



WORLD INTELLECTUAL PROPERTY ORGANIZATION  
(WIPO)

# FRANCHISING GUIDE

*International Bureau of WIPO*



GENEVA  
1994

**WIPO PUBLICATION**  
**No. 480 (E)**

**ISBN: 92-805-0525-4**

**WIPO 1994**

## PREFACE

*In view of the growing importance of franchise agreements, the present Guide has been written by the International Bureau of the World Intellectual Property Organization (WIPO), in accordance with its program. The following experts have given advice in the preparation of the Guide:*

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*The International Bureau would like to express its gratitude to these experts for their invaluable contributions.*

*February 1994*



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## I. INTRODUCTION

### A. *A Brief Explanation of Franchising*

1. Even if the term “franchising” is unfamiliar to most consumers, they are familiar with the results of franchising. The most widely known results of franchising appear to be fast-food restaurants such as McDONALD’S, hotels such as HOLIDAY INN or cosmetics retail shops such as YVES ROCHER. Franchising extends, however, to industries as diverse as the hiring of formal wear, car tuning, the preparation of taxation statements or returns, lawn care, day-care schools and dentistry. In short, it may apply to any economic activity for which a system can be developed for the manufacture, processing and/or distribution of goods or the rendering of services. It is this “system” that is the subject matter of franchising.

2. In developed market economy countries, the sale of goods and services through franchising has grown remarkably since the 1950s. Indeed it has been estimated that, in the United States of America, franchising accounts for more than a third of all retail sales in terms of dollars. In Australia, it is estimated that franchised fast-foods account for 90% or more of total sales in that market. It has been reported that franchising is practiced in altogether more than 70 countries around the world.

3. This rapid growth and success of franchising has been attributed to a number of factors, the most basic one being perhaps that franchising combines the depth of knowledge and the strength of one entity, the franchisor, with the entrepreneurial spirit of a businessman, the franchisee, and that it is possible to increase the number of franchisees according to market conditions. In this way, a large and stable organization is able to grow and develop, motivated or indeed driven by the spirit of small business.

4. From a legal standpoint, franchising relies on contract law and, therefore, does not necessarily require any special regulatory or legislative structure in order to function and develop. It is, therefore, appropriate to stress at the outset that no specific regulation of franchising has been or would be necessary for franchises to thrive in any economy. However, some governments have never-

theless chosen to adopt legislation to regulate franchising. Overregulation could, however, have the effect of discouraging investment in this area.

5. Whether or not such government-mandated regulation is provided as in all commercial activities, the best protection against the possibility of abuse is knowledge — knowledge held by potential franchisees and their professional advisers as to what franchising is and how it works. Accordingly, the purpose of this Guide is to give a brief general survey of the structure and nature of a franchising arrangement and, in particular, to help prospective franchisees understand franchising and better defend their interests, thereby allowing franchising to fulfill a positive role in the economy.

6. Franchising is a complex subject, and informed advice on the business, financial and legal aspects of franchising should be sought from professionals with extensive franchising experience before any particular franchise agreement is entered into. This Guide should not be viewed as a substitute for such advice.

#### *B. An Example of a Franchising Agreement*

7. In order to illustrate better the discussion on franchising, this Guide uses a fictional franchise from time to time as an example. That fictional franchise relates to a restaurant selling Italian food and operating under the name of VESPUCCI. While VESPUCCI is the mark (both for goods and services) and the trade name under which the franchisees operate the restaurants, the company offering the franchise (the franchisor) is referred to as Vespucci, Inc.

8. Vespucci, Inc. has developed a system for preparing and selling its food products, which are sold in large volume and in a uniform manner. The system includes various factors that contribute to the success of VESPUCCI restaurants, including recipes and methods of preparing food that produce a product of consistent quality, good siting of the restaurant, the design of employees' uniforms, the design of the buildings and billboards, quality sources for supplies, the design of packaging, an inventory of ingredients used in the preparation of the food, and management and accounting systems.

9. Vespucci, Inc. has developed this system over a period of years, and its development has not been easy, since it had many failed experiments before arriving at the system that it is willing to share with franchisees.

10. Vespucci, Inc. imparts its knowledge to its franchisees to assist them in developing a new business. Thus the franchisee opening a VESPUCCI restaurant has the benefit of Vespucci, Inc.'s experience. Even if the local franchisee has no previous experience of running a restaurant, he will, by following Vespucci, Inc.'s system, stand a better chance of operating a successful business. Without the franchisor's guidance, the local restaurant owner is liable to make serious mistakes which could cause the business to fail. Moreover, Vespucci, Inc. retains the right to supervise and control the way in which the local franchisee is operating the local VESPUCCI restaurant. By retaining that right, Vespucci, Inc. can be sure that the local VESPUCCI restaurant is operated in a proper manner, so that the goodwill of the VESPUCCI mark and trade name is maintained and the value of the local restaurant, indeed of the whole system under which VESPUCCI restaurants are operated, is not reduced.

11. Vespucci, Inc. trains the local franchisee to operate a restaurant in exchange for a financial benefit (to Vespucci, Inc.). The benefit is received in the form of a payment by the local franchisee to Vespucci, Inc. That payment may include an advance payment or "up-front fee" and some form of continuing payment based, for example, on a percentage of the franchisee's total sales. Payment in kind might also be envisaged. In addition, depending on the nature of the agreement, the franchisee may have a number of other payments to make for items such as special food spices, rental of equipment (e.g., ovens, cutting machines, etc.), purchase of consumable goods and miscellaneous articles necessary for his business.



## II. COMPARISON OF RETAIL SALES, STANDARD LICENSING AND FRANCHISING ARRANGEMENTS

12. Business transactions can take a variety of forms; franchising arrangements are only one of them. In order to understand what a franchising arrangement is, it may be useful to discuss first two other types of business arrangement which, while different from franchising, share with it certain important features: retail sales arrangements and standard license arrangements.

### A. *Retail Sales Arrangements*

13. Retail sales arrangements are governed by the traditional principles of civil and commercial law, such as contract law. The manufacturer or distributor makes a profit by selling his products to the retailer at a sufficiently high price.

14. A retail sales arrangement involves one party that manufactures and/or distributes a product and a second party that sells it. The seller may be an agent of the manufacturer or may be an independent merchant, purchasing the goods for resale. If the seller is a independent merchant, he may have concluded a "distributorship" agreement with the manufacturer or distributor of the goods. If the distributorship is exclusive the merchant is assured that the manufacturer or distributor will deal only with him for the purposes of distributing those goods within the territory (e.g., a province, a region or a whole country) defined in the contract. The exclusive distributor would normally be entitled to announce his special relationship with, and use the marks and trade names of, the manufacturer or distributor for the purposes of advertising and selling the goods.

15. Although exclusive distributorships exist, distributorships are typically non-exclusive. From this viewpoint, a franchising arrangement may be more attractive.

## B. *Standard License Arrangements*

16. In its simplest terms, a standard license arrangement is one under which one person (the licensor), who is the owner of a right to prevent other persons from commercially exploiting or using certain intellectual creations (e.g., inventions, designs) or distinctive signs (e.g., marks, trade names), agrees not to exercise that right against a given person (the licensee) in exchange for a fee, and perhaps also subject to the licensor's control of such commercial exploitation or use.<sup>1</sup> In the case of license agreements involving marks or other distinctive signs, the licensor will not normally exercise any more control over the licensee than is necessary to ensure that the goods being sold, or services provided, under his sign are of a certain quality, and/or that they possess certain specified characteristics.

17. For example, a company called Desk Gear, Inc. (another fictional example) may own the rights in a trademark affixed to certain goods, such as the mark FLUME for writing instruments. Another company is given permission by Desk Gear, Inc. to manufacture and sell pens having the mark FLUME affixed to them in exchange for a fee paid to Desk Gear, Inc. for each such pen manufactured and sold. Desk Gear, Inc. will normally have retained the right to check that the pens meet the quality standards necessary to maintain the goodwill of its FLUME trademark. It may also have retained a right to control the manner in which the mark itself is actually applied to the pens, and to their labels or containers, and the manner in which the goods are presented to the public by the licensee.

## C. *Franchising Arrangements*

18. Although different definitions could be proposed, franchising may be described as an arrangement whereby one person (the franchisor), who has developed a system for conducting a particular business, allows another person (the franchisee) to use that system in accordance with the prescriptions of the franchisor, in exchange for a consideration. The relationship is a continuing one, as the franchisee operates in accordance with standards and practices established and monitored by the franchisor and with his continuing assistance and support.

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<sup>1</sup> For a more detailed discussion of the licensing of industrial property, see *Licensing Guide for Developing Countries* (WIPO publication No. 620(E)).

19. The franchising arrangement therefore relates to a *system*, which the franchisor allows — or licenses — the franchisee to exploit. This may be referred to as the franchised system, or simply “the system.” The franchised system is a package comprising intellectual property rights relating to one or more marks, trade names, industrial designs, inventions and works protected by copyright, together with relevant know-how and trade secrets, to be exploited for the sale of goods or the provision of services to end users.

20. The factors that typically characterize a franchise relationship include:

*A license to use the system:* In return for an agreed payment, the franchisee is allowed to use the franchised system. He is in effect given a license to use the franchisor’s system to carry out his business. Where the franchised system is to be exploited at a particular location, such as at a franchised restaurant or shop, that location is usually referred to as the “franchised unit.”

*An ongoing interactive relationship:* The relationship is ongoing, involving multiple sales of the franchised product (or offering of franchised services) over a period of time, with the franchisor giving continuous assistance to the franchisee in establishing, maintaining and promoting the franchised unit. This includes updating the relevant information as the franchisor develops new or better techniques for operating a franchised unit. The franchisee for his part has a continuing obligation to pay fees to the franchisor for the use of the franchised system or to compensate the franchisor for providing ongoing management services.

*The franchisor’s right to prescribe the manner of operating the business:* The franchisee agrees to abide by directives issued by the franchisor which set out the manner of operation of the system. Such directives may include quality control, protection of the system, territorial restrictions, operational details and a host of other regulations governing the conduct of the franchisee in relation to the franchise.

#### D. *Comparison of Types of Arrangement*

21. The preceding paragraph identified three distinguishing characteristics of a typical franchise arrangement: the license to use the uniform system, the ongoing interactive relationship and the following of a prescribed manner of operation. These characteristics may be used to compare a franchise arrange-

ment with a retail sales arrangement and a standard license arrangement. In practice, franchise arrangements may also take a “hybrid” form, borrowing features from two or more types of contract. Moreover, businessmen prepared to engage in franchise arrangements are generally less concerned with the precise legal form of the agreement than with the business aspects of the deal.

(i) *Grant of a License to Use the Franchised System*

[Licensing of a Uniform System]

22. The heart of a franchising arrangement is a license, granted by the franchisor to the franchisee, to use the franchised system. This is essential to allow the franchisee to conduct his business in the manner developed by the franchisor. In contrast, a retail sales arrangement involves the simple sale of goods and does not necessarily require the grant of a license.

