Franchising & Licensing - What are they? and how can you benefit from them?

Almost everyone is familiar with the term franchising, or has at least had some contact with the products or services offered by franchises. What is franchising? How does it work? And why, over the last 10 to 20 years, has franchising become the fastest growing way of doing business in just about every country in the world?

– And What makes a Good Franchise – “the Four I’s”.

This article endeavours to answer the questions posed above and provide the reader with a basic understanding of how franchising & Licensing works. It will discuss the benefits given by a franchise, and some pitfalls to be aware of when looking for one. The article is written to offer an informative introduction on franchising & Licensing only – and to provide a useful background which will allow businesses to benefit from innovation.

If you wish to know more about Franchising & Licensing please seek the assistance of a Franchising/licensing consultant or IP professional– and always remember that contractual documents do not have to be written in ambiguous legalese. Like any contract it should be clear to both parties what is being asked for or given, the relevant dates for delivery, supply and payment, how long the agreement is to run for, whether there is a right of renewal, and importantly when the contract may be terminated and the reasons for such a termination.

Why are franchises so attractive?

There are a number of reasons why franchises have become the fastest growing way of doing business but the most worthy explanation is that franchising and franchises are simply filling a market need.

The 1980’s and 1990’s brought radical changes to the employment market and the way people worked. A series of oil-shocks and severe stock market corrections, a freeing up of the world economy, reduction in subsidies, government deregulation and downsizing has thrust into the job market capable, energetic and resourceful people who want to work for themselves.

Franchisees are, in the majority of cases, people who have previously been employed by someone else and a franchise opportunity is seen as a more relaxed way of making the transition from working for an employer to being self employed. The risk factor of a proven business is also seen as a better option than breaking totally new ground.

Most importantly though, franchises are invariably taken up by people who are prepared to invest in themselves, their personality and their skills - those fleeing the angst of office or corporate politics and looking for employment freedom and the rewards that hard work will bring.
Because franchises are a personal investment, not only in the equity invested in the business, but also in the time and energy required to achieve success, it is important when choosing a franchise to take that a few commonsense precautions.

**Background**

Franchising is a system of business that has grown steadily in the last 50 years and is estimated to account for more than one-third of the world’s retail sales. There are few of us how who are not touched by the results of franchising. Franchises range from the ubiquitous McDonalds® to lawn mowing services such as Mr Green®, valet services, medical and dental services, to book keeping services and even to services helping us to prepare our tax forms.

Franchising is not restricted just to fast food outlets and gardening contractors. There are now franchises for mentoring managers and sportspeople and franchises for internet shopping.

Who knows what the future will bring? The only thing that we can be sure of, is that if there is a need in the market place, it is more than likely going to be filled by an innovative and creative business which is seeking to capitalise on its market lead and Intellectual Property advantage through some form of franchising scheme.

**Franchising – What is it?**

Franchising is a term which can be applied to just about any area of economic endeavour. Franchising encompasses products and services from the manufacture, supply for manufacture, processing, distribution and sale of goods, to the rendering of services, the marketing of those services, their distribution and sale.

**Definition of Franchising:**

*Franchising may be defined as a business arrangement which allows for the reputation, (goodwill) innovation, technical know-how and expertise of the innovator (franchisor) to be combined with the energy, industry and investment of another party (franchisee) to conduct the business of providing and selling of goods and services.*

The fact that, as a method of doing business, franchise arrangements have grown so rapidly in the last 10 or 20 years (world wide) is due simply to the fact that franchises are an effective way of combining the strengths, skills and needs of both the franchisor and the franchisee. To be truly successful, the one is reliant on the other.

In most instances, franchising combines the know-how of the franchisor with the wherewithall of the franchisee and, in the more successful franchising systems, the energy of both.

**Franchising – the basics – how does it work?**
In a basic franchising arrangement the franchisor has developed a system for conducting business. The system has been found to be successful. The franchisor wishing to emulate the success of that business system, usually in a different geographic area, establishes a blueprint for others also wishing to emulate this success to operate the same business using the same name and same systems.

**Advantages of owning a franchise**

The main advantage of owning a franchise is the feeling of freedom that being self-employed brings. This freedom is tempered with the knowledge that the owner has invested in a proven system and has the training, support and encouragement of other franchisees and the franchisor.

