



GLOBAL JOURNAL OF MANAGEMENT AND BUSINESS RESEARCH  
ECONOMICS AND COMMERCE  
Volume 13 Issue 4 Version 1.0 Year 2013  
Type: Double Blind Peer Reviewed International Research Journal  
Publisher: Global Journals Inc. (USA)  
Online ISSN: 2249-4588 & Print ISSN: 0975-5853

# A Primer on Franchising in the United States: A Vehicle for Economic Mobility?

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**GJMBR-B Classification** : *JEL Code: J60, O10*



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# A Primer on Franchising in the United States: A Vehicle for Economic Mobility?

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## I. OVERVIEW

There are an estimated 3,000 different franchise businesses, commonly called *franchises*, operating in the United States, with approximately 746,828 franchise businesses across 300 business categories. Franchising is said to provide 8,100,000 million Americans with direct employment, and nearly 18 million total jobs in franchise-related operations. Franchising generates \$769 billion of output and \$454 billion towards the United States GDP (or 4.6% of total GDP). The International Franchise Association estimates that franchising involves 40% of all retail sales and that nearly 4% of all small businesses in the United States are franchises. (A-Z Franchises.com, 2013).

## II. WHAT EXACTLY IS FRANCHISING?

From the legal point of view, there is no *one* universally accepted definition of a franchise. The following definition is found in the text of the State of Washington *Franchise Investment Protection Act*:

"*Franchise* means an oral or written contract or agreement, either expressed or implied, in which a person (the franchisor) grants to another person (the franchisee) a license to use a trade name, service mark, trade mark, logotype or related characteristic in which there is a community of interest in the business offering,

selling, distributing goods or services at wholesale or retail, leasing or otherwise and in which the franchisee is required to pay, directly or indirectly, a franchise fee." (Revised Code of Washington (RCW), Chapter 19.100, 2013.)

A second definition is found in the relevant Illinois statute:

"*Franchise* means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which: (a) a franchise is granted the right to engage in the business of offering, selling or distributing goods or services, under a marketing plan or system prescribed in substantial part by a franchisor; and (b) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logo-type, advertising, or other commercial symbol designating the franchisor or its affiliate; and (c) the person granted the right to engage in such business is required to pay a fee of \$500 or more." (Illinois Franchise Disclosure Act of 1987, 2013.)

## III. SETTING UP THE FRANCHISE RELATIONSHIP

Franchisors usually recruit potential franchisees by advertising their particular businesses either in the general media or in specialized "trade publications." Additionally, in the United States, there is an annual "*Franchise Expo*," where all of the major franchisors are represented and where interested individuals can speak face-to-face to franchisor representatives. [See Appendix I.] The franchisor then will send detailed "franchise information kits" to those who answer the advertisements. Typically, this franchise kit points out the great potential for success in this particular industry. It may offer either a single-location franchise or, in some cases, a "master franchise." Thus, from the outset, the prospective franchisee relies heavily on the franchisor for guidance, support, and critical "business information," such as market studies, profit projections, location analysis, leasing information, and information relating to procurement of supplies and equipment for the individual franchise location.

Although there are many individual variables, the details of the arrangement usually follow a set pattern. Once the parties have decided to enter into a franchise relationship, the parties will sign a detailed

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*franchise agreement*. (Slawson, 1971; Burke, 2003). In the franchise agreement, the franchisor will grant the franchisee the right to use the trade mark or the service mark or distribute the standardized product (in a distributorship) in exchange for the payment of an initial franchise fee. The franchisor will often use its real estate expertise (or the services of a designated third party) to determine a specific franchise location, to design or arrange for the standardized construction of the facility, and to install standardized fixtures and equipment on the premises (such as signs, menu boards, logos, lighting, décor, etc.). The franchisor may lease these premises itself to franchisees or may sell such an operation to the franchisee as a "turn-key" operation. (Principe v. McDonald's Corp., 1980).