23. In this regard the distinction between a franchise arrangement and a standard license arrangement is a more subtle one. It has been stated that franchising is merely a sophisticated form of a standard license arrangement and that a franchising arrangement goes beyond the mere licensing of one or more specific intellectual property rights, such as trademarks, because it is a license to use a system that includes, but is not limited to, intellectual property rights. Indeed, under a franchise arrangement, the franchisee does more than merely selling goods or providing services under another’s mark, although he might not himself do any manufacturing at all. Franchising goes further by allowing the franchisee to manufacture and sell goods or provide services as part of a larger system.

24. For example, the licensing by Desk Gear, Inc. of the manufacture and sale of pens bearing the FLUME mark can be considered a standard license agreement. If, however, Desk Gear, Inc. decides to establish a system including store design and marketing techniques for the sale of its pens and to allow someone to make use of that system to sell FLUME pens, that would be franchising.

[Method of Generating Income]

25. In a retail sales relationship, the first party manufactures the goods and transfers them to the second party at a price which includes its profit and the second party resells the goods at a higher price, thereby making its own profit. In a typical, straightforward franchising relationship, the franchisor explains to

each franchisee how to make use of the system and, in return, acquires income by receiving a portion of the franchisees' income, for instance a percentage of sales. In addition, the franchisor may ensure income by selling goods to the franchisee, who becomes a permanent "customer" of the franchisor by agreeing to acquire from him certain goods needed for the operation of the franchise.

(ii) *Ongoing Interactive Relationship*

26. In a retail sales arrangement, the manufacturer and the distributor are usually independent of each other. In a standard licensing arrangement and in a franchising arrangement, the parties are independent but have a close working relationship defined by the terms of the license agreement and franchise agreement, respectively. The income of each party is dependent on the combined efforts of both parties. The more successful the licensee's or franchisee's business becomes, the greater the income for both parties.

27. In contrast to a standard license arrangement, however, the franchisee's success is also dependent on the franchisor's ability to develop a profitable system, to train the franchisee in the proper operation of the system, to improve and promote the system, to supervise or monitor the franchisee and to assist him during the term of the franchise agreement in order to enhance the likelihood of success. In a franchise arrangement, at least part of the ongoing nature of the relationship presupposes the franchisor continuing to develop the franchised system and communicating the new developments to the franchisee.

(iii) *Following the Prescribed Method*

28. In a retail sales arrangement, the seller does not exercise control over the manner in which the goods are sold by the buyer to the end user. In a license arrangement that gives the licensee consent to use the licensor's mark, the owner of the mark will normally exercise some sort of control over the quality of the goods or services produced or offered under the license. This will, in particular, assure the licensor that he can prevent any damage to his mark's goodwill due to diminishing or inconsistent quality of the goods or services produced or offered by the licensee. With respect to marks, the legal systems of some countries require license contracts to contain provisions requiring quality control by the licensor and such provisions are essential under the legal systems of many countries to enforce and avoid the loss of rights in licensed marks.

29. Specifically with respect to a franchise arrangement, the franchisor will supervise not only the manner in which specific rights, such as trademark rights, are used by the franchisee, but also prescribe the manner in which the fundamental aspects of the franchised system are implemented and managed. Therefore, the extent of the franchisor's influence over the franchisee is greater than that of a licensor over a licensee.

### III. TYPES OF FRANCHISE

30. This Guide deals with only one general category of franchises, which may be referred to as “business format” franchises. This broad category, of course, comprises a number of variations. Such variations may consist of changes in the nature of the franchised system, the scope and content of the license granted, the nature or object of the ongoing relationship and the scope and degree of supervision exercised by the franchisor over the manner in which the franchise is exercised.

31. A business format type of franchise has been described as being

“... characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service and trademark, but the entire business format itself — a marketing strategy and plan, operating manuals and standards, quality control, and continued two-way communications.”<sup>2</sup>

32. In order to perceive more clearly the potential of franchising, a brief description of certain basic types of business format franchises is useful. Categorizing franchises on the basis of their function yields three principal types: processing franchises, distribution franchises and service franchises. Franchises could also be categorized in terms of the possible relationship existing between franchisor and franchisee. These include relationships like those between manufacturer and wholesaler, manufacturer and retailer, wholesaler and retailer and service industry and retailer.

#### *Processing Franchises*

33. In a processing franchise, sometimes called a “manufacturing” franchise, the franchisor supplies an essential ingredient or technical knowledge to a processor or manufacturer. The franchisor will grant the franchisee authorization to manufacture and sell products under the marks of the franchisor. In certain

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<sup>2</sup> Quoted in *International Franchising: Commonly Used Terms*, Vol. 1, published by the International Bar Association, 1989.

instances the franchisee may further be licensed to use trade secret information or patented technology held by the franchisor, apart from which he may be provided with training and/or information relating to the marketing, distribution and servicing of the product. Such franchises are common, for example, in the restaurant and fast-food industry.

#### *Service Franchises*

34. In a service franchise, the franchisor develops a certain service which is to be rendered by the franchisee, under the terms of the franchise agreement, to his customers. An example of a service franchise would be one involving the provision of automobile tuning or repair services, or the provision of credit card services.

#### *Distribution Franchises*

35. In a distribution franchise, the franchisor (or someone else on his behalf) manufactures the product and sells it to the franchisees. The franchisees then sell the products to customers, under the franchisor's trademark, in their own geographical areas. For example, the distribution of automobile fuel, cosmetics or consumer electronics can be carried out under franchises.

## IV. STRUCTURES FOR CARRYING OUT FRANCHISING

36. Before dealing with the provisions that are typically found in a franchise agreement, the ways in which franchising may be structured have to be considered. The illustration in Appendix I shows in graphic form the more usual ways in which franchising arrangements are structured. Those structures are only examples and are not intended to be an exhaustive enumeration of the ways in which franchising can be organized.

37. A franchisor may wish to set up a franchising program in a number of ways. He may, for example, conclude franchise agreements directly with one or more franchisees. A franchise agreement may also consist of, or include, a franchise development agreement, whereby the franchisee (franchise developer) agrees to open a number of outlets or trading units. A franchisor may wish to enter into what is called a "master franchise agreement," whereby the other party to the agreement, the "master franchisee," will grant franchises to a number of franchisees.

38. Making a choice between the different possible structures depends very much on the particular circumstances of the franchisor and the franchisee and the nature of the franchise. Several factors should be taken into consideration, including:

- the franchisor's reasons for franchising,
- the resources of the franchisor,
- the size and resources of the master franchisee or franchise developer, and
- the nature of the market to be served (including its location, foreign or domestic, and its relative importance to the franchisor).

### A. *Unit Franchising*

39. Unit franchising is the most straightforward way in which franchising can be carried out, because it involves direct relations between the franchisor and the franchisee, whereby the franchisor enters into a franchise agreement

directly with the franchisee. This type of structure is illustrated in figure (a) of Appendix I.

40. In domestic situations — where the franchisor and franchisee are in the same country — unit franchising is the most commonly used structure. It allows the franchisor to replicate his business as efficiently as possible without having to establish new structures, such as subsidiaries or joint ventures.

41. Unit franchising is less common, however, in international dealings — where the franchisor and franchisee are located in different countries. Linguistic, cultural, commercial, political and economic differences between the countries in which the franchisor and franchisee are located generally dictate different approaches to the implementation of the franchise in those countries. The franchisor may find that, because a different approach is necessary in the franchisee's country, it may be necessary to establish a local presence there in the form of a master franchisor, or engage in multiple-unit franchising through a local subsidiary or a joint venture.

42. The alternative to establishing such a local presence is for the franchisor to establish within his own organization the expertise that will enable him to adapt his franchise to the needs of each of the local markets in which he wishes to operate. While this approach maximizes the franchisor's supervision of the way in which the franchise is implemented, it significantly increases the administrative burden, and hence the cost, of operating in other countries and would detract from one of the major advantages of franchising, which is not to divert resources to establishing business operations abroad.

### B. *Territorial Franchises*

43. Franchise agreements which aim at covering a substantial territory or geographical area by setting up, simultaneously or successively, a number of units, shops or outlets, over an agreed period of time, may be referred to as "territorial franchising." Two forms of setting up territorial franchises are the "franchise developer agreement" and the "master franchise agreement," which may be combined. These two forms are discussed below.

44. The type of structure chosen for a franchise agreement may have a bearing on the manner in which a franchisee or a master franchisee is legally organized. Two organizational forms should be mentioned, particularly in

connection with the establishment of international or cross-border franchise agreements: subsidiaries and joint ventures. It should be noted, however, that in a franchise agreement any manner of legal organization or corporate form may be used, depending on business considerations and the applicable legislation (in particular, tax, labor, foreign investment and competition law).

45. In international franchising, where the local master franchisor is a *subsidiary* of the franchisor, the latter will have direct control over the network of franchisees, while still securing the necessary local input. This would require the existence of a subsidiary entity, possibly constituted as a local company, in the country in which the franchisor wishes to operate. The subsidiary would then act as the franchisor, granting franchises to one or more local franchisees.

46. Unlike a subsidiary, a *joint venture* is a form of alliance of two separate companies. The companies agree to act together, typically forming a separate legal entity, for a particular purpose. The exact form of the joint venture, in other words the type of legal entity that it is, depends on the wishes of the parties to the joint venture and on national law. The franchisor will actively participate in the joint venture entity to carry out the franchise. The formation of a joint venture can sometimes provide security for the owner of the intellectual property rights because, with the franchisor involved in the management of the joint venture entity, the use of the franchised system by franchisees can be controlled.

47. A problem that is unique to joint ventures is the relationship with the franchisor's joint venture partner. Typically, the joint venture partner is a local individual or enterprise chosen by the franchisor as a partner for his experience in local customs and business. Such experience will be valuable in tailoring the franchise to local needs and tastes, not to mention dealing with local business and legal matters, although the franchisor would have to share the management of the joint venture with his partner.

#### (1) *Franchise Developer Agreement*

48. A franchise developer agreement links the franchisor directly with the franchisee, who is expected to open and operate several units. This franchise will include a "development agreement" whereby the franchisee is required to develop the assigned territory by establishing a number of franchise units or outlets which he will usually own directly. In this case the franchisee will not sub-franchise out to third parties. This type of structure is illustrated in figure (b) of Appendix 1.

49. Generally this agreement will include a schedule setting out the time frame for establishing the franchise units and developing the assigned territory. The individual units opened by the franchisee under this type of structure would not have independent legal standing, and could be divisions or branches of the franchisee's enterprise.

## (2) *Master Franchising*

50. In a master franchise agreement the franchisor grants another party, usually called the "master franchisee," rights (which may be exclusive) for a given geographical area. The master franchisee is given the right, by the franchisor, to grant franchises to third parties, usually called "sub-franchisees," to exploit fully the potential business opportunities in the larger geographical area. It may be agreed that some of those sub-franchisees will run more than one franchise unit, in which case the sub-franchise agreement is called a "multi-unit franchise." This type of structure is illustrated by figure (c) of Appendix I.

51. A master franchise agreement allows a franchisor to delegate the exploitation of a geographical area to another person, the master franchisee, in situations where that geographical area is remote from or little known to the franchisor, or where it is found to be convenient for business strategy purposes.

52. This approach to franchising is particularly important in international franchising, because a franchisor may wish to establish franchise operations in a given country, in which he may have no business experience. Accordingly, a candidate is found who has such business experience and who can establish one or more sub-franchisees to take advantage of business opportunities in the country. A master franchise agreement may, however, be a business-strategy choice in any case, regardless of whether the franchisor has had prior experience in a given market.