Owning a franchise should also provide a semi-monopoly environment in which to conduct business in a particular area. Generally, there is also an informed ready-made customer base. There will of course be competitors but the franchisee will be granted the sole franchise for a given area and often will be given client listings or job sheets.

Most importantly though, being part of a franchise ensures the franchisee is part of an instantly recognisable brand, the product or service expectations that a brand brings, and the reputation gained by the brand over time.

A franchise also offers the franchisee with the ability to capitalise on the know-how and systems that have been proven to be successful. The quality of the product or service provided is therefore in many ways guaranteed. Some of the advantages a franchise offers are:

- Freedom of employment
- Proven product or service outcomes
- Semi-monopoly; defined territory or geographical boundaries
- Proven brand, trade mark, recognition
- Shared marketing, advertising, business launch campaign costs
- Industry know-how
- Reduced risk of failure
- Access to proprietary products or services
- Bulk buying advantages
- On-going research and development

**What makes a good Franchise? – “the four I’s”**

Franchising to the uninformed is often seen as easy money or a get rich quick scheme.

These perceptions are usually the result of looking from the outside and seeing a successful, flourishing business, being run efficiently, with charm and grace - seemingly with a minimum of fuss.
Successful franchises are the result of innovation, initiative, investment and industry.

A good franchise is always sparked by a good idea which fills a market need. The good idea, for example the “Hire-a-Hubby®”, “Mr Green®” or the “All Around®” concepts happened along at the right time and at the right place – The good idea was reinforced by the initiative and drive of their creator to make the idea work.

A blueprint “system” for repeating success was established, developed, updated and monitored requiring the investment of time, money – and innovation. This innovation ensured that client expectations are met, anticipated and managed and, of course – the innovation resulted in a unique, memorable and exclusive name being devised and an unique brand established

**Franchise Arrangement**

The franchise arrangement is an arrangement whereby the franchisor permits – licenses the franchisee, in exchange for a fee, to exploit the system developed by the franchisor.

The franchised system is generally a package including the intellectual property rights – such as the rights to use the Trade Mark, trade names, logos, and “get-up” associated with the business; any inventions such as patents or designs, trade-secrets, and know-how of the business and any relevant brochures, advertising or copyrighted works relating to the manufacture, sale of goods or the provision of services to customers. The Intellectual Property is unique to the business and provides the business with its competitive advantage and market niche.

**Typical franchise system**

A typical franchise system will generally include:

(i) *A license to use the system*

In return for an agreed amount the franchisee is granted a license to conduct his or her business along the lines prescribed by the franchisor. This will usually include the use of all relevant Intellectual Property, marketing and advertising publications, store design and “get-up”, as well specialised equipment necessary to operate the systems and on-going or development and improvements to the system.

(ii) *A shared development and improvement obligation*

Most franchising arrangements have an on-going shared development and improvement obligation which is encumbent on both the franchisor and franchisee. This requires a mutual trust and respect and a sharing of the overall aims and goals of the franchise. The basic tenant for this approach is that what is good for one must be good for the other.
The franchisor is also obligated in the arrangement to nurture, encourage and provide assistance to the franchisee.

The franchisee for their part is required to maintain and promote the franchise and to conduct business prescribed in the system manuals and best practice guidelines.

The franchisee also has the continuing obligation to pay maintenance fees to the franchisor in accordance with the franchise arrangement. These fees usually include an advertising / marketing component as well as an on-going management service fee.

(iii) The franchisor’s right to determine how the business operates.
Most Franchise arrangements contain a component which stipulates that the franchisee is to conduct the business along prescribed guidelines and in accordance with the franchise best operating practice. The franchisor for his part is required to maintain, distribute and update the manuals, operating procedures and quality requirements when changes are made – and to provide on-going training.

The franchise arrangement will usually also require the franchisee to protect the Intellectual Property of the franchise system, and to operate in accordance with territorial or geographical obligations agreed. Both parties will be required to conform to the agreed accounting disclosure provisions.

The franchising arrangement is a legal document relying on contract law and inevitably on mutual trust between both parties.