The franchisor will intensively advertise the product (sometimes on a national basis) in exchange for an advertising fee, usually calculated on the basis of a percentage of the gross sales, on average 3-7%. (Franchise fees will be discussed in greater detail, below.) In addition, the franchisor, in fulfillment of its legal obligation under the *Lanham Act* (1946) to maintain "*quality control*," will create a training program (the most famous may be McDonald's "*Hamburger U*"), prepare training manuals, and will set out stringent guidelines in such areas as the hiring of personnel, a company's uniform requirements or dress code, procurement of supplies, and cleanliness and employee grooming standards for the day-to-day operations of the business.<sup>1</sup>

Among other requirements, "the Lanham Act places an affirmative duty upon a licensor of a registered trademark to take reasonable measures to detect and prevent misleading uses of his mark by his licensees or suffer cancellation of his federal registration." (Dawn Donut Co. v. Hart Food Stores, Inc., 1959. p. 366.) This duty "derives from the Lanham Act's abandonment provisions, which specify that a registrant's mark may be canceled if the registrant fails to control its licensees' use of the licensed mark." (Dawn Donut Co. v. Hart Food Stores, Inc., 1959, p. 366, citing Mini Maid Servs. Co. v. Maid Brigade Sys., Inc., 1992, p. 1519.) As a result, in order to avoid non-compliance with the *Lanham Act*, a licensor of a trademark has a legal obligation to maintain adequate control over the use of its mark. (Gilson, 2013.) In this regard, Professor Gilson (2013, Section 6.04) notes: "Control over the nature and quality of the licensee's goods or services is the touchstone of a valid trademark license."

Once the franchise becomes operational, the franchisee must follow the procedures set out in the franchisor's *confidential operating manual* or risk the termination of the franchise. The *operating manual* usually requires strict accounting procedures (the franchisor will sometimes provide this necessary service, again at a fee), and authorizes the franchisor to inspect the franchisee's books and records. The franchisee will pay

a set royalty (usually based on a percentage of gross sales, on average 5-8%) on a monthly or semi-monthly basis. The franchise agreement will usually obligate the franchisee to secure liability insurance to protect the franchisee and franchisor from casualty losses or law suits—although it would be rare for a franchisor to be held liable for the tortious or improper conduct of a franchisee under the theory of *respondeat superior* because the franchisee is generally considered to be an independent contractor. (Cano v. DPNY, Inc., 2012; Haller & Weisbord, 2013.)

Only by maintaining *uniform standards of quality and appearance* can the franchisor preserve its unique reputation and foster the public's perception and acceptance of its product—often generically termed "good will." (E.g., State Department of Transportation v. Cowan, 2004; Scott, 2003.) In *Cowan*, the court noted: "While different jurisdictions vary slightly in their definitions of goodwill, the term generally is used to describe that component of value attributed to a business's reputation in the community, loyal customer base and ability to attract new customers." (State Department of Transportation v. Cowan, 2004, p. 5, citing Rohan & Reskin, 2004, § 29.01[1].) In *Dugan v. Dugan* (1983, p. 3), the Supreme Court of New Jersey stated that "goodwill is essentially reputation that will probably generate future business." David Logan Scott (2003, p. 170) stated that "A business may build goodwill over time as loyalty builds among its customer base."

Professor Emerson (2013, p. 375) cites certain specific topical concerns as they relate to the ownership of the good will associated with franchising: "termination, nonrenewal, trademark infringement, non-compete covenants, antitrust tying, vicarious liability, taxes, and equitable estoppel. In each area, one can find inconsistent approaches with regard to who owns the goodwill, franchisor or franchisee."

For this reason (and also for important economic reasons) franchisors will typically attempt to obligate a franchise to procure products and supplies from them at set prices (the legality of this practice, termed a "tie-in," will be discussed at length in Part II of our study) or will attempt to "designate" suppliers who

<sup>1</sup> Typically, franchisor control is almost 100 percent. For example, a McDonald's franchise agreement reads:

"The McDonald's System is a comprehensive restaurant system for the retailing of a limited menu of uniform and quality food products, emphasizing prompt and courteous service in a clean, wholesome atmosphere.... The foundation of the McDonald's System and the essence of this License is adherence by Licensee to standards and policies of Licensor providing for the uniform operation of all McDonald's restaurants... including, but not limited to, serving only designated food and beverage products; the use of only prescribed equipment and building layout and designs; strict adherence to designated food and beverage specifications and to Licensor's prescribed standards of Quality, Service, and Cleanliness...." (Husain v. McDonald's Corp., 2012, p. 869.)

can meet the franchisor's specifications and standards.<sup>2</sup> Critics of franchising have argued that these practices, and others which permit the franchisor to "suggest" resale prices (Biggers, Mann & Roberts, 1999), may mean that franchisees will pay inflated prices for supplies or services either to the franchisor or related parties.