53. One possible disadvantage of master franchising for a franchisor is that he has to share some degree of control over the manner in which the franchise is implemented in the country in which a master franchisee is established. This is often mitigated, however, by provisions in the master franchise agreement specifying the latitude that the master franchisee has for making alterations to the franchised system in order to accommodate local needs.

(3) *Combined Structures*

54. A franchise agreement may be based on a combination of the structures mentioned above. It may, for example, combine a master franchise, under which a number of independent sub-franchisees will be established, with a franchise developer agreement under which the same master franchisee, or one of his sub-franchisees, is additionally committed to open a number of his own units in the same territory. A master franchisor could also be mandated to conclude franchise development agreements with one or more of the independent franchisees under the master franchise. These structures are illustrated by figure (d) of Appendix I.



## V. TYPICAL PROVISIONS IN A FRANCHISE AGREEMENT

55. Provisions typically found in a business format type of franchise agreement will vary depending on its particular object and purpose. Competent professional advice should be sought where required to understand the objects and purposes of a given franchise agreement and to determine whether its provisions are appropriate and balanced.

56. The typical provisions of a franchise agreement are discussed below in three sections: section A details the rights and obligations of the franchisor and section B the rights and obligations of the franchisee, while section C refers to miscellaneous provisions and deals with the possibility of the agreement being breached or terminated, as well as its term and the means of renewal.

57. When speaking of the obligations of the franchisor, it should be borne in mind that one of the legal structures discussed in Part IV other than direct franchising may be used. In such cases, the obligations of the franchisor may actually be assumed by a master franchisee. It is of critical importance to review the franchise agreement carefully to determine which entity owes obligations to the franchisee under the agreement. Similarly, it is important to the franchisee to know to which entity obligations are owed.

### A. *Rights and Obligations of the Franchisor*

58. The obligations of a franchisor towards the franchisee can be divided into two principal areas. The first includes the obligation of the franchisor to license intellectual property rights and other relevant rights to a franchisee to allow the franchisee to use the franchised system. The second includes the obligation to communicate the franchised system to the franchisee to allow the grant of the franchise to have practical effect. In other words, the franchisor must not only grant a right to the franchisee to use the franchised system, but also tell him how it is done.

(1) *To Grant the Essential Element of a Franchise Agreement — an Intellectual Property License*

59. This is the heart of the franchise agreement — the license given by the franchisor to a franchisee to use the franchised system. For example, Vespucci, Inc. agrees to allow the franchisee to do business under the franchised system using its trademarks, trade name, trade dress, industrial designs, inventions, copyrighted works and trade secrets. All specific intellectual property titles, such as trademark registrations, design registrations and patents are enumerated. Trade secrets, technical know-how, manufacturing data and business information are described in general terms or incorporated in the agreement by reference to other documents, such as an operating manual or a set of guidelines.<sup>3</sup>

60. The franchisor is required to identify precisely these various intellectual property rights and the manner of their use by the franchisee. This can be done in the franchise agreement, including appendices and supporting documents.

61. Intellectual property rights are established and maintained in accordance with national laws. Since successful franchising depends on establishing, maintaining and, where necessary, enforcing strong intellectual property rights, the agreement should specify that it is the franchisor's obligation to keep those rights in force. The agreement should also specify whose obligation it is to take care of or follow up the administrative procedures that have to be pursued to that end before the local authorities, and to take action in defense of intellectual property rights which have been infringed. It may be agreed, for example, that the franchisor must prosecute any infringer, but the franchisee must provide cooperation and assistance for that purpose.

62. The strong protection of intellectual property rights held by the franchisor benefits the franchisee since these are the rights under which the franchisee is licensed to operate the franchised system and which give him a competitive advantage over those who cannot use the system. So, any weakening of those intellectual property rights will accordingly weaken the competitive advantage of the franchisee.

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<sup>3</sup> The general nature of intellectual property rights is briefly discussed in Appendix II. For a more thorough discussion of intellectual property, see *Background Reading Material on Intellectual Property* (WIPO publication No. 659(E)).

(2) *To Communicate the Franchised System to the Franchisee*

63. It is not sufficient for a franchisor to have developed a franchised system and to grant a franchisee a license to use the system. To allow the franchisee to make effective use of the system, it must be communicated to him. The franchised system will be communicated to the franchisee in one or more of several possible ways, which include the provision of a manual of operations and training courses.

(a) **Operating Manual**

64. The operating manual is certainly one of the most important means of communicating the franchised system for many franchises. It should include the information necessary for actually carrying out the franchised system.

65. For example, Vespucci, Inc. has developed an operating manual which contains a specific description of all aspects of the operation of a franchised unit, including information on site selection for the unit, employee recruitment and training, accounting, supplies and stock control, recipes, food preparation, cleaning schedules, sales routines and business policy. In short, it contains a comprehensive enumeration of all the specific details that have made VESPUCCI restaurants successful in the past in other locations.

(b) **Training**

66. A franchisor can be expected to provide a franchisee and, where appropriate, his employees with sufficient training to operate the franchised system, and also with further training, as necessary, after the franchised unit is opened.

67. The training provided by the franchisor may include the following elements:

*Marketing Training:* The franchisor will generally train the franchisee in marketing, selling and promotional techniques in relation to his products, their advantages over products distributed by others and the recommended use of the franchisor's products to enhance the franchisee's ability to sell them.

*Processing Training:* In respect of franchises where goods are to be prepared and sold, for example, fast food, the franchisor will provide training in the manner in which the goods are to be prepared or processed, and in the manner of dispensing them to the public.

*Repair Training:* The franchisor will probably train the franchisee in product repair, as well as ensure that he has the proper stock of replacement parts and diagnostic and service equipment. It is imperative for the success of a distribution franchise that the franchisee should be capable of repairing and servicing the product. Where services are provided, the franchisee should be capable of correcting insufficient or improper servicing.

*General Business Training:* The franchisor may teach the franchisee how to keep proper accounting records, inventory, credit sales records, personnel records, tax records and all the other financial and administrative details that are necessary for the operation of a successful business. The franchisor may even develop computer programs designed to assist the franchisee in maintaining proper records.

68. Whatever the extent of the training program, it should be clearly revealed to the prospective franchisee, including any expenses that the franchisee may incur (such as fees, travel, accommodation or meals) in connection with his participation in the training. The franchise agreement should specify who bears the costs associated with such training. The agreement should also mention the consequences of not completing the initial training provided by the franchisor, including the possible forfeiture of fees which may have been paid in that connection.

69. The training program may take place in several phases, depending on the circumstances of the franchise. For example, the first phase of training by Vespucci, Inc. may involve bringing the new franchisee to its head office to conduct an initial training program. The second phase may involve sending instructors to the franchisee's restaurant just prior to its first opening. The instructors train the franchisee's employees and work with them in establishing the new franchise. The third phase may involve subsequent retraining, after the franchise has started operating. This may be particularly important if new products, equipment or procedures are adopted by Vespucci, Inc. to make the franchised system more efficient or profitable.

### **(c) Opening Assistance**

70. If the franchisor is responsible for selecting or approving the site of the franchised unit, constructing a building on the site, setting up and stocking the building and eventually opening the franchised unit, he should provide a reasonable schedule up to the date when the building will be ready for occupancy. It is important to have this information because, if the franchisee

has paid an initial fee and made commitments to purchase equipment or hire workers, he should be advised as to how soon the franchised unit will be ready to operate, so that the commitments can be met on time.

**(d) Continued Support**

71. The franchisee will interact with the franchisor and provide him with feedback on a continuous basis during the operation of the franchise. The franchisee may ask for specific assistance from the franchisor when he needs it, and the agreement should prescribe the fashion in which such help should be requested by the franchisee and provided by, or on behalf of, the franchisor.

72. The franchise system will undoubtedly undergo changes to take into account changes in the tastes or wishes of consumers and in the conditions under which franchisees operate. Accordingly, for franchisees to remain competitive, the franchisor must continue to develop and improve the franchised system to align it with such changes.

73. Such improvements to the franchised system must be communicated to the franchisee, for example, by additional training or the operating manual. If these improvements are protected by the franchisor in the form of additional intellectual property rights, the original franchise agreement should be so drafted that it automatically accords a license to the franchisee to use them and thereby take advantage of the improvements.

74. The franchisee will normally be required to accept and follow the instructions of the franchisor in respect of such changes and improvements. The changes should not, however, be such that they fundamentally alter the essential elements of the system which was agreed upon initially. On the other hand, an agreement in an international franchising setup should contemplate some leeway for the franchisee, allowing him to make certain adjustments to the changes or improvements communicated by the franchisor, in the light of prevalent local conditions.

**B. *Rights and Obligations of the Franchisee***

75. The franchisee's obligations can be divided into four basic areas: compliance with a development schedule, payment of the various fees required

under the franchise agreement, compliance with certain requirements imposed by the franchisor to allow quality control to be exercised, and respect for the confidentiality of certain information.

(1) *Development Schedule*

76. In the case of development franchises, and sometimes also in the case of master franchises, a development schedule will be included in the agreement. The development schedule will specify the number of franchise units, shops or other outlets which have to be opened by the franchisee, or by the sub-franchisees under a master franchise, within an agreed period of time. Compliance with the development schedule is an important factor in taking the best advantage of the commercial opportunities existing in a given territory or market. Not only will the income of both parties to the franchise agreement depend on the timely opening of the franchise units, but the creation of clientele and the extent of market share will also be contingent on the timely establishment of such units in the appropriate locations.

77. The franchise agreement may stipulate that untimely compliance with an agreed development schedule may produce certain consequences, such as limitation or forfeiture of the franchisee's exclusivity status. Serious cases of non-compliance with the development schedule could be grounds for termination of the franchise agreement between the franchisor and the developer franchisee. That would not, however, necessarily affect the sub-franchises or individual unit agreements which may have been concluded by the master franchisee.

(2) *Payment of Fees*

78. One of the most important provisions in the franchise agreement is the identification of the various fees to be paid by the franchisee to the franchisor, and the method of their calculation. The franchise agreement should specify all payments to be made by the franchisee to the franchisor, including any initial payment, also called an "entrance fee," for granting the franchise, and ongoing royalty payments, payment for advertising and promotion, security deposits and any other payments. More specialized fees that are unique to a particular type of franchised system may also be required. These may, for example, include charges for the use of a computerized reservation network in the case of hotel franchises. The basis for computing ongoing fees, such as royalties and advertising payments, should be

specified in the agreement, together with a schedule of due dates and an indication of the reports that are required to show the correctness of such payments.

79. It should be noted that, in some countries, the types of fee that afford the franchisor his income may have implications as to the level of the taxes payable. In some countries, transfer of technology agreements and service agreements may be subjected to different treatment for taxation purposes. Countries seeking foreign investment will generally grant favorable taxation treatment to transfer of technology and licensing agreements. To the extent that franchising agreements can be considered as transfer of technology agreements (not merely service agreements), they may benefit from that favorable treatment. This fact should be borne in mind particularly by parties entering into an international franchise agreement.