**Licensing**
There is no such thing as a standard license. Every arrangement is unique and has its own special requirements, aims and objectives.

All licenses should be read and re-read and should be placed before a licensing professional or IP professional before being signed.

Needless to say, every license should be clear to all parties concerned. The individual parties should be aware of the obligations that the contract places on them, the conditions that have to be met and the time lines by which specific functions are to be performed. All of these features should be transparent and measurable. Each party should also be acutely aware of the other parties’ responsibilities.

Territorial or geographical boundaries should be made clear, as should all payment obligations and the amounts that are to be paid (and how they are calculated). All payment, dates should be clearly laid out, preferably in a schedule.

Penalties, such as default payments, breach of contract conditions, rights to assign, the term of the contract, and the right to renew are also important considerations that are often overlooked or not fully understood.
Bonus conditions might also be negotiated and should not be dismissed in a licensing agreement.

There are, though certain features that should be considered in the development of every license. The following is a list of some of the things that should be considered:

- Is the license exclusive, i.e. granted to only one person, or non-exclusive?
- Can the licensee sub-license?
- Are there any limitations to the license eg, geographic or territorial?, minimum sales, minimum production requirement etc?
- What is the amount, frequency, and form of payment, eg either lump sum or by way of royalty, or both, or other payment schedule?
- Who pays for prosecution and maintenance of any IP (patents, trade marks, designs)?
- How are any developments, modifications or improvements to be protected and who owns them?
- Who is responsible for filing for further improvement patents NZ/AU/overseas?
- In whose name will the applications be made in?
- Are there specific clauses relating to co-operation of licensor in matters relating to the IP such as infringement?
- Who pays for any matters such as preparation of the license, recordal of licensee, etc?
- Is there a required commitment on the part of the licensee to fully exploit the invention?
- Does the license contain a clause which allows for the license to be cancelled if the IP is not being used?
- What is the term of license?
- Is there a right to renew?
- What are the conditions of termination?
- When are royalty or other payments due?
- If sub-licensing is permitted what payment does the licensor receive?
- What information is the licensee committed to providing to the licensor?
- What happens if the IP under which the license is granted is refused, infringed, opposed, revoked or other?
- Is copyright a consideration?
- Does the licensee agree not to challenge the validity of the patent?
- Does the licensor agree to provide essential “know-how”?
- What provisions for any “hardware”, should the license be terminated?
- How will any disputes be resolved?
- What happens in the event of death of one of the parties?

What is the Difference between a Distribution, License and Franchise Agreement?
Distribution agreements, licenses and franchise agreements are all legal vehicles which allow business to be conducted efficiently and the business interests of both parties to be identified and protected.

The agreements do not have to be complicated documents shrouded in mystery. They should be simple scripts which are easily understood and simple to read.

Ideally the agreements should lay a platform for the success of the business arrangement and should be reviewed at a regular basis.

No agreement should be entered into without seeking the advise of an IP professional or franchising lawyer.

**Distribution Agreement**

The majority of distributorships are non-exclusive. As a consequence a franchise may offer significant advantages in terms of market presence dominance.

A distribution agreement is a contract between a manufacturer, producer or importer and the seller or distributor.

The distributor may be an exclusive agent selling only those goods belonging to the producer or, as is normally the case, the exclusive agent is the only distributor of a particular producers goods in the market. And exclusive distributorship may allow the distributor to grant sub-distribution licenses.

**License Agreement**

A license arrangement is a business arrangement where a licensor via a monopoly right such as a Patent, a Trade Mark, a design or a copyright has to exclusive right which prevents others from exploiting the idea, design, name or logo commercially.

The license allows the licensee to use make and sell, the product or name for a fee without censure.

In a Trade Mark license, for example, the licensee will be granted full privilege to use the Trade Mark on goods or services provided that the use is in accordance with agreed signage protocols and quality guidelines.

There is usually no training component, product development strategy and limited marketing support.

**Franchise Agreement**
As previously discussed, a franchising arrangement might be considered to be a more robust arrangement for new entrants into a line of business. The franchise agreement covers obligations on both parties and includes a training, mentoring and technical advise component for the franchisee. A franchise agreement is a specialised license and will cover all aspects of IP, user obligations and use provisions.

