that have purchasing cooperatives, especially co-ops controlled by the franchisees, which allow franchisees to obtain equipment, fixtures, ingredients, supplies and other inputs to the business which meet the franchisor's standards and specifications, but to procure them from independent, competitive sources.

**Covenants against involvement in other businesses** are a feature of many franchises. These contract clauses restrict or prohibit involvement by the franchisee in outside or competitive businesses during and for some period after the term of the franchise. This can become an especially burdensome restriction if growth opportunities within the franchise system are not generally available, leaving the franchisee with few choices for reinvestment and growth.

Franchises are often promoted as a means of reducing the financial risks of business ownership. A small but persuasive body of academic research shows that franchised small businesses often have **lower profitability, higher costs and a greater risk of business failure** in their first five years of operation when compared to similar but non-franchised small businesses. This is not necessarily true of all franchise offerings. Still, it underscores the need for the investor to be diligent in investigating a franchise offering both as to the franchise program itself and as to the soundness of the underlying business that is the subject of the franchise offering.

## **HOW TO EVALUATE A FRANCHISE OFFERING**

Balancing all of the theoretical advantages and disadvantages of franchises – plus whatever other considerations may arise in respect to a given product or geographic market, the idiosyncrasies of a particular franchisee-investor, and the characteristics of a given industry sector or franchisor – is a challenging task for each prospective franchisee. The franchisee must evaluate his or her own suitability to function as a franchisee and must assess the merits of each franchise offering he or she considers. There is no such thing as too much due diligence for a prospective franchisee.

The franchisee-investor must make a thorough and careful assessment of the price-value relationship between the franchise fees charged by a franchisor and the package of services offered. The prospective franchisee should carefully compare other franchise offerings in the same industry sector as well as offerings in other industry sectors involving comparable levels of investment. This will help the investor assess whether the particular features of a given franchise offering are representative or whether a particular offering may be above or below the norm being offered in that industry, or in franchising generally.

Other sources of information available to a prospective franchisee (beyond the franchisor's FDD) were discussed earlier. These sources include the FDDs of competing franchisors and franchisors in other industry sectors, the annual report of a publicly traded franchisor, interviews with other franchisees in the system, inquiry of public agencies, and even basic economic research in the public library. This type of information can be obtained from other franchisees, the investor's own professional advisors, attendance at trade shows, asking the Better Business Bureau for a business experience rating of the franchisor or its local franchisees, and trade associations – either in the particular industry sector involved or the International Franchise Association in Washington, D.C., the American Franchise Association in Chicago, or the American Association of Franchisees and Dealers in San Diego. [“A Consumer's Guide to Buying a Franchise”](#) is available from the FTC. The FTC can be contacted at 877-FTC-HELP or 600 Pennsylvania Avenue, NW, Washington, D.C., 20580.

The assistance of an *experienced*, professional franchise advisor – whether a lawyer, CPA or trusted business advisor – is indispensable for the evaluation of any franchise offering.

### **Risk Factors**

Certain external risk factors not covered by most FDDs should be taken into account before making a franchise investment. The prospective franchisee should consider that franchise offerings involve a range of risk that runs from blue chip offerings, to competent but not nationally prominent franchisors, to high risk but honest startups and very small franchisors. A few offerings also descend into very dangerous areas populated by severely undercapitalized franchisors, marginally qualified franchisors, and the occasional outright crook who appears with a “franchise” deal.

The recent track record of the franchisor and its franchisees (especially new franchisees) is probably the most reliable single indicator of the near-term prospects of the franchise offering. A track record, however, does not by itself provide assurance as to the franchisor's long-term prospects.

The franchisor may suffer a simple reversal in competitive fortunes or might be taken over by an incompetent, competitive or disinterested new owner.

Industry trends and experience are also important. One would be reluctant to acquire a franchise, however well capitalized and competently managed the franchisor might be, in an industry sector suffering rapid decline in consumer popularity. Tales of well-structured “buggy whip” franchises abound.

Another risk factor often overlooked by an enthusiastic prospective franchisee is the absolute level of investment required. The FDD’s disclosure of the investment commitment necessary to open the franchised business is never the end of the spending. Significant additional investment in facilities may be required to deal with Minnesota’s climate or local zoning or permit requirements. Substantial further outlays are necessary simply to operate the franchised business. Business assets also wear out and will need to be replaced, requiring still further investment obligation. Some franchisors are also significantly more aggressive than others in requiring reinvestment by their franchisees through remodeling or even relocation requirements. Franchisees should guard against becoming overextended financially.