80. Information on the fees to be paid is important to the franchisee because one of the major areas of consideration will be the franchisee's ability to raise sufficient funds to enter the franchise relationship and eventually open one or more franchised units. Thus, a particular concern of franchisees is whether the franchisor has not understated the amount of money necessary for a franchisee to start a franchised unit. Some franchisees have eventually failed because they have been under-capitalized owing to the franchisor's lack of candor in explaining the amount of money that the franchisee would need in order to start.

81. Fees may be levied in a number of different ways. They may, for example, take the form of a monetary payment, or entail the purchase of products by the franchisee at an agreed marked-up price which includes the franchisor's profit "fee." It should, however, be noted that in some countries the franchisor cannot insist on setting the price at which the franchisee should sell the product.

#### **(a) Initial Fee**

82. The initial or entrance fee is typically a lump-sum payment, although it may be paid in installments (for example, 25% on signing the contract, 25% on completion of training, 25% on opening of first franchised unit, etc). The franchisor may regard this fee as a payment for the license to use his intellectual property rights, for the initial training he offers and for the administrative expenses associated with establishing the new franchised unit, or a combination of two or more of these.

**(b) Ongoing Fee**

83. Ongoing fees may be presented as royalty fees or as service fees, depending on the applicable legislation, in particular, tax law. Royalties paid by the franchisee may be regarded by the franchisor as his basic source of income, representing payment for the continued use of the system already developed. They should, moreover, at least in part, represent payments to the franchisor for the conduct of research and development efforts to improve the franchised system and communicate the improvements to the franchisee. Service fees, considered as earned fees, might be more favorably treated under tax law.

84. National laws may require that agreed ongoing fees be broken down and attributed to different elements of the franchise package. In such cases, if one of the elements, for example, a patent or design right ceases to exist during the operation of the franchisee, the ongoing fees may be adjusted accordingly.

**(c) Advertising and Promotion Fee**

85. In most franchising relationships, it is of critical importance for the success of individual franchised units, and for the franchised system as a whole, to advertise and promote both the units and the system. This ensures a continuing demand for the products or services of the franchised units. The franchisor will therefore normally require the franchisee to spend a specified amount on advertising and promotion.

86. Payments made for advertising or promotion are therefore not properly "fees" which go to the franchisor. They rather constitute an obligation to spend specified amounts of money to ensure continuing demand for the franchise's products or services. Depending on the type of franchise and the specific franchise agreement, the specified amounts can be divided among local, regional, national or even international promotion efforts.

**(d) Fees for Specific Services**

87. In most franchises, the franchisor has an ongoing responsibility to render services to the franchisee, in the form of advice on the management of franchised units, advice on the form and content of advertising and the updating of the franchise. Often the franchise agreement will provide that fees for these services are to be separately calculated and paid.

(3) *Compliance With Quality Control Requirements*

88. The franchisor's control over the manner in which the franchisee operates the franchised system is essential to ensure that the operation is properly carried out and that intellectual property rights owned by the franchisor, in particular his distinctive signs, are protected. This is necessary because in a franchise operation the public will directly associate the franchisor with the franchisee. Therefore, sustaining the reputation and goodwill of the franchisor's distinctive signs is in the interest of both parties. As regards the control of the quality of the goods produced or the services provided by the franchisee, the franchisor will usually insist on the instructions and recommendations in the operating manual being complied with, on having the right to inspect the franchisee's operation and on supplies being ordered from him or from a recommended or approved source.

89. While it seems clear that the franchisor must impose quality control requirements on the franchisee to protect both parties' interests in the franchised system, care should be taken to ensure that the requirements do not violate national competition laws. On the other hand, national trademark laws often require licensors to exercise control over the use of their licensed marks in order to enforce their rights and preserve the validity of the license contract. As franchise agreements normally include the licensing of rights in marks and other distinctive signs, these control requirements should be borne in mind.

(a) **Compliance With Recommendations Contained in the Operating Manual**

90. Provision is made in the franchise agreement for requiring the franchisee to comply with the recommendations made by the franchisor on the operation of the franchise, and especially those set forth in the operating manual. As mentioned above, the franchisee would be required to comply also with any changes, improvements or updates incorporated in the operating manual.

91. The requirement that a franchisee devote his best efforts to the proper operation of the franchised unit is common. Vespucci, Inc., for example, relies on the franchisee, within his exclusive territory, in order to benefit from the franchise to the fullest extent possible. To that end Vespucci, Inc. would seek to prevent the franchisee from entering into any business relationship that is in direct or indirect competition with Vespucci, Inc. during the period of the franchise.

92. Moreover, in the case of owner-operated franchise units, it may be reasonable for a franchisor to require a franchisee not to be involved in the same or a similar business during the term of the franchise agreement. If such a condition forms part of the franchise agreement, the prospective franchisee should be clearly informed (as regards possible covenants limiting the competing activities of a franchisee after conclusion of the agreement, see paragraphs 122 *et seq.*).

**(b) Obligation to Allow Inspection**

93. In order to ensure that the requirements laid down by the franchisor are being adhered to, the franchise agreement will provide for the franchisor's right to conduct periodical inspections of the franchised unit. It may also be provided that the franchisor will be allowed to speak to customers and staff members of the franchisee.

**(c) Requirement to Order Supplies from an Approved Source**

94. As noted above, the franchisor has a strong interest in ensuring that the franchisee meets a minimum level of quality of the finished product. One way of controlling the quality of the finished product is to control the quality of the raw materials used by the franchisee, to the extent that those materials constitute an essential factor of the franchised system. For example, the requirement that a restaurant such as a VESPUCCI franchisee purchase flour or beef only from the franchisor or from an approved supplier prevents the franchisee from lowering the quality of the finished product through the use of inferior materials, which may be less expensive. Therefore, the requirement that the franchisee use only flour or beef purchased from Vespucci, Inc. or from a supplier approved by it, in the preparation of the food sold under the franchise helps, where that requirement is justified, to ensure that the standard of quality established by Vespucci, Inc. is met.

95. The franchisee should also be informed of any benefit that the franchisor may derive from such an arrangement, so as to be in a position to determine whether the price of the products is excessive in the light of prices for similar goods or services on the open market. This information should also include benefits accruing to the franchisor from any requirement to purchase, rent or lease of real estate, services, signs or equipment, if the purchase, rent or lease must be made from specific persons (or companies), including the franchisor.

96. It should be noted that such provisions may run counter to national or regional laws protecting free competition. In some countries or regions this issue has been resolved by allowing such obligations only where necessary to protect the intellectual property rights of the franchisor or to maintain the reputation of the franchised system. Moreover, it may be required by competition laws that such restrictions apply only where it is impractical to lay down objective quality specifications so that the franchisee can buy the goods from any person subject to compliance with those specifications.

97. A franchise agreement may require the franchisee not to sell products other than those approved by the franchisor. The franchisor does not want the franchisee to sell any line of goods which he considers will reflect adversely on the franchised system or compete with his own product line.

98. Again, such a restriction may raise problems with national or regional competition laws but is generally accepted as reasonable where the sale of the product or provision of the service in question by the franchisee would compete with the sale of the franchisor's line of products, reflect adversely on the reputation of the franchised system or expose the franchisor to additional liability.

#### (4) *Confidentiality Requirement*

99. An undertaking to preserve confidentiality over certain elements of the franchised system will operate to the benefit of both franchisor and franchisee. Any franchisor will have spent a great deal of time and energy on developing the franchised system, which is to a large extent contained, or described, in the operating manual. Accordingly, it is essential to the maintenance of the trade secrets of the franchisor that the operating manual and any other information of a confidential nature be kept in confidence by the franchisee. Naturally, such information may be disclosed to the franchisee's employees in order that the business of the franchised unit may be carried out. The franchisee may therefore be required by the franchise agreement to oblige his employees to keep that information confidential.

### C. *Miscellaneous Provisions*

100. There are a number of provisions which can be found in most business contracts, including franchise agreements, such as those pertaining to

exclusivity, term and renewal of the agreement, the implications of breach, transfer and termination. These provisions are discussed below, with particular reference to their implications for a franchise agreement.

(1) *Exclusivity*

101. A franchisor may decide that if each franchisee is limited in some fashion to a specific geographical area the income of the individual franchised units, and hence the overall income of the franchisor, could be maximized. In such cases, "exclusivity" clauses may be included in the franchise agreement.

102. Exclusivity in respect of a territory or geographical area will generally require commitments by both the franchisor and the franchisee. The franchisor will protect a franchisee from competition by other franchisees within the exclusive territory by undertaking not to grant other franchises for that territory. Such obligation may be absolute or limited to certain types of sales, sectors of consumers or periods of time.

103. In turn, the franchisee would have to accept limitations aimed at preventing him from interfering with other franchisees outside the assigned territory. Those other franchisees would have undertaken equivalent obligations. The limitation on the franchisee's activities could include one or more of the following:

- prohibition to establish a franchise unit other than at a specified location or within a specified territory;
- prohibition to sell other than from a specified franchised unit or within a specified territory;
- prohibition to advertise, solicit or accept sales other than at a specified location or within a specified territory.

104. Different degrees and sorts of exclusivity may be considered for the purposes of franchising. A franchisee (or master franchisee) may be accorded exclusivity to sell goods (or provide services) to the general public, but the franchisor may have reserved for himself or for other franchisees the sale to, for example, hospitals or armed forces establishments in the specified area, or in the entire territory or country. A franchisee may have exclusivity to sell through agreed outlets open to the public, but sales through other means, for example, by correspondence or door-to-door sales, might be expressly reserved.

105. Of particular concern to a franchisee is whether a franchisor will be entitled to locate a store owned and operated by him (known as a “company store”) in the area assigned to an exclusive franchisee. Such a company store may have a competitive advantage over a franchised unit. Unless the agreement specifically forbids the franchisor to establish a store in the designated area, he may have the right to do so.

106. Exclusivity may also be linked to a time factor. A franchisee may be given the first franchise in an area where a franchisor intends to establish further franchises at a later date. Exclusivity might be agreed for a number of years so as to give the franchisee lead time over future franchisees. The franchisor may grant the franchisee an exclusive territory, with a provision that no further franchised units will be established within, for example, a period of two years. After that, the franchisor may have the right to open a limited number of new franchised units in the area, but it may be agreed that none of them will be located within a limited distance (for example, three kilometers) from the original franchisee. The franchisor may agree to give the original franchisee a right of first refusal to operate all or some of those new franchises.

107. The length of the period of exclusivity could be made to depend on the achievement of a minimum volume of sales or on compliance with a development schedule in case of a multiple-unit or master franchise.

108. Whatever exclusivity arrangements are made, their scope and effect, should be explained to the franchisee before the franchise agreement is concluded. Additionally, care should be taken to ensure that provisions dealing with the grant of exclusive geographical areas do not conflict with national or regional laws protecting free competition.

## (2) *Term of Agreement*

109. The parties to a franchise agreement normally decide to set a definite term on the agreement, subject to premature termination, as discussed below. The term should be long enough for both parties to derive some benefit from the agreement if it is not renewed, mainly owing to the high initial training and starting costs of a franchised unit. In particular, if the franchisee is required to make a significant investment, such as in land, building, assets and inventory, this justifies giving the franchise agreement quite a long term. But the term should still be short enough for the parties to sever the relationship in a reasonable period of time for personal or business reasons without being in breach of the agreement.

110. It should be noted that, under the laws of certain countries, certain particular kinds of industrial property license or technology transfer agreement, of which a franchise agreement may be one, are subject to a fixed time limit or a time limit that must meet specified criteria. Certain laws may also prohibit an automatic renewal of the contract.