The *termination provisions* of the franchising agreement will often constitute "legal traps for the unwary!" (Lederman & Steinberg, 2012.) The franchise agreement will usually set out the duration of the franchise, and will contain provisions for renewals after the initial time period. (Emerson, 2008.) The franchisee will usually be required to agree to a "*covenant not to compete*" which may severely restrict its ability to continue in the same or similar line of work for a set time after the termination of the franchise. (Klarfeld & VanderBroek, 2011; Emerson, 1995.)<sup>3</sup> Also considered are the conditions of default, such as the franchisee's insolvency or the failure to pay the monthly or semi-monthly franchise fee when due. In these and other circumstances, the agreement will usually provide that the franchisor must give the franchisee a "reasonable time" (usually ten days) to "*cure*" any instances of default. Most agreements provide for a notice of termination, and several state laws have set out a "good faith" or similar standard for termination, or have a required "notice period" of up to ninety days before the franchisor can effect a final termination. (Sanders, 1981; Lederman & Steinberg, 2012; Emerson, 2013.)<sup>4</sup>

#### IV. PARTIES TO THE RELATIONSHIP

The person or business entity that grants a franchise to another is called the franchisor or franchiser. [For this paper, the authors will use the term *franchisor*.] The person receiving the franchise is known as the franchisee. Franchises may be involved in retail businesses and may involve the sales of products or services to consumers. In the late 1990s, the "profile" of a typical franchisee in the United States would have revealed the following:

- 42% of all franchises are sold to husband-wife teams;
- 35.2% of franchisees have "significant" corporate experience (5-8 years);
- 49.7% have "some college," and 38.1% have a bachelor's degree;
- The average franchisee had a median income of \$66,617 prior to becoming a franchisee, and a "net worth" of \$329,704 (including the value of any home);
- The average age of a franchisee is 40 years old; the percent sold to women is roughly 11%; and
- The percent of minorities is 5%. (See, e.g., Fibre new.com (Website), 2013).

Interestingly, the 7-Eleven franchise has put forth several questions that they deem relevant in determining if an individual "fits the profile" of a potentially successful franchisee:

"These basic qualifications are only half the story. When considering if 7-Eleven is the right choice, candidates should consider if they possess the traits most common to successful 7-Eleven franchisees: Can you manage multiple tasks simultaneously and adapt to market and company changes? Can you hire, train and supervise employees? Are you willing to empower them and delegate responsibilities to them? Are you dedicated to operations excellence? Do you focus on the details? Are you committed to creating and managing an organization that effectively recruits, trains, retains and motivates people? Do you have a strong desire to build incremental income through execution and the ability to implement company programs and strategies? Do you have food service management or retail experience? Can you deliver an exceptional customer experience while maintaining a commitment to the core values of 7-Eleven? Do you support and understand your local community? Do you have strong ties to your community?" (7-Eleven.com (Website), 2013.)

#### V. CATEGORIES OF FRANCHISING

##### a) *Franchises Fall into two General Categories*

A *distributorship*, which is also termed a *product or trade name franchise*, is a franchise relationship in which a manufacturer/franchisor licenses a franchisee to sell its product either exclusively or in combination with other products. The franchisee is often given the "exclusive right" to sell the product in a

<sup>2</sup> Among the issues raised in determining whether a practice is legal or is illegal as an impermissible tie-in are (1) whether there are one or two products involved in the arrangement, i.e., are the trademark and a product sold at the franchise one or two products; (2) whether the franchisor has coerced its franchisees to take the tied product; (3) whether the franchisor has the requisite economic power in the tying product market; and, (4) the application of defenses. (Schlotzsky's, Ltd v. Sterling Purchasing and National Distribution Co., Inc, 2008; McCarthy, 1970.)

<sup>3</sup> See also Casey's Gen. Stores, Inc. v. Campbell Oil Co., 441 N.W.2d 758, 761 (Iowa 1989), which found that "[n] on competition agreements between a franchisor and a franchisee are designed not only to protect the interests of the immediate parties but also to protect other franchisees against competitive activities. Thus, to the extent that such non-competition agreements are exacted from all franchisees, each franchisee is thereby protected from competition from other franchisees." This is certainly a *different view* of the purposes of these covenants, rather than the standard one of the protection of the franchisor's business interests.

<sup>4</sup> The Virginia Automobile Dealers Association (2013) has compiled the "Top Ten" reason for termination. They include: lack of capitalization; loss of floorplan; bankruptcy; apathy; lack of effort; conviction of a crime; loss of license; fraud; change of control (ownership) without consent; and breach of a supplemental agreement such as a "promise to build a new facility, to relocate, to meet certain sales requirements, or for other purposes."

designated area or territory, or in a "primary area of responsibility." (Klein, 1995; Lockerby, 1986; Gumick & Vieux, 1999.) The franchisee will often pay a royalty fee to the franchisor and a "per product" fee on products sold in some combination.

