Importance of Franchising to the Economy

Many leading international businesses have grown through franchising. The franchise model enables business owners to expand their business in partnership with independent entrepreneurs while retaining control of the business model. It is estimated that franchises account for 14 percent of the world's total retail sales. In Europe, there are some 170,000 franchising units, providing employment to approximately 1.5 million people and accounting for a total turnover of approximately 160 billion Euros. In the U.S., approximately one in every twelve new businesses is founded on a franchising agreement. In developing countries, over the last decade, the expansion of franchising has also been significant. For example, in Malaysia, the total franchise sales were recently estimated at about US$ 5 billion, providing employment to 80,000 people and creating over 6,000 franchisees.
Processing franchises. Often referred to as “manufacturing” franchise, the franchisor supplies technical knowledge to a processor or manufacturer. The franchisor grants the franchisee authorization to manufacture and sell products under the trademark(s) of the franchisor and often provides training and information on marketing, distribution and servicing of the product. This type of franchise is most common in the restaurant and fast-food industry.

Service franchises. Here the franchisor develops a certain service that is then provided by the franchisee, under the terms of the franchise agreement, to the customer. The most common example is the provision of after-sale automobile repair services.

Distribution franchises. In this case the franchisor manufactures a product and then sells it to the franchisees. The franchisees in turn sell these products to customers, under the franchisor’s trademark, in their respective geographical sales territories. The sale of electronic goods of various brands by specialized retail outlets is a good example of this type of franchise.

The Franchise Agreement

At the core of the franchising arrangement is a license agreement, granted by the franchisor to the franchisee, to use the franchised system. Amongst other things, the license agreement requires that the franchisee conducts the business in the manner prescribed by the franchisor.

In a franchising relationship, the parties (franchisor and generally many franchisees) have a close working relationship defined by the terms of the franchise agreement. The income of each party is dependent on the combined efforts of both parties. The more successful the franchisee’s business becomes, the greater the income for all parties. The franchisee’s success is also dependent on the franchisor’s ability to develop a profitable system, train the franchisee in the proper operation of the system, improve or promote the system, and support the franchisee throughout the life of the franchise agreement to achieve continued success.

Franchising establishes a business relationship between the franchisor and the franchisee lasting for a number of years. Therefore, it must be built on a solid foundation, for which having a clear understanding of the terms and conditions of the license (franchise) agreement is crucial. Understanding the legal language of the agreement can be daunting, so the advice of an experienced franchise attorney should be sought by a prospective franchisee to fully grasp the legal issues and to avoid making costly mistakes.

IP Issues in Franchising

IP rights are at the heart of any franchising agreement. Therefore, it is necessary to clearly identify and list all types of IP, for example the trademark, trade names, copyright, patent, trade secrets or know-how, which the franchisor will be licensing to the franchisee. The most vital part of IP in a franchise is the trademark, since the whole idea is to manufacture, deliver or distribute a product or service under a certain brand, which has already proved to be successful in the marketplace. Before entering into a franchising agreement, a prospective franchisee must ensure that any IP rights being licensed under the agreement exist, are owned by the franchisor, and that the franchisor is competent to license the IP rights. Equally, the franchisor has to ensure that the IP will not be misused by the franchisee.

As the success of a franchise system often depends on know-how and confidential information, the franchise agreements often include clauses stipulating that the franchisee take all reasonable measures to
prevent the loss or theft of any of the know-how or trade secrets of the franchisor.

Business Issues

Before entering into a franchising relationship, an entrepreneur (a prospective franchisee) should take into account the benefits and costs of entering into such an arrangement. The franchisee should consider the deal from every possible angle, taking into account, for example, personal expectations, financial capacity and local circumstances. An entrepreneur has to decide whether this is the right approach for his business aspirations.

Some potential benefits for the franchisee include the following:

- **Lower risk of failure.** The most vulnerable phase for a business is the start-up phase during which the failure rate is high. A franchisee, however, benefits from a system with a proven track record for products and services that have already done well in the marketplace.