111. It should be further noted that the laws of some countries provide that an industrial property license such as a franchise agreement may not contain a provision prohibiting the free use of the technology or related technical information after the expiration of the licensed industrial property right. On the other hand, balanced grant-back clauses are generally acceptable under such laws.

112. Termination of the franchise agreement may, of course, take place at any time by mutual consent between the parties. The agreement may also provide for the possibility of termination at any time by one party giving the other advance notice to that effect.

### (3) *Provisions on Breach of Agreement*

113. If both parties are dissatisfied with the agreement and wish to terminate or modify it, that may be done. The terms of the franchise agreement should, however, provide for the case where one party unilaterally terminates the agreement, and for the consequences of such action.

114. It should be noted that in certain countries, under the laws governing the transfer of technology (which may include franchise agreements), if the parties to an industrial property license or technology transfer agreement terminate it before the end of its normal term, notice to that effect must be given to the government authorities within a fixed time limit after the date of termination.

#### (a) **Breach of Agreement by Franchisor**

115. The parties may wish to include in the contract a provision to the effect that, if the franchisor breaches an essential provision of the agreement, the franchisee should have the option of terminating it and claiming redress.

116. The franchise agreement may contain a definition of "material breach." For example, any action that invalidates the franchisor's trademark, or the

supply of substandard products by the franchisor to the franchisee, where high-quality products are essential to the franchisee's operation, may be considered material breaches and provide grounds for termination of the agreement. If the franchisor promises the franchisee continuing support in the form of new product line development, advertising and promotion, celebrity participation or the opening of new territories, and unjustifiably fails to fulfill its promises, such a failure may constitute a material breach of the franchise agreement.

117. A breach on the part of the franchisor may amount to a material breach, but may be susceptible of cure or correction. For such cases the franchise agreement will normally provide that the franchisor is to be called upon and given the opportunity to make the necessary corrections within a specified period, for example, 30 days, before the franchisee can terminate the agreement.

#### **(b) Breach of Agreement by Franchisee**

118. In order to protect his interest in the franchised system, as well as his interest in ensuring a steady income, the franchisor will probably wish to secure the right to terminate the franchise for any major breach of the agreement. Therefore it is normally required that the breach be a "material" one.

119. The failure of the franchisee to operate the franchise properly may constitute a material breach which may make the agreement liable to termination. For example, if the franchisee is not meeting a reasonable sales quota which has been discussed and agreed upon, the franchisor may want to terminate the agreement. Also, if the franchisee becomes insolvent, has breached the confidentiality requirement, is under-reporting royalties, is failing to pay royalties when due or is otherwise operating in a manner that falls short of the franchisor's standards of quality and service, with resulting poor quality of the product or poor service, termination may be justified. Moreover, where allowed under national law, any challenge by the franchisee to the intellectual property rights that form part of the franchise may provide a basis for termination of the contract. If a breach of the aforementioned kind does occur, and it is possible to correct it, the franchisee should be given an opportunity to do so.

120. In addition, the persistent breaching of certain minor obligations over a period of time, or a series of minor breaches occurring at the same time, may amount to a material breach justifying termination of the agreement.

121. Where a franchisee declares himself bankrupt, commits fraud or is found guilty of criminal acts, the franchisor could terminate the franchise without having to give advance notice to the franchisee, since this type of situation would not normally be capable of “correction.”

(4) *Rights and Duties of the Parties on Termination*

122. Termination occurs when the term of the franchise agreement comes to an end and the agreement is not renewed, or if the agreement is terminated before its normal expiration because a material breach has been committed by the franchisee or franchisor. The agreement can also be terminated prior to expiry by mutual consent between the parties. In any case, the question arises what are the rights and duties of the franchisor and franchisee upon termination. Accordingly, the franchise agreement should indicate what the parties are to do upon termination of the agreement.

123. On termination of the agreement, the former franchisee is no longer entitled to use the intellectual property rights that were licensed under the franchise. This is because they are rights that have been granted to, or registered by, the franchisor and to which the franchisee has no claim. In particular, the franchisee must be aware that the moneys paid by him (in fees or otherwise) for the advertising and promotion of the marks and trade names used under the franchise agreement would not afford him any right of continued use of those proprietary signs after the termination of the agreement. When the franchise agreement ends so too does the franchisee’s entitlement to use the subject matter of any intellectual property included in the franchised system, in particular, the franchisor’s distinctive signs (marks, trade name, trade dress, etc.)

124. With respect to technology not covered by registered industrial property rights, the laws of certain countries governing the transfer of technology provide that, after the expiration of some types of agreement, such as those conveying trade secrets or “proprietary” know-how, the technology recipient will be free to use the technology. It may, however, be permissible to oblige the technology recipient not to communicate the confidential information to others for a specified period of time or until the information is disclosed or otherwise becomes public.

125. The reason for including in the franchise agreement a so-called “post-termination restriction” is that the franchisor, having taught the franchisee how to operate a successful business, does not want the franchisee to compete with

him in the same area after the franchise is terminated. Also relevant is the interest of the franchisor to be left in a position to offer something to new franchisees who may wish to step in. On the other hand, the former franchisee will have spent a period of his life running the franchised business, and as a result will have learned to do it well, and might not be interested in moving. Thus the former franchisee may not want to be prohibited from practicing that business in the same area. A fair balance has to be struck between these two competing interests.

126. The laws of some countries recognize that there are grounds for restricting the franchisee from operating the same type of franchise in the same geographical marketing area for a reasonable period of time after termination. The franchisor should have the opportunity to train a new franchisee and be permitted a reasonable period of time to set up the new franchisee in the business. After the new franchise is established, the former franchisee may compete with the new one on equal terms, but using his own distinctive signs.

127. These post-termination restrictions and the reasonableness of their scope will generally concern three questions: the length of time, the geographical area and the types of business activity prohibited. The question of the length of time during which a former franchisee can reasonably be prohibited from competing generally depends on the particular circumstances of each situation, but may be subject to a specific limitation imposed by national or supranational competition laws.

128. As for the size of the geographical area in which a former franchisee can be precluded from competing, it should generally match the market area in which the franchised unit operates. Certain national or supranational competition laws may allow such restrictions to extend to all areas in which the former franchisee would be in competition with other franchisees or with the franchisor.

129. Another restriction that will have to be assessed for its reasonableness is that relating to the type of business that the former franchisee is precluded from operating. For example, a restaurant franchisee could be restricted from operating the same type of restaurant in the same area after the franchise is terminated, such as, in the case of VESPUCCI, an Italian-food restaurant where food is served on the premises. A former VESPUCCI franchisee should not, however, be prohibited from operating a restaurant that specializes in fast food, for example, which is a different type of operation aimed at a different segment of consumers.

130. Finally, any money owed by the franchisee to the franchisor, or vice versa, should be paid. Inventories and other assets purchased by the franchisee that have no significant value outside the franchise operation should be transferred to the franchisor, and the franchisee should be paid a fair market price for them.

131. It should be borne in mind that, even if the goodwill value of the franchised system has increased during the operation of the franchise agreement, the franchisee will not be entitled to any payment in that connection upon termination of the agreement.

#### (5) *Transfer of Agreement*

132. Provisions on the transfer of the agreement usually relate to two situations. First, the situation where a franchisee wishes to sell the franchised unit, in its entirety or only in part, or to transfer all or part of his rights under the franchise agreement, or both; and, secondly, the situation where a franchisee dies or is incapacitated.

##### (a) **Sale by Franchisee**

133. It would seem that, if the franchisee has developed a successful franchise and wishes to sell it to a willing buyer at a price that includes a profit, he should have the right to do so; he may wish to pursue some other business or retire from business altogether. The increased value of the business, achieved by the franchisee's efforts, should give him the right to profit by the sale of the franchise to a buyer capable of paying the contract price. If the franchisee is not permitted to sell the franchise to such a buyer, he loses the benefit of the effort he has expended in developing a successful franchise.

134. The franchise relationship is a very personal one, however. The franchisor relies heavily on the ability of his franchisees to operate their franchised units in the prescribed manner. The franchise agreement establishes a sort of partnership based on the conviction that the other party is trustworthy and capable of fulfilling his obligations. This is all the more true where know-how and trade secrets are to be communicated by one party to the other. If the franchisor does not have the right to approve a purchaser, he may find himself bound to accept a franchisee whom he believes will be unable to operate the franchise properly, or with whom he will not be able to develop a bona fide business relationship.

135. One solution is to require the consent of the franchisor prior to sale by the franchisee of the franchised unit or rights under the agreement. Such consent should not be withheld unreasonably. Furthermore, the franchising agreement may provide that the franchisor may himself purchase a franchised unit that is offered for sale.

136. Another solution is to give a franchisor a right of first refusal in the event of any bona fide offer made by a third party. Under such an arrangement, if the franchisee receives, from a qualified purchaser, a bona fide offer in writing to purchase the franchise, the franchisee may notify the franchisor of the terms of the offer and the identity of the prospective purchaser. The franchisor should be allowed a reasonable period of time to investigate and match the offer if he wishes. If he fails to do so, then the sale to the new franchisee is deemed to have been approved by him.

137. Where the franchisee is a company or a limited liability entity, change in share ownership may entail a change in the ownership of the franchised units. It may also bring about a change in the management of the franchisee's enterprise. The franchise contract should provide for those cases. In international franchising, the commercial legislation of the country where the franchisee is to be set up should be taken into account.

#### **(b) Death or Incapacity of Franchisee**

138. The same situation as in the case of a sale by a franchisee arises when the franchisee dies and the ownership of the franchise passes to his heirs. If the franchisor can establish that the heirs are incapable of operating the business properly, then he should have a right to repurchase the franchise at a fair market price.

#### **(6) *Renewal of Agreement***

139. The renewal of a franchise agreement is not necessarily automatic. Renewal is therefore an issue which the agreement must deal with in some detail. Moreover, renewal should not be expected in franchising agreements, especially in the case of development or multi-unit franchises. These agreements will generally not be extended beyond their term once the development objective has been attained.

140. The question of renewing the franchise, on terms that will be fair to both parties, presents certain difficulties. If the franchisee is successful, he would like to continue the arrangement under the original conditions. At the end of the first term of the franchise agreement, the franchisor may be offering new franchises for a higher royalty than was agreed many years earlier, when the original franchise was negotiated, and he would like the renewed franchisee to pay the same royalty rate as the new ones.

141. The franchisor would therefore usually grant a renewal on the same terms as are being offered to new franchisees, but the renewing franchisee would not be required to pay another initial fee on renewal because the franchisor would not have to incur the investigation and training costs again. On renewal it is not usual for the franchisee to be required to pay another advance or "up-front" franchise fee.

142. It may have been stipulated that renewal of the agreement may be contingent on meeting certain requirements, or that certain conditions are to be agreed upon prior to the extension of the franchise. The franchisee might, for example, be required to upgrade or refurbish the franchised unit, or adjust to new features or technical requirements contained in an updated operating manual.