A second category of franchising is a *chain-style business*, which is also termed a "*business format franchise*," in which a franchisee operates a business under the franchisor's trade name and is thus identified as a member of a "select group" of persons who deal in the particular business. The franchisee is ordinarily obligated to follow a standardized or prescribed format or "method of doing business" and may be subject to the franchisor's control with regard to the materials used in making the product, the design of the facility, site selection, lease negotiation, the hours of business, the qualifications and training of personnel, and the like. In consideration of receiving these services, the franchisee pays an up-front franchise fee and agrees to pay an on-going royalty. The on-going royalty allows the franchisor to provide continued training, research, product development, and support for the entire franchise system. (Perkins, Yatchak & Hadfield, 2010.) In addition, franchisees may be required to pay a percentage of gross sales for advertising expenses or, in some cases, for accounting or other ancillary services provided by the franchisor. (See *Krehl v. Baskin-Robbins Ice Cream Company*, 1982).

It may be interesting to note that the overall number of distributorships has *decreased* in the United States since 1972, owing to the closing of many gasoline stations, and automobile and truck dealerships (GM and Chrysler announced plans to terminate about 2,200 dealerships)-most especially in the period following the recession of 2008-2009. (See, e.g., Lafontaine & Morton, 2010.) In contrast to this decline in distributorships, chain-style franchises have increased in numbers. Large franchisors (with more than 1,000 units each) seem to dominate this category of franchising; most of these franchisors engage in either the restaurant business (Burger King, McDonald's, KFC, Pizza Hut, etc.) or in the retail sales of automotive products and services.

## VI. FRANCHISE FEES

Most franchise systems charge franchisees a *royalty* based on a percentage of gross sales. The average royalty fee is 6.7 percent; however, the percentage varies by type of industry, ranging from 4.6 percent for restaurant and hotel franchises to 12.5 percent for personnel services franchises. Some franchise systems use a *percentage range* that allows for more flexibility based on the nature of the franchise relationship or the age or experience of the franchisor.<sup>5</sup> An example of a flexible formula is a sliding percentage scale that adjusts downward as unit revenues rise or is lower for new units.

### a) Advertising Fees

A second category of fees revolves around marketing and advertising. Keup and Keup (2012) outline the six critical "pillars" of a marketing strategy especially relevant to franchising: advertising, television commercials and interactive TV, sales, direct mail, public relations, and the Internet. These "pillars" may apply both to the efforts of the franchisor initially to market its franchise opportunities or to the franchise organization or their individual franchisees to interact with the public. Franchise systems employ different types of marketing and advertising programs based on their individual industry, location and density of franchise operations, and the business model employed. There are three common advertising models: national/general, local, and cooperative/regional. National advertising is generally for established brands and "large-scale" advertising campaigns; local advertising is usually determined by the individual franchisee and specifically advertises the individual franchise operation; cooperative/regional programs usually promote the generic franchise within a geographically designated market area. Smaller or "start up" systems may only have one general advertising program, especially at the outset of operations, and may leave advertising to the individual franchise units until a national brand has developed.

Advertising fee percentages vary greatly. The average advertising fees range from 4-5%, again calculated on the basis of a percentage of gross sales; however, in practice, some franchise companies charge lower fees than those stipulated in their franchise agreements based on the ability of the franchisee to pay. In some cases, local advertising costs (including sponsoring of local sports teams, "couponing," or "special promotions") can be credited towards regional/cooperative or national requirements. Further, cooperative/regional advertising may not be fully-assessed until a national franchise operation reaches a larger size in its market.

Total franchise fees, which are a combination of royalties and advertising fees, thus may range from a low of 6.3 percent to more than double at the high end of 14 percent. As might be expected, differences in industries, the nature and frequency of services provided by the franchisor, and the perceived value of the franchisor's brand are among the factors accounting for the variance in total fees vary charged to franchisees in a franchise system.

## VII. LINES OF BUSINESS

It is interesting to note the wide variety of *business format franchises* which include:

<sup>5</sup> An excellent depiction and summary of the top 48 U.S. franchises may be found at *AwsomeFranchises.com*, at <http://awesomefranchises.com/a-to-z-franchise-listings>. The website states: "A comprehensive franchise directory containing all the information you need on current franchising available including franchise fees, franchise costs and franchise training."