- **Benefit from brand reputation.** The franchisee benefits from the image, reputation and goodwill already attached to the brand, thus the cost of advertising will be significantly lower. In addition, the franchisee may benefit from the collective advertising effort of all franchisees (as well as the franchisor).

- **Collective purchasing power.** Franchisees may sometimes benefit from the collective purchasing power of all franchisees, obtaining supplies at a lower cost thus increasing the profit margins. However, it is not uncommon that franchisees are contractually limited to buying their supplies through the sources authorized by the franchisor.

- **Training and technical support.** Franchisees often benefit from training and technical support, for example, how to conduct their business successfully and ensure that it conforms to the standard operating procedures of the franchising system. This may include support on accounting procedures, management of human resources, and marketing and financial administration.

- **Easier to obtain financing.** A franchisor may support the request of a franchisee for funding from lending institutions, thus increasing the likelihood of obtaining funds for developing the business.

- **Research and development.** As the franchisor develops new or better techniques for the operation of the franchised units, this information is shared with the franchisees. This gives the franchisees access to the results of research and development that they may not be able to afford on their own.

Franchisable Businesses

Franchises are common in a wide variety of sectors. The best known are probably fast-food restaurants; however, franchising is common in accounting and tax services, business and management consultancies, education and training, fashion, clothing and shoe stores, drug stores, hotels, insurance companies, leisure and sports, travel agents and even laundry and dry-cleaning businesses. For a business to be franchisable, it must be a credible business, with an identity that is clearly differentiated from that of its competitors (brand image), a standardized operating system which is properly documented, and which can be learnt by a new franchisee within a short period of time and, above all, it must be capable of providing a much above average return on the franchisee’s investment.

Many countries have national franchising associations, which provide information about franchising opportunities.
On the other hand, some of the drawbacks of franchising for an entrepreneur may include:

- **IP rights.** All IP rights relating to the franchising agreement are owned by the franchisor regardless of how much the franchisee has contributed, for example, to increase the value and enhance the reputation of a mark.

- **Payment of franchising fee and royalties.** On entering into a franchising relationship the franchisee is required, invariably, to pay an initial fee for the grant of the franchise. Thereafter, royalty fees are to be paid at a rate stipulated in the franchising agreement. For the franchisee, these amounts may represent significant costs that it may not be able to afford or that may limit its ability to obtain sufficient returns on its initial investments. In addition, the permanent liability of making payments often brings with it a feeling that the franchisee does not own the business but is merely renting it.

- **Limited freedom to operate the business.** The standard operating procedures generally provide the blueprint of how things must be done by franchising units; therefore the franchisee is very limited in his actions. A franchisor may, for example, limit the franchisee to selling only the products or services that he has approved. Sometimes, the standard operating procedures may prove to be inadequate in international franchises where foreign methods may not be suitable for local circumstances and the overall local business environment. The franchisee is often unable to vary, modify, adapt or improve the system to suit local conditions.

- **Innovations often assigned to the franchisor.** If the franchisee develops certain innovations, within the limited freedom to operate, a franchise agreement would generally require the innovation to be contractually assigned to the franchisor so that it may be made available to all other franchisees.

- **Dependence on franchisor’s success.** If the franchisor is successful, it is likely - though by no means certain - that the franchisees will also prosper and benefit from the success of the franchisor. However, if the franchisor is not successful or encounters any problem it is more than likely to have a negative effect on the franchisees.

**Look Before You Leap**

Bearing in mind the factors mentioned above, an entrepreneur has to decide whether franchising is really the right form of business for him before entering into a franchising agreement. Once an entrepreneur has decided that a franchise arrangement is the most suitable form of business for him, a careful examination and study must be made to consider the entire franchise agreement, in the light of business trends, personal considerations and local circumstances. Franchisees should take special care in deciding whether the overall “system” recommended by the franchiser is suitable for their local market conditions.

For more information on various practical aspects of the IP system of interest to business and industry, please visit the website of the SMEs Division at www.wipo.int/sme/. The next article in the IP for Business series will discuss enforcement of IP rights.