## VI. MAKING THE DECISION TO FRANCHISE

### A. *The Franchisor*

143. Returning to our example, it is clear that Vespucci, Inc. has developed a significant amount of expertise in running an Italian-food restaurant. It could, in all probability, continue to operate a single restaurant successfully, but that very success has led it to decide to open additional restaurants. In simple terms, Vespucci, Inc. has two options when carrying out its plans to open additional restaurants: it may open new restaurants owned by it and operated by its own employees, or it may franchise.

144. If Vespucci, Inc. decides to open additional restaurants owned by it and operated by its own employees, it must raise the necessary capital for that type of expansion. That means raising money not only for the purchase or lease of land and the building and fitting out of new restaurants, but also for expanding its own staff to handle the additional work of a larger organization.

145. On the other hand, franchising would afford direct benefits to Vespucci, Inc. in that it would not have to raise capital for the construction of new restaurants. The franchisor can obtain new markets for the distribution of his goods or services with minimal capital expenditure. Also, by franchising, Vespucci, Inc. would not have to raise the capital to finance the recruitment of staff to operate the new restaurants and to manage a larger corporation, which that type of expansion would require.

146. There are additional advantages for Vespucci, Inc. in that the franchisees are normally independent business people and highly motivated to make their franchised units work. The likelihood of such an individual franchised unit succeeding is thus enhanced, and is indeed perhaps greater than that of a restaurant owned directly by Vespucci, Inc. itself.

147. Particularly in the case of international franchising, the local franchisee will have knowledge of local business practices, not to mention customer preferences, that the franchisor does not have. For example, Vespucci, Inc. may not have knowledge of the laws and local practices pertaining to operating a restaurant outside its home country. By working with a local franchisee,

however, Vespucci, Inc. can acquire that knowledge and to a large extent can rely on the local franchisee to adapt the VESPUCCI system to local tastes and business practices. For Vespucci, Inc. to acquire the knowledge on its own would require a large, and continuous, investment of time and resources.

148. Moreover, as discussed above, the franchisor will have to decide on the legal structure within which to implement the franchise, that is, whether it should be in the form of a direct franchise, a multiple-unit franchise, a master franchise agreement, or some other structure.

149. One approach which a franchisor may take when recruiting franchisees is "conversion franchising." A conversion franchise is one entered into by a person who is already carrying on the business to which the franchise relates. Such franchises normally involve businesses in which specific skills are required, for example, hairdressing, which skills would be impractical to impart to an unskilled franchisee. It is the franchise, including the proprietary techniques and marks, that is attractive to a potential franchisee who is skilled in a particular activity, and would induce him to "convert" from his old way of doing business to the new franchised way.

#### B. *The Franchisee*

150. On entering into a franchise agreement, the franchisee acquires the expertise of the franchisor in the manufacture of the goods and/or the provision of the services that form the subject matter of the franchise. Along with this expertise comes the marketing experience and stability of the franchisor, but placed at the service of another person, the franchisee.

151. The franchisee can, on the basis of the franchised system, set up outlets with a greater chance of success than if he had to do it alone, and is better placed to compete efficiently with large undertakings. This is because he has the benefit of the franchisor's advice on matters such as site selection, operation of the business, building plans and the like, and is saved the expense and the greater risk of business failure if he were to have to experiment on his own. Indeed it has been estimated, in at least one country, that over 25% of ordinary businesses fail, compared with only 5% of franchised units.

152. As explained in Part II, one aspect of franchising is its ongoing interactive nature; as the franchisor develops new or better techniques for the

operation of franchised units, the information is passed on to the franchisees. This gives franchisees access to the results of research and development that they may not be able to afford on their own.

### C. *The Public Benefit of Franchising*

153. Because franchising promotes the introduction of new competitors into the marketplace, it increases competition between brands (so-called "inter-brand" competition). For example, there may be a number of restaurants selling fast food in a given area. The introduction of a VESPUCCI restaurant increases the competition between restaurants selling food under different marks.

154. Franchising is also one of the ways in which foreign investment may take place in a country. The conclusion of a franchise agreement between a foreign franchisor and a local franchisee (or master franchisee) will generally benefit the local economy, not only in the form of the investment that will take place, but also in the creation of labor opportunities and the transfer of the know-how embodied in the franchised system. Franchising will also bring an increase in tax revenues for the State and have a beneficial impact on related or auxiliary industries, especially those supplying goods or services used by the franchisees.

155. Moreover, as indicated above, the failure rate of franchised businesses is much lower than that of non-franchised businesses. Franchising provides a further benefit, therefore, because the public costs associated with the failure of businesses are reduced.

### D. *Entering Into a Franchise Agreement*

156. Negotiations with a view to concluding a franchise agreement will often be conducted on the basis of certain documents proposed by the franchisor. Such documents may include a preliminary confidentiality agreement, an application form or a questionnaire, and an information document about the franchisor.

157. The preliminary confidentiality agreement will commit the parties to treat and maintain as confidential any particular piece of information which one party may disclose to the other during the initial discussions on a possible franchise agreement. If after the first contacts one of the parties (or both) decides not to pursue the agreement, or if for any reason the negotiations were to fall through at an early stage, any information disclosed in confidence would have to be treated as a trade or business secret by the party receiving it, and could not be used by that party without authorization from the other party. Confidentiality agreements will protect, in particular, any confidential information or trade secrets which the franchisor discloses to the franchisee about its business methods or procedures, its manufacturing processes, etc.

158. The application form or questionnaire provided by the franchisor is intended to be completed by the prospective franchisee. It constitutes an explicit expression of his wish to start negotiations for the purpose of concluding a franchise agreement with the franchisor. Those documents would also provide basic information on the applicant, which the franchisor will want to examine before pursuing further negotiations. The application form or questionnaire will facilitate negotiations, and allow the franchisor to make a preliminary selection of potential business partners, particularly where a large number of applications are submitted.

159. The information document on the franchisor is intended to give prospective franchisees background information on the franchisor's activities, basic economic and financial data on the franchisor's company, and a general description of the franchise which is being offered. This information is particularly useful to any prospective franchisee, since it will help him understand the business he would be joining and take an appropriate decision.

160. Before entering into a franchise agreement the prospective franchisee must consider and answer three basic questions: Is franchising the right form of business for me and what advantages can I derive from this franchise? What is the franchisor offering? Is the franchise arrangement, as a whole, attractive to me?

(1) *Is Franchising the Right Form of Business for Me?*

161. A typical franchise agreement provides for a fair amount of supervision exercised by the franchisor over the operation of the franchised unit by the franchisee. It is true that this supervision is exercised for the benefit of both parties because the quality of the individual franchised unit, and the franchise

system as a whole, is thereby enhanced. Nevertheless, some prospective franchisees may consider such intervention oppressive and unacceptable.

162. The prospective franchisee has to bear in mind that he will not acquire any title or interest in any intellectual property rights included in the franchised system; those rights will be merely licensed to him for the purpose of the franchise agreement. The franchise agreement must be seen as a *lease*, the object of which is the franchised system. On termination of the agreement, the franchisee will be required to stop using the system and stop exploiting the licensed intellectual property rights, in particular, the franchisor's marks, trade name and other distinctive signs. Any enhancement of the reputation or goodwill of those proprietary distinctive signs will inure to the benefit of their owner (i.e., the franchisor or a related entity) and not the franchisee. If the prospective franchisee is one who prefers to establish his own commercial identity in the marketplace, or is unwilling to invest in promoting a mark or a name in which he will eventually have no interest, he should seek a different form of business arrangement.

163. The prospective franchisee must be prepared to accept the intervention of the franchisor in the manner in which the franchised business is operated, and be willing to use the franchisor's distinctive signs, in order to receive the benefits that the franchise has to offer: the right to use a proven, tested system and the assurance that his efforts will produce goods or provide services of a desirable level of quality. Once the franchise agreement gets under way, there will be a community of interest between franchisee and franchisor, and each will depend on the other for the success of their business.

164. The prospective franchisee should also consider the various advantages that the proposed system offers in the light of future business plans. The franchise deal would allow the franchisee to acquire know-how that is specialized and commercially proven and may include training in various aspects of business management, quality control and marketing. These advantages would be "permanently" acquired by the franchisee, and could be valuable for the pursuit of future business activities, even after the franchise agreement has ended. The franchisee would effectively learn a business system which is operational and successful. The prospect of acquiring that know-how and training from the franchisor may be a decisive reason for entering into a franchise agreement. Due consideration should of course be given to any contractual provisions that limit the franchisee's use or communication to others of confidential information or trade secrets acquired during the franchise relationship, as well as any limitations on the establishment of, or participation in, a competing business after termination of the franchise agreement.

(2) *What is being Offered by the Franchisor?*

(a) **General**

165. What the franchisor offers is defined by the franchise agreement and its supporting documents. It is important for the potential franchisee to understand what he will receive through the franchise agreement, in order to determine whether it is a business arrangement he wants to pursue. If the proposed deal is not acceptable or not commercially viable, there is no need to pursue it further.

166. Entering into a franchise agreement is a serious step for a franchisee, since a significant amount of capital investment is often called for, not to mention the plain hard work of starting up a franchised unit. Entering into a franchise agreement as the franchisee has been compared to buying a house. A prospective buyer will want to know everything about the house prior to its purchase, beyond the fact that the outside of the house looks nice. He will want to assure himself of the soundness of the house as well as of the seller's legal title to sell it. No less important is the prospective franchisee's decision on whether the franchisor is sound and reputable and does indeed have the right to license the intellectual property rights embodied in the franchised system.

167. Although the franchised system will be presented by the franchisor for acceptance by the franchisee, the system which the franchisee signs into should be properly adapted to the local culture. Local circumstances, preferences and tastes have to be taken into account, and the franchise concept may have to be adjusted accordingly.

(b) **Disclosure of Important Information**

168. Prospective franchisees should seek and, if necessary, insist that the franchisor disclose fully all the aspects of the franchise relationship before a franchise agreement is negotiated.<sup>4</sup> The requirement of complete disclosure of

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<sup>4</sup> A small number of laws require such disclosure. Examples are found in the United States of America (nationally under the Federal Trade Commission's Franchising Rule (16 C.F.R. Section 436) and in several States, such as the State of New York (Franchise Sales Act, N.Y. General Business Law, 680 *et seq.*) and in France (Loi Doubin (Law No. 89-1008 of December 31, 1989)). A different approach exists in Canada, where five out of the six provinces in the country have not adopted such laws. Similarly, a recent report by a committee in Australia concluded that franchising did not require any specific regulation.

the terms of the franchise does not of course ensure the success of the prospective franchisee, but it does permit him to make a decision based on complete information. Even unfavorable information must be disclosed, as well as terms and conditions of the agreement that restrict or obligate the franchisee.

169. It is worth stressing that it is not the quantity of the information supplied by the franchisor that is important, but the quality of the information and the timing of its submission. The information must be selective and relevant to the business of the prospective franchisee. Likewise, any information which may affect the decision to engage in the franchise agreement should be obtained from the franchisor in good time. These points are discussed further in the following paragraphs.

*(i) Type of Information Which the Franchisee Should Seek*

170. A full account of the information concerning the franchise and the franchisor that should be disclosed to the franchisee prior to the signing of an agreement would be beyond the scope of this Guide. Information provided by the franchisor should not be so abundant that it makes its analysis difficult, but should be sufficient to allow the prospective franchisee to take an informed commercial decision. Such disclosure should, however, include information relied upon to explain any terms, conditions and representations made by the franchisor in respect of the franchised system and the franchise agreement. Consideration should further be given to acquiring the information described in the following paragraphs.