- *Automotive*, including motor vehicle parts and supply stores, tire dealerships, automotive equipment rental and leasing, and automotive repair and maintenance: approximately 2%;
  - *Commercial and Residential Services*, including building, developing, and general contracting; heavy construction; special trade contractors; facilities support services; services to buildings and dwellings; and waste management and remediation services: approximately 4%;
  - *“Quick Service” (“Fast Food”) Restaurants*, including limited-service eating places, cafeterias, fast-food restaurants, beverage bars, ice cream parlors, pizza delivery establishments, carryout sandwich shops, and carryout service shops with on-premises baking of donuts, cookies, and bagels: approximately 37%;
  - *Table/Full Service Restaurants*: approximately 13%;
  - *Retail Food*, including includes food and beverage stores, convenience stores, food service contractors, caterers, and retail bakeries: approximately 6%;
  - *Lodging*, including hotels, motels, and other accommodations: approximately 9%;
  - *Real Estate*, including lessors of buildings, self-storage units, and other real estate; real estate agents and brokers; and property management and other related activities: approximately 4%;
  - *Retail Products and Services*, including furniture and home furnishings stores, electronics and appliance stores, building material and garden equipment and supplies dealers, health and personal care stores, clothing and general merchandise stores, florists and gift stores, consumer goods rentals, photographic services, and book and music stores: approximately 6%;
  - *Business Services*, including printing, business transportation, warehousing and storage, data processing services, insurance agencies and brokerages, office administrative services, employment services, investigation and security services, tax preparation and payroll services, and heavy equipment leasing: approximately 11%; and
  - *Personal Services*, including educational services, health care, entertainment and recreation, personal and laundry services, veterinary services, loan brokers, credit intermediation and related activities, and personal transportation: approximately 8%.
- a) *Product distribution franchising includes the following major categories*
- *Automotive and Truck Dealers*;
  - *Gasoline Service Stations*; and
  - *Beverage Bottling*, including soft drink and bottled water manufacturing, beer and ale wholesalers, and beer, wine, and liquor stores.
- b) *Statistics gathered from FranchiseKnowHow.com (2013) indicate the following industries with the highest percentages of franchise operations*
- Quick Service Restaurants: 211,313; franchise operated: 125,000 or 59%;
  - Mail and Copy Centers: 5,200; franchise operated: 3,546 or 68%;
  - Children Exam Preparation and Tutoring: 7,192; franchise operated: 2,361 or 33%; [Dominated by Huntington, Kumon and Sylvan].
  - Tax Preparation Services: 25,000; franchise operated: 5,416 or 22%; [Dominated by HR Block and Liberty].
  - Real Estate Brokers: 109,400; franchise operated: 22,000 or 20%; [Led by Century 21].
  - New Car Dealers: 24,888; franchise operated: 24,888 or 100%.
- c) *Industries with the lowest percentages of franchise operations include*
- Beauty Salons: 81,632; franchise operated: 6,500 or 8%;
  - Senior Home Care: 20,433; franchise operated: 1,677 or 8.2%;
  - Home Health Care: 23,000; franchise operated: 565 or 2.5%;
  - Pet Care: 11,353; franchise operated: 252 or 2.2%.

## VIII. PERFORMANCE MEASUREMENT

Meeting profit or other financial expectations is critical to franchisee satisfaction. Franchisees who are satisfied are more likely to comply with system requirements that build the value of the franchised brand. Growth in franchising is generally defined by rising royalties on rising sales. Carper (2010) insists that profitability is key to both franchisee retention and franchise growth. Moreover, to be successful, the franchisor must develop a serious commitment to franchisee profitability. In order for the franchisor to determine when and how to best invest in that commitment, many turn to internal financial benchmarking as their solution. The main difficulty that franchisors may confront is that franchisees may lack critical financial and management skills, do not know how to comply with financial reporting requirements, and/or provide inaccurate or unreliable financial information because they do not understand its importance.

Financial benchmarking entails identifying a point of reference from which measurements of any sort may be made, and in doing so, it provides a process for educating franchisees on the importance of appropriate measurement. It has become customary and inarguably a good business practice to stay up-to-date with the financial performance of franchises. Note that most franchise agreements will require *benchmarking* and frequent reporting from franchisees.

Recently, Griffith University (Southeast Queensland, Australia) has determined that a higher the reporting compliance of performance metrics the better the franchise relationship tends to