**Things to be Aware of When Choosing a Franchise**

Franchising is business. It is the buying and selling of goods and services and, like every business transaction, requires careful thought before the transaction action is completed.

Buying a franchise is just the same as buying into any business. The purchase needs to be made in the cold light of day and not on impulse.

Balance sheets need to be looked at and bottom lines investigated. The franchise should also be compared with similar franchises in similar areas so the apples are compared with pears and realistic expectations and incomes ascertained.

The most overlooked aspect of franchising and one that is invariably taken for granted is the Intellectual Property owned by the franchisor – or in some cases not owned by him.

An essential factor of a franchise is its name. This is how franchises products and services are brought, sold and marketed. It is how its customers know the business. Particularly when entering into a new franchise system, or into a new area it is imperative that the monopoly position encompassed in the name of the franchise is investigated thoroughly.

The brand and the exclusivity that it brings to a business will after all form a large part of the purchase price of the franchise and is one of the most attractive forces to potential customers.

A name-brand availability search is therefore essential and should be performed by a professional search service.

Other aspects of Intellectual Property such as patent ownership, copyright and marketing wishes should also be investigated and their ownership (right to use) determined.

Just about all franchisees have a genuine passion for their products and the business that they are in – so it is important that when choosing a franchise that it is not chosen because you like the product but with an eye to the bottom line today and in the future. Conversely, a franchise shall not be chosen simply because the bottom line looks good.

Bottom lines and profit can easily evaporate if there is no passion for the product, the business or a commitment to the customer.
The Franchisor – Starting a Franchise Chain

Franchising is in many ways as knowledge industry. The franchisor has as a result of innovation, intensive system development and product refinement gained market acceptance and customer loyalty. The franchisor wishing to exploit his market position shares his knowledge with the franchisee.

The platform on which the franchise is built is its Intellectual Property. Franchisor’s gain their income by parting with this knowledge.

The franchisor would be wise therefore to protect the Intellectual Property involved in the franchise and ensure the monopoly position is not eroded by seeking the advice of an IP professional [link to Pipers People] with the aim of (where appropriate) giving Trade Marks, Patent or Design rights.

The franchisor in order to successfully impart his knowledge and to assist franchisees also run successful businesses using his methods will communicate his methods via basic operating procedures manual, quality assurance manuals and training manuals. The strongest most durable franchise invariably has the most comprehensive work manuals and maintenance programmes.

This aspect of starting a franchise is often the biggest hurdle facing prospective franchisors but it is, along with a consistent brand, the platform which will bring the biggest reward. It is also the franchisor’s only assurance that the systems, innovation and development (the IP) that may have taken to refine are carried out in a consistent manner and the investment in the Intellectual Property is protected and not diluted.

Goodwill

Goodwill has been defined as “The benefit and advantage of the good name, reputation and correction of a business with its customers, suppliers, and distributors.”

It is often referred to as the attractive force, which brings in custom.

Goodwill as the subject of proprietary rights cannot exist by itself. It has no independent existence apart from the business to which it is attached.

The most obvious form of goodwill is seen as the name sign or trademarks under which a business trades and by which it is recognized in the market place.

In franchising, a franchiser by building a successful brand through marketing, good practice and innovation creates goodwill which is utilised by the franchisees to further give the goodwill and add value to the business.

The franchisee will undoubtedly pay for this attractive force and the immediate customer recognition that it brings to a “new” business in the franchise arrangement.
In most agreements new franchises will have limited reputation or goodwill and the payments they be minimized. As the business grows and market recognition increases, the goodwill coming to the business will also increase. Consequently, there is a stronger attractive force bringing with it more custom, and the payments for even new entrants will be substantially greater than for earlier franchisees.

Goodwill therefore is an important component when valuing a business and should be evaluated and protected. Goodwill can be most easily be defined and protected by gaining.

Registered Trade Marks for the trading name and logs of the franchise, and even in some cases for the shapes and colours of its goods. Goodwill may also be protected by asserting copyright relating, to manuals, advertising and marketing brochures, recipes, management and accounting software and even the design and layout of shop premises, the design of employees uniforms and TV ads.

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