The ABC's of Franchise Law

By David R. Brown

Thousands of brands of goods and services reach the market each day through franchises. Business owners in fields as diverse as fast food restaurants, hotels, and real estate brokerages, find the franchise model appealing. They perceive that operating a franchised business under a recognized brand name inspires confidence in the consumer as to the origin and quality of their offerings, and look forward to easy access to a proven business model. Franchising trade groups estimate that today there are over 534,000 franchised businesses operating in the U.S., which though a mere 3.2% of all businesses by number, represent fully 35% of revenue in retail goods and services. In light of the growing prevalence of franchises as a business model, and their considerable economic power, the nature of the legal relationships which they entail bears examination.

What is a Franchise?

In essence, a franchise is a method of licensing independent persons or entities to sell a good or service, or do business employing unique techniques, using the franchisor's intellectual property, such as trademarks and patents. The law recognizes three main types of "franchise." The first, which best fits the commonplace idea of a "franchise," and which is the focus of this article, is the *business format franchise*. Business format franchises entail a very close and comprehensive relationship between the franchisor and the business owner-franchisee. Chain restaurants and auto dealerships, relatively uniform and familiar in appearance, menu and cleanliness standards, exemplify the business format franchise. Certain product distributorship and licensed manufacturing operations which involve a limited grant of intellectual property to a business owner, are also sometimes referred to as "franchises," but are not considered here.

As they have grown in popularity since the 1960's, business format franchises have developed in a patchily-regulated environment. The perception of overwhelming bargaining power on the part of the franchisor, evidenced by franchisee complaints and frequent litigation has led the federal government and a minority of states to regulate the offering of franchises, and to a lesser degree, franchise relationships themselves. The regulatory trend has been, and continues to be, policing the disclosures contained in franchise offering documents so that each potential franchisee has sufficient information to make an informed decision on the franchise being offered, and not towards active regulation of the franchise relationship once formed except as required to correct truly unfair or abusive franchisor practices.

Who Regulates Franchise Offerings and the Franchisor-Franchisee Relationship?

There is no comprehensive federal franchise regulation program, although the Federal Trade Commission ("FTC") does prescribe minimum disclosures to potential franchisees known as the "FTC Franchise and Business Opportunity Disclosure Rule" or simply the "FTC Rule" Fifteen states (the "Regulating States") have adopted franchise statutes which complement the FTC Rule, and which prescribe the use of a standardized franchise offering document, the "Uniform Franchise Offering Circular" or "UFOC." Illinois is one of these states. Like its counterparts in majority of the other 15 regulating states, the Illinois Franchise Disclosure Act (the "Act") puts disclosure of the terms of the franchise first, and provides only a few limits on the terms of the franchise relationship beyond a general prohibition of deceptive practices.

The FTC Rule sets out minimum disclosure standards for franchise offerings nationwide, but defers to more specific state laws where they exist, i.e., in the Regulating States. Among the information required to be disclosed under the FTC Rule is: the

This article appeared in the Fall 2005 issue of the GReview.

THE ABC'S OF FRANCHISE LAW
(CONTINUED)

experience of the franchisor and its principals; the franchisor's litigation history; the economic details of the franchise offer, including all initial and ongoing fees; territorial and customer limitations on the franchise; the term of the franchise and renewal options; training programs required or offered; and current financial information on the franchisor. The FTC Rule does not require that the offering materials be filed with any government agency, so it is important to note that neither the FTC nor any other regulator has examined or passed upon its contents.

The Regulating States require that franchisors provide a Uniform Franchise Offering Circular ("UFOC") to each potential franchisee. The UFOC provides many of the same disclosures as does the FTC Rule, but generally in greater detail, and, importantly, is allowable as a disclosure document under that rule. As a result, franchisors generally use the UFOC in all states in order to streamline the offering process. In a major departure from the FTC Rule, the Regulating States generally do require that the UFOC and other offering documents be filed with the appropriate franchise regulator before any offer of the franchise is made, although the level of substantive review carried out by a particular state is generally minimal and should not be relied upon by a potential franchisee as a sign of the offering's merit.

What Special Provisions Does Illinois' Franchise Law Contain?

Illinois provides few restrictions on franchisors or protections for franchisees, with two important exceptions. First, franchisors must allow potential franchisees at least 10 days to review the UFOC and other offering materials, before signing a franchise agreement, in contrast to other states which lack such a "waiting period." Second, franchisees whose franchises are terminated by the franchisor and who are then bound by a covenant not to compete generally are entitled to reasonable compensation for the value of their business.

What's the Bottom Line for Potential Franchisors?

A business considering expansion through franchising must first ascertain whether franchising represents a viable business model. If it does, in light of the very detailed disclosure requirements of the FTC Act and the UFOC, close cooperation with counsel and state regulators is essential in order to ensure that potential franchisees receive all required information, minimizing the risk of lawsuits and regulatory action years later.

And for Franchisees?

Potential franchisees must carefully consider whether the benefits of the franchise outweigh the loss of control over even seemingly unimportant business decisions (e.g., what color napkins will we use?). With very few exceptions, the law offers them little in the way of meaningful protection from even onerous franchisor requirements, if properly disclosed at the outset. Thorough business and legal due diligence on a potential franchise must be conducted so that all aspects of the relationship may be evaluated before making a long-term commitment.

This article appeared in the Fall 2005 issue of the GReview.