Like any business, franchises are rarely profitable in their first few months or year of operation. Allowance must be made for the costs necessary to support the business during its start-up phase, including personal living expenses of the investor.

A prospective franchisee should carefully evaluate the other types of change that inevitably occur that could significantly impact a particular line of business. Rapidly evolving technological change, vulnerability to significant regulatory change (as has happened in some industries which have become deregulated in the last decade) and businesses that may be vulnerable to being cloned by aggressive competitive organizations may provide unusually high and unacceptable levels of risk to an investor.

Similarly, franchises that are vulnerable to a single source of supply for a key product or ingredient will present a much higher level of risk than some other types of franchised businesses which are not dependent upon single sources of supply for critical products.

A person considering the acquisition of a franchise should also consider buying an established franchised business from an existing franchisee. Access to these opportunities is frequently possible through real estate brokers, the franchisor itself, or local business journals. In such a case, the franchisee will be paying the going concern value for an existing business with a known performance at a given location, but will avoid the uncertainties and delays inherent in starting up a new franchised business.

### **Upside Opportunity**

In addition to considering a franchise opportunity's risks and downside, a franchisee should also consider the upside opportunity value. Various means are available to provide some growth opportunity within a franchise organization. These include such vehicles as acquisition of area franchise rights or multiple unit development rights within a prescribed market area. Investors will find that franchisors in a start-up mode, or just entering a geographic market, will be much more interested in granting such developmental opportunities than will established franchisors with mature systems. Franchisees are often successful in negotiating options for additional franchises or other forms of additional development rights – either in conjunction with the acquisition of the original franchise or after the franchisee has established its own track record in successful operation of the franchised business.



A franchisee should examine the FDD and Franchise Agreement to determine:

- whether the franchise is vulnerable to encroachment by other franchised or franchisor-owned outlets;
- whether the franchisor or its affiliate is distributing - or may come to distribute - identical goods, or goods identified by the same brand, through other channels of distribution; and
- whether the franchise agreement entitles or may compel the franchisee to expand or contract the menu of goods and services the franchisee is to offer periodically.

A franchisee may wish to bargain for rights of access to such expanded or innovative distribution programs.

Franchisees should pay especially close heed to the duration of the franchise and whether any extension or renewal rights are granted in the franchise agreement. If renewal rights are granted, on what terms may they be exercised? A “renewal” right that requires execution of a new franchise agreement on such terms and conditions as the franchisor offers in the future may be no more than a blind “put” to the franchisee and constitute more of a risk than a benefit.

## **RIGHTS WHEN THINGS GO WRONG**

Both franchisees and franchisors have a variety of legal and contractual means available to rectify problems that inevitably arise in franchise systems.

### **FOR A FRANCHISEE**

The franchisee who experiences a serious problem with its franchisor should turn first to the franchise agreement for an understanding of what rights and remedies may be provided for problems the franchisor anticipated when the franchise agreement was drafted and sold. The difficulty for the franchisee, however, is that to the extent that a franchisor can anticipate problems, its lawyers will usually draft provisions to deal with them that tend to be biased in its favor. Problems that the franchisor failed to anticipate, almost by definition will not be covered by the franchise contract, leaving the franchisee to seek other and more uncertain means of recourse.

Fortunately for franchisees in Minnesota, the state franchise law and regulations provide strong protection for Minnesota franchisees in certain areas. A prospective franchisee should become familiar with these regulations to understand what ground rules Minnesota law provides for various circumstances.

It goes without saying that in this area, as with many of the other areas touched on in this book, consulting an attorney, preferably one experienced in dealing with franchise matters, is highly advisable in any circumstances that have created a significant problem for the franchisee. While most problems that arise in a franchise system are business problems that should and can be dealt with effectively through the ordinary business relationship between franchisee and franchisor, the

franchisee still may be able to deal more effectively with problems, even within ordinary business channels, by having a better understanding of what the franchisee's legal rights and responsibilities are in a particular circumstance.