[Business Experience of the Franchisor and his Principal Officers]

171. To be able to evaluate the value of the franchise properly, the franchisee should be advised of the business experience of the franchisor company and its principal officers. This should include the business history of the franchisor and its affiliated companies. Specific information on how long the franchisor has been operating the franchise system and on the scope of its franchise operations should be included. If the franchisor has a long history of operating with a large number of successful franchisees, the prospective franchisee will feel comfortable with the idea of joining such a franchise. If, on the other hand, the franchisor has only been in business a short time, although successfully so far, the risk is somewhat higher.

172. The franchisee should be told of the franchisor's ability to meet his financial obligations. The most recent current balance sheet and

income statement available could be supplied to the prospective franchisee. It may be advisable to require an additional statement describing changes in the franchisor's financial position over a longer period, for example, three years.

[Criminal Charges or Civil Litigation]

173. The franchisor should be obliged to disclose all relevant criminal charges or material civil litigation, involving the company or principal employees and concerning the operation of the franchise, that have occurred over a reasonable period of time in the past.

174. If the franchisor, or any of his principals or agents, have been accused or convicted of serious criminal charges that would affect the operation of the franchise, such as fraud, misrepresentation or embezzlement, for example, that information should be disclosed to prospective franchisees. While the committing of a particular offense in the past through an error of judgment may not affect the current operation of the franchise, the disclosure of such information gives the prospective franchisee the opportunity to take an informed decision.

175. The duty to report civil litigation involving the franchisor and his principal officers and agents is somewhat narrower than the duty to report criminal offenses. Civil litigation reports may be limited to lawsuits that are material to the operation of the franchise or the franchise relationship. Most business enterprises become involved in civil suits regarding the payment of overdue debts and other commercial disputes, but the civil litigation that should be reported is that which relates to the franchised system. For example, suits brought by franchisees who allege that the franchisor has committed fraud or misrepresentation of earnings would obviously be material. Likewise any suits brought by third parties on the grounds of product liability involving the quality of the goods (or services) offered by the franchisor or one of his franchisees would be relevant.

[Bankruptcy, Insolvency or Reorganization as a Result of Bankruptcy]

176. Any declaration of recent bankruptcy or insolvency or reorganization of the franchisor as a result of bankruptcy should also be disclosed. Such disclosure by the principals or agents of the franchisor concerning their private affairs is also advisable, as well as that concerning the bankruptcy, insolvency or reorganization of other companies in which the principals of the franchisor are also involved.

**[Information Concerning Other Franchisees]**

177. The requirement that franchisors supply information to prospective franchisees concerning the names and addresses of other similarly situated franchisees gives the prospective franchisee the opportunity to contact the others and enquire about their experience of the operation of the franchised system. It should, however, be noted that this opportunity may not be useful to a prospective franchisee if the other franchisees are located in geographically remote places and are not easily reached for consultations, apart from which the experience of other franchisees in different areas or countries may not be relevant to local conditions. However, if several franchisees have been established in the same or a neighboring geographical area, the prospective franchisee may wish to learn of their experiences.

178. Other information that may be of interest to a prospective franchisee is the number of franchise agreements that have been terminated or not renewed, along with the reasons for doing or not doing so. While a certain number of terminations and non-renewals should be expected, a very large number may indicate that the franchisor is arbitrarily terminating or refusing to renew franchises.

**[Predicted Income or Profit]**

179. A critical area of information conveyed to the prospective franchisee by the franchisor involves the prediction of the income or profit that the franchisee may expect to make from the operation of the franchise. This information is obviously material to the franchisee's motivation to enter into the franchise relationship. If such earnings claims are made, they should be based on data in the franchisor's possession.

180. It may occur that information on predicted income or profit is not available to the franchisor, or such information may not be reliably extrapolated on the basis of prior experience in other countries or markets. A prospective franchisee should, therefore, not expect to obtain that information in all circumstances.

181. If the franchisor's data refer to different geographical markets, and may not therefore be entirely relevant to the market in which the franchisee will be operating, the prospective franchisee should be advised accordingly. Also, if earnings projections are based on certain assumptions, the nature of the assumptions and the underlying data supporting them must be clearly explained to the prospective franchisee.

182. Furthermore, representations made to the franchisee regarding earnings must be consistent throughout the negotiations. The franchisor should not start the negotiations with very conservatively estimated earnings claims, in order to protect himself against charges of misrepresentation, and then suggest to the prospective franchisee during the negotiations, in order to close the deal, the probability of much higher earnings.

[Description of Financing Arrangements]

183. If the franchisor offers either direct or indirect financing arrangements to the prospective franchisee, the terms and conditions of those arrangements should be fully disclosed to him. The information should include a description of any benefits that the franchisor receives from any person (or company) offering or arranging for financing or any affiliation between that person (or company) and the franchisor. Again the franchisee should be in a position to evaluate the franchisor's interest in recommending such financing.

[Exclusivity or Limitations on Sales by Franchisee]

184. It may be proposed that the franchise agreement contain certain exclusivity clauses having an effect on the manner and extent to which the franchisee may conduct his business. Particularly relevant would be any sector of the market or type of sales which the franchisor intends to reserve for himself or for other franchisees operating in the same geographical area. Here too the prospective franchisee should be advised, before the franchise agreement is concluded, on the nature and scope of exclusivity clauses and on the limitation which such clauses would imply for the franchisee's business activities.

(ii) *Form and Timing of the Presentation of Information by the Franchisor*

185. It may be advisable to require that all pertinent information be disclosed to the prospective franchisee in a single document. Such disclosure in a single document is intended to prevent the franchisor from conveying the required disclosure material in a series of installments over an extended period of time, with the more favorable information being submitted early in the negotiation and the less favorable later, after a prospective franchisee has been persuaded to accept the franchise agreement.

186. It may also be advisable to insist on the disclosure being sent to the prospective franchisee before any face-to-face meeting between him and the franchisor. Again, this protects the prospective franchisee against the fran-

chisor strongly influencing him in favor of entering into the franchise and providing adverse information only at a later date, when the prospective franchisee is less inclined to evaluate it critically. While the franchisor may continue to give the prospective franchisee advertising brochures or make additional presentations, the information contained in them should not contradict the original information presented. Also, if there is a material change in circumstances that would affect the operation of the franchise, the prospective franchisee should be notified as soon as possible.

### (iii) *Consequences of Failure to Disclose Information*

187. Failure by the franchisor to provide material information may entitle the franchisee to terminate the franchise and win compensation for damages sustained, as well as to recover fees paid to the franchisor. A case of fraud or flagrant misrepresentation may expose the franchisor to additional liability, both civil and criminal.

188. As indicated, the requirement of disclosure by the franchisor to the franchisee does not guarantee the latter's success. Even if the franchised system is successful, individual franchisees may fail, or achieve only marginal success, for reasons unrelated to the efforts of the franchisor. The location may turn out to be disadvantageous, for example, because of an unforeseeable shift in highway traffic patterns or other changing conditions. The local economy may suffer a recession and thereby adversely affect the franchise. A particular franchisee may have insufficient business skills to operate the franchise successfully, or he may be inept in dealing with the public or managing employees. Franchising is an investment and, like any other investment, carries a risk of failure. The requirement of disclosure ensures that the franchisor is completely candid with the franchisee, providing information that enables the franchisee to make an informed decision on whether to enter into the franchise agreement.

### (3) *Is the Arrangement, as a Whole, Attractive?*

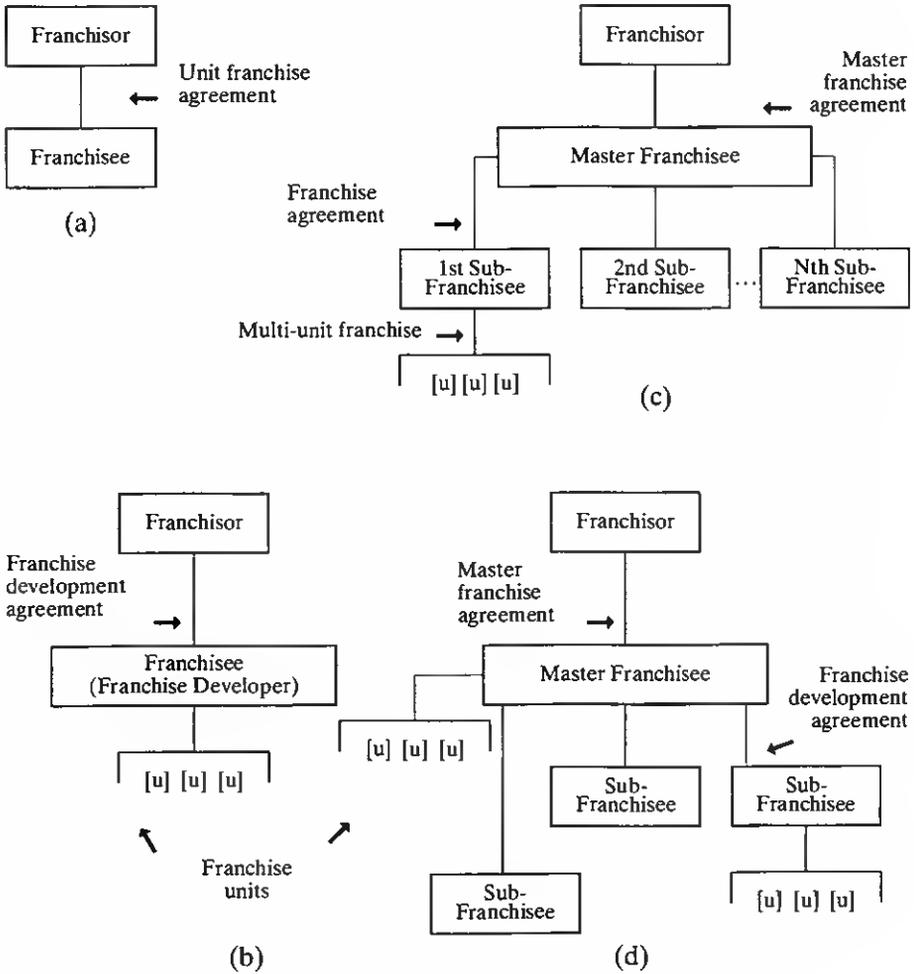
189. Once the true scope of the system being offered by the franchisor has been determined, the prospective franchisee should ask himself the question, "Could I develop the system on my own as efficiently and economically within the same time frame?" If the answer is "yes," then there is perhaps no need to conclude the franchise agreement. However, if the answer is "no," and the prospective franchisee wants to enter into that type of business, then the franchise offer may be considered.

190. Once the prospective franchisee has decided that a franchising arrangement is a suitable form of business arrangement, time should be taken to consider the entire franchise agreement, in the light of business trends and personal considerations, to determine whether he wants to sign the franchise agreement offered by the franchisor.

191. The prospective franchisee should not precipitately enter into the contract on the initial excitement of being offered an attractive business opportunity. He should take sufficient time to reflect on the franchise agreement as a whole, and also on such knowledge as he may have gained of the franchisor, to determine whether the franchise agreement is right for him and whether the franchisor is a suitable business partner. This time for consideration will act as a "cooling-off" period during which the prospective franchisee will take his final decision about the proposed franchise deal.

