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What is Franchising, Anyway?

Franchising presents a tremendous opportunity that allows a business to expand. As a business model, it provides significant benefits to brands looking for rapid expansion as well as entrepreneurs and investment firms looking to diversify their investment portfolio. Franchising, however, is heavily regulated both at the state and federal levels. The essential franchise business model and regulatory scheme are outlined below.

The fundamental business model of franchising is as follows: The owner of a brand—the *franchisor*—enters into an agreement through which it licenses its (i) trade name and (ii) business operating system to an operator—the *franchisee*. The franchisee, in turn, agrees to operate the licensed business—the *franchise*—in accordance with the contract between the franchisor and franchisee—the *franchise agreement*. In exchange for the opportunity to utilize the trade name and business operating system, the franchisee typically pays to the franchisor an initial franchise fee and a continuing royalty fee often based on gross sales. It is also important to note that the franchisor may also operate, and continue to develop, its own non-franchised locations—*company-owned units*.

The brand is the most valuable asset of a franchisor, and (typically) why franchisees decide to open a franchise. A key feature of a successful brand is the consistency amongst all of the franchised and company-owned units. After all, consumers go to a McDonald's restaurant without placing any regard on whether the specific McDonald's restaurant they visit is a franchise or a company-owned unit. Consumers expect the same products or services because of their familiarity with the brand. Consequently, most prudent franchisors exercise extensive control, and issue detailed instructions, over how the franchise is to be operated. The aim of such control is to ensure that a customer who visits a McDonald's in California will have the same experience when they visit a McDonald's in Washington, DC.

There are many benefits to franchising as a distribution and growth model. It presents franchisors with opportunities for growth while minimizing risk and maximizing local management. First, franchising minimizes the financial investment required to establish a new unit. Unlike adding a company-owned unit, the franchisee (not the franchisor) makes the financial investment to build and operate the business. The franchisor, in turn, enjoys the increased presence in the market. If the franchisee is successful, the franchisor also reaps the economic benefits derived from collecting royalties. Second, a franchisee, as the business owner, carries the burden of the success of the unit. The incentive to work hard and grow the unit is naturally higher because the franchisee will reap the economic benefits of higher sales. Thus, franchising maximizes growth while minimizing risk.

The franchise distribution model is regulated at both the federal and state levels. Before a business relationship is considered a "franchise"—subject to this extensive regulation—it must meet the definitions set forth by the Federal Trade Commission ("FTC") and the various state franchise laws. While some distinctions exist, chances are that if a business relationship meets the definition of a franchise under one statute, it will likely satisfy every statutory definition of a franchise. There are three typically required elements:

1. The franchisee makes a payment required by the franchisor. This payment can take many forms and the minimum payment may vary amongst states.
2. The franchisor grants the franchisee a license to use its trademark—the ability to utilize the brand.
3. The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation.

Slight variations of the second element are found in a number states. Some states, such as California, Maryland, and New York, to name a few, include the "marketing plan" approach to define a franchise. As an example, under the California "marketing plan" approach, the franchisor must also grant the franchisee the "right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial party by a franchisor." Cal. Corp. Code § 31005. Other states, such as Hawaii, Minnesota, and Mississippi, utilize a "community of interest" element. For example, under the Hawaii "community of interest" approach, there is a "community interest in the business of offering, selling, or distributing goods or services at wholesale or retail, leasing, or otherwise." Haw. Rev. Stat. § 482E-2. If a business is found to meet the definition of a franchise, regardless of whether it is marketed as a franchise, then the business relationship will be subject to the franchise regulation of the state in which the unit sits as well as the FTC Franchise Rule, located at 16 C.F.R. § 436 (the "FTC Rule").

Under the FTC Rule, the franchisor must also comply with certain disclosure requirements. 16 C.F.R. § 436. Pursuant to the FTC Rule disclosure requirement, it is considered "an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act" for a franchisor not to furnish a prospective franchisee with the franchisor's current Franchise Disclosure Document ("FDD"). *Id.* The FTC Rule also imposes requirements for the contents and form of the FDD, down to specifying the contents of the cover page. 16 C.F.R. § 436.3. The contents of the document include information about the franchisor and any parents, predecessors, and affiliates, the business experience of its managers, litigation history, fees, intellectual property, and financial performance representations. 16 C.F.R. §§ 436.4, 436.5. In total, there are 23 total items that must be delineated in every FDD. While the FTC Rule establishes the remedies against violation, only the FTC may prosecute a violation of the FTC Act; there is no private right of action. A franchisee's only course of action must be found in state law.

The particulars of franchise regulation and regulation of the offer and sale of a franchise varies by state. Some states require that a franchisor register a current version of their FDD with the state's respective business oversight agency. Today, 14 states have franchise registration laws—California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Before a franchisor is able to offer a franchise for sale within most of these states, franchisors must submit their FDDs (and other related documents) with the state's business oversight agency and seek the state's approval.

Once a franchise business relationship is established, the business relationship is governed by the state specific statutes and the FTC Rule. While this commercial relationship implicates interests and rights that are common to other commercial relationships, given the specialized governance, franchising presents complex and nuanced issues. It is of paramount importance for franchisors and franchisees, alike, to retain counsel with the requisite specialized knowledge.

Mulcahy LLP is a boutique litigation firm that provides legal services to franchisors, manufacturers and other companies in the areas of antitrust, trademark, copyright, trade secret, unfair competition, franchise, and distribution laws.