In this sense, franchisees must remember that franchise problems, like problems in any other area, can be dealt with most effectively if they are addressed constructively. Methods that usually don't work include harsh or adversarial demands on their franchisor, or running to a public enforcement agency at the first sign of trouble. Methods that sometimes do work, however, include a constructive, if frank and forceful, approach to the appropriate officials of the franchisor organization with a clear articulation of the franchisee's needs and goals. This approach must also take into account and accommodate the legitimate business and legal interests of the franchisor.

Working collectively with other franchisees can be quite effective – either on an ad hoc basis or through a franchisee organization – if structured along the same constructive, business-oriented lines.

## **FOR A FRANCHISOR**

Franchisors have various means available to solve problems with franchisees, even though the franchisee is the beneficiary of the relationship regulation enacted by the State of Minnesota.

First, the franchisor, like the franchisee, must turn to the franchise agreement to ascertain what contractual rights and obligations may apply in a given set of circumstances. A healthy measure of judgment is also indicated to assure that contractual rights are only exercised in a prudent and appropriate manner. Just as a pedestrian may have a legal right to step off the curb into a crosswalk, but would be prudent not to exercise that right arbitrarily, a franchisor may have ample legal recourse under its franchise agreement in a particular set of circumstances, but be better advised to work with the franchisee or a franchisee association on a business level, or through some other less forceful means to resolve a problem.

Most legitimate power exercised by a franchisor beyond the literal terms of the franchise agreement derives from the Federal Trademark Act of 1946, known as the Lanham Act. Accordingly, franchisors should consult frequently with their trademark counsel not only to help create the franchise agreement in the first place, but also to understand how and when the rights accorded to the owner and licensor of a federally registered trademark might be helpful in dealing with problems with a franchisee.

Termination and litigation rights held by a franchisor can be powerful and effective tools when used in appropriate circumstances, but are regarded by most responsible franchisors as methods of last resort in dealing with problems with franchisees. Because termination of or refusal to renew a franchise are closely regulated by the Minnesota Franchise Act, a franchisor should never undertake either of these ultimate steps without first consulting its franchise lawyer.

## ABOUT THE AUTHORS

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Mr. Selden is a shareholder and head of the Franchise Practice Group of Briggs and Morgan, P.A., in Minneapolis, Minnesota. He was chairman of the American Bar Association's Forum on Franchising from 1985 to 1989; editor of the *Franchise Law Journal* in 1983-84; and a member of the Forum's Governing Committee from 1983 to 1989. Mr. Selden was the reporter of the Uniform Franchise and Business Opportunities Act promulgated by the National Conference of Commissioners on Uniform State Laws, and is a member and former Chairman (1983-87) of the Industry Advisory Committee to the Franchise Regulation Committee of the North American Securities Administrators Association. Mr. Selden was an accredited delegate of the International Bar Association to the UNIDROIT conference on a model international franchise law. Mr. Selden's law practice involves representation of regional, national and international franchisors, national and global franchisee associations, and franchise system purchasing cooperatives.

He has published articles on franchising and other topics in the *Franchise Law Journal*, *The Wall Street Journal*, *The Business Lawyer*, the *IFA Franchise Legal Digest*, and other publications, and has spoken at numerous programs on franchising and antitrust issues sponsored by the Forum on Franchising, International Franchise Association, Practicing Law Institute, Minnesota (and other states') continuing legal education, and the ABA Sections on Antitrust Law, and Patent, Trademark and Copyright Law. Mr. Selden was chairman (1994-96) and is a member of the board of directors of the Better Business Bureau of Minnesota. He is listed in *The Best Lawyers in America*, and has been selected as a "Leading Minnesota Attorney."

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Ms. Gipson is a shareholder and member of the franchise practice group, and trade regulation and business litigation sections at Briggs and Morgan, P.A. She concentrates her practice principally in the areas of franchise and distribution law. Ms. Gipson represents franchisors and manufacturers in litigation involving claims for violations of state franchise acts, special industry and dealer acts, antitrust claims, and breaches of contract. She also counsels franchisors throughout the registration and disclosure process and provides advice regarding distribution strategies to avoid inadvertently creating a franchise. Ms. Gipson has spoken on the topic of franchise relationship statutes at the American Bar Association's Fundamentals of Franchising Program. She is a *magna cum laude* graduate of the University of Minnesota Law School, where she was elected to the Order of the Coif. Ms. Gipson has been named a "Rising Star" by *Minnesota Law & Politics*.

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ISBN 1 888404-48-5