## APPENDIX I

### EXAMPLES OF FRANCHISING STRUCTURES





## APPENDIX II

### OVERVIEW OF INTELLECTUAL PROPERTY RIGHTS TYPICALLY INCLUDED IN FRANCHISE AGREEMENTS

1. This Appendix identifies the intellectual property rights most commonly included in a franchised system. Under each heading, the nature of the intellectual property right is briefly discussed, and one or more fictional examples are given.

#### A. *Marks and Trade Names*

2. Marks and trade names are distinctive signs commonly used in the course of trade. Their function is different, however. A mark is any sign capable of distinguishing the goods (trademark) or services (service mark) of one enterprise from those of other enterprises. The right to the exclusive use of a mark is typically acquired by registration with the appropriate government agency in a given country. In some countries, however, the rights in a mark can be acquired by its use in commerce.

3. A trade name is a name or designation that identifies a natural person or legal entity, or any business establishment, engaged in commercial activities. Unlike marks, trade names may be generic or descriptive as long as they do not give rise to any mistake or confusion as to the identity of the persons involved or the origin of their goods or services. Rights in trade names are acquired by their adoption or use in commerce. In some countries, however, trade names may be registered in the same way as marks.

4. Turning to the examples, Vespucci, Inc. has adopted the mark VESPUCCI under which products and services are offered at restaurants identified by the trade name VESPUCCI. DESK GEAR, INC. (trade name) has adopted the mark FLUME under which pens are manufactured and sold by it or by others under license.

5. Consumers purchasing products from a franchisee or using services provided by a franchisee expect the quality to meet the standards established by the mark owner. Vespucci, Inc., has established a reputation for operating restaurants identified by the trade name VESPUCCI which sell Italian food products with consistent characteristics and quality under the VESPUCCI mark. Therefore consumers expect any food sold by establishments bearing the VESPUCCI trade name or under the VESPUCCI mark to have the same characteristics and achieve that same level of quality.

6. In the above example, Vespucci, Inc. has decided to license the use of its mark and trade name to franchisees who are willing to meet those high standards of quality. The mark and name are at the heart of the franchise system, and Vespucci, Inc. risks its reputation by allowing the franchisee to use them. To minimize this risk, Vespucci, Inc. will exercise some control over the manner in which a franchisee operates, so as to maintain a certain level of quality in connection with goods or services sold under the VESPUCCI distinctive signs. Moreover, Vespucci, Inc. will maintain the right to inspect the operation of the franchisee to ensure that the required level of quality is being met.

#### B. *Copyright*

7. The system for the protection of literary and artistic works by copyright is well established in the national laws of most countries and internationally under the Berne Convention for the Protection of Literary and Artistic Works. Copyright law may be useful for protecting several elements of a franchise system, such as the operating manual, artistic works and computer programs.

##### (i) *The Operating Manual*

8. Generally a franchisor develops an operating manual, which contains a comprehensive description of all the specific details that have made the franchised system successful in the past in other locations. This information is quite valuable to the franchisee as it permits him to establish a successful business in the shortest possible time.

9. The franchisee's employees will have access to the manual, and if they copy it and supply it to an unauthorized person, or resign from the franchisee's employment and set up a competing business with the help of the copied

manual, the value of the franchised system is greatly reduced. The franchisee has paid for the right to possess and use the manual, and it should not be available to a competitor, in the form of an unauthorized copy, to help him compete with the franchisee. Such copying is prohibited by copyright law, and so the interests of both franchisor and franchisee are protected.

10. In the case of Vespucci, Inc., a great deal of time and effort and many failed experiments have gone into developing the unique and successful system that it is seeking to franchise. Many of the elements that make up this successful system are described in the operating manual. It may, for example, include recipes and techniques for the preparation of the various items it offers on the menu, techniques for cleaning the equipment used in the preparation and serving of the food, techniques for employee training and techniques for serving customers. Vespucci, Inc. retains the copyright in the operating manual, and therefore has the right to prohibit its unauthorized reproduction by the franchisee, the franchisee's employees or any other person.

#### (ii) *Artistic Works*

11. Items such as the design of menus, interior decoration, advertising and radio and television commercials used to promote the franchised system may be protectable as "artistic works."

12. Many of these items, such as advertising and promotional material, menus and the particular shape and ornamental aspect of food containers, have been created by Vespucci, Inc., in which case they want to retain the exclusive right to reproduce or copy them and rely on copyright protection for the purpose.

13. Under many laws, however, a work has to qualify as "original," "distinct" or "artistic" before it can enjoy copyright protection. This condition, and the possibility of copyright law being preempted by statutes governing other forms of intellectual property, should be taken into account.

#### (iii) *Computer Programs*

14. The third area of potential copyright protection is that of computer programs, which have been widely accepted as protectable under copyright laws. This form of protection is important in franchising if the franchisor has developed a special computer program to assist the franchisee. For example, functions such as accounting, labor costs, taxes, inventory control, shipping

and various other areas can be efficiently managed by a purpose-designed computer program.

15. In the example used in this Guide, Vespucci, Inc. has developed such a program, called "Opro," for operating program. This program is capable of keeping track of the inventory that is unique to each VESPUCCI franchise, and of handling all the routine accounting tasks including payroll and bookkeeping. "Opro" is also capable of generating the periodical reports that Vespucci, Inc. requires, under the franchise agreement, for computing the basis for the royalties or other fees that are due.

### C. *Industrial Designs*

16. Many countries have industrial design legislation the purpose of which is to protect, generally speaking, the ornamental or aesthetic aspect of a useful article. The ornamental aspect may consist in the shape, pattern and/or color of the article; it must appeal to the eye and must be reproducible by industrial means.

17. Generally the rights in an industrial design allow the reproduction, importation, selling or stocking of products that incorporate the design to be prevented. The design may have to be registered with the appropriate office in the country where protection is sought. While the protection is of limited scope, the procedure for obtaining it is quite easy in most countries.

18. For example, in the case of Vespucci, Inc., the unique designs of the uniform and shoes worn by the employees have been protected as industrial designs. In addition, the various containers used by Vespucci, Inc. to package the food for its take-out service have a unique shape that has likewise been protected as an industrial design.

### D. *Patents*

19. A patent is a right granted on application by a government office (or a regional office acting for several countries) in respect of an invention. A patent has a limited term, and during that term the invention may not be

exploited without the authorization of the patent holder. Inventions that may be exploited under a franchise might, for example, relate to cooking apparatus (for a restaurant franchise), automobile diagnostic equipment (for a franchise concerning automobile tune-up services), and eyeglass fitting devices (for a franchise concerning the provision of optometric services). Processes may also be patented and may be included in the franchised system.

20. For example, Vespucci, Inc. has patents covering the machines it uses for cooking its food. These machines give an added degree of control to the cooking operation, so that food of a uniformly high quality can be produced which at the same time appeals to a number of different tastes in terms of how well cooked the food is. Vespucci, Inc. considers these machines essential to the provision of the type of food that its franchisees provide. The nature of the machines is such that their design and construction cannot be kept secret. Accordingly, Vespucci, Inc. has applied for and received patent protection for those machines.

#### E. *Unfair Competition*

21. Although protection against unfair competition is not in itself an intellectual property right, it is one of the *objects* of intellectual property. Such protection is directed against acts of competition that are contrary to honest practices in industry or commerce. The Paris Convention for the Protection of Industrial Property defines unfair competition and mentions particular examples of it in Article 10*bis*(2) and (3), which reads as follows:

“(2) Any act of competition contrary to honest practices in industrial or commercial matters constitutes an act of unfair competition.

(3) The following in particular shall be prohibited:

1. all acts of such nature as to create confusion by any means whatever with the establishment, the goods, or the industrial or commercial activities, of a competitor;
2. false allegations in the course of trade of such a nature as to discredit the establishment, the goods, or the industrial or commercial activities, of a competitor;
3. indications or allegations the use of which in the course of trade is liable to mislead the public as to the nature, the manufacturing process, the characteristics, the suitability for their purpose, or the quantity, of the goods.”

(i) *Trade Dress*

22. Acts of unfair competition include those that create confusion, by any means, with the establishment, the goods, or the industrial or commercial activities, of a competitor. A particular example of acts that create confusion is the misappropriation of "trade dress."

23. While a franchisor may not have the right to prevent others from using a particular color or ornamental design, he may have the right to prevent competitors from copying the color scheme or unique shape of the building, the artistic design of the menus and the color and style of employees' uniforms to an extent that consumers would otherwise mistakenly believe that the competitor is associated with the franchise. Such protection is in addition to the marks or trade names owned by a franchisor to identify his goods or services or his establishment.

24. For example, in addition to the words and symbols that Vespucci, Inc. uses to identify its products and services, the overall design of the restaurant, including color schemes, furnishings and other decorative items, contribute to customers' recognition of the VESPUCCI restaurants. This overall design of VESPUCCI restaurants may be protectable as trade dress under the principles of unfair competition.

(ii) *Trade Secrets*

25. Another example of an act of unfair competition is the fact of gaining access by unlawful means to the trade secret of a competitor, or using or disclosing, without authorization, such a trade secret which has been communicated in confidence. Trade secrets include so-called "proprietary know-how."

26. A trade secret is information developed by a person, such as a franchisor, in carrying out his business that gives him an advantage over competitors who are not aware of the information. Some countries grant special protection against the wrongful procurement or use of such information, under limited conditions. In particular, protection applies only to information that is kept in secret by the owner, so that, if the information becomes publicly available, trade secret protection no longer exists.

27. It is essential for the franchisor to keep information considered to be a trade secret confidential or, where it is necessary to disclose it to others, such

as franchisees, such disclosure must take place in a confidential manner. In any case, the franchisor is under an obligation to establish clearly what information is to be regarded as confidential and therefore as a trade secret of the franchisor, and for what purpose or purposes disclosure is authorized.

28. If such confidentiality is maintained, franchisees and the employees or suppliers of franchisees who receive the secret information in confidence can, in most countries, be prohibited from disclosing or using it for their own gain. Competitors who discover the information independently, by lawful means, are not prevented from using it, however.

29. The question whether a former franchisee can use the trade secrets disclosed to him for his own purposes, or disclose them to third parties, after termination of the franchise relationship and, if so, under what conditions, may be the subject of contractual clauses in the franchise agreement.

30. Trade secret protection is well suited to the protection of franchised systems. If the franchisor has developed a series of recipes, processes, methods and other business information useful in the successful operation of the franchise, he will convey this information to the franchisee to assist him in operating the franchise. This information enables the franchisee to start up and operate a successful business as quickly as possible. The franchisee and his employees or suppliers have the benefit of receiving the information from the franchisor, and are permitted to use it on payment of compensation to the franchisor.

31. For example, Vespucci, Inc. has developed a great deal of information which it would like to keep as a trade secret. It has developed recipes for the preparation of its food and techniques for serving it. This information is contained in the operating manual entrusted to each franchisee. While the operating manual is protectable under copyright law, this protection serves only to prevent others from copying it; it does not prevent anyone from using the information contained in it. Trade secret protection is directed towards providing the latter type of protection, and is essential to Vespucci, Inc., and to its franchisees, if they are to prevent others from using their hard-earned knowledge to go into competition with them.

