

## **BASIC LEGAL CONSIDERATIONS IN FRANCHISING**

Franchising continues to grow in popularity as a method of investment for individuals that are either looking to start a new business or expand their existing business. The franchise relationship typically consists of two main parties: the owner (the Franchisor) of a system that sells and distributes products and/or services under a common name using a specific marketing plan or scheme (the System); and the investor (the Franchisee) in the System who desires to individually own and operate a separate franchise location using the System. There are a number of legal considerations surrounding the franchise relationship which must be considered to help ensure the greatest chance for success in franchising.

Under Federal law and the laws of those states that have franchise disclosure statutes, a "franchise" by definition must have three essential elements before a business relationship will be considered a franchise. These elements include:

1. The right to sell or distribute goods or services under a marketing plan or scheme; and
2. The sale or distribution of the goods or services is substantially associated with a trademark, trade name, service mark, commercial symbol/logo or specific form of advertising; and
3. The payment of a direct or indirect, initial or continuing fee for the right to sell the goods or services.

If all of these elements are present in a business relationship, a franchise exists, and the laws pertaining to franchising must be followed. While state laws may set forth separate rules and regulations for franchises, the Federal Trade Commission (the FTC) also regulates franchises on the Federal level under applicable FTC rules. All franchises are required to adhere to these state and Federal laws. Among them, before a Franchisor may sell a franchise, the franchise must be registered in the state and have all required franchise disclosure documentation prepared for Franchisees.

The two primary documents the Franchisor must prepare and register for the franchise are the Franchise Disclosure Document (the FDD) and the Franchise Agreement. The FDD is a set-format 23 Item document whereby the Franchisor discloses a number of specific aspects of the franchise to potential Franchisees, including background information on the business and Franchisor, litigation, estimated fees and total investment, obligations of the Franchisor and Franchisee, the territory, all trademarks and other proprietary information, the ability to renew, terminate and transfer the franchise, and a detailed list of all existing franchise locations, among various other requirements. The Franchise Agreement is the legal contract between the Franchisor and Franchisee for the purchase and operation of the franchise, which provides a contractual basis for the relationship between the Franchisor and Franchisee. In addition, the Franchise Agreement should have adequate controls to ensure the integrity and consistency of the System amongst Franchisees, including the requirement to purchase goods or services from designated suppliers, following specific marketing plans and operating procedures, establishing reporting requirements, and addressing termination and renewal procedures.

From the Franchisee's perspective, prior to entering into a franchise relationship, the Franchisee should perform a due diligence analysis of the franchise to "validate" the System. At a minimum, the due diligence analysis should include: reviewing the FDD; contacting the Franchisor and existing Franchisees; performing independent research; determining costs for establishing the franchise; creating a business plan and/or pro-forma; securing adequate financing (including personal living expenses for the Franchisee until the business "cash-flows"); performing a legal review of the FDD, Franchise Agreement and other legal documents; and, creating a legal entity for the operation of the franchise, among other things. Some Franchisees may have other legal concerns, such as the establishment of appropriate investment documents where multiple investors are involved, addressing the legal issues in purchasing or leasing commercial real estate and/or equipment, and various ongoing legal matters surrounding the Franchisee's relationship with its customers, employees and the Franchisor.

The legal issues surrounding both sides of the franchise relationship can be complex, so Franchisors and Franchisees should strongly consider retaining the assistance of an attorney experienced in franchise law to assist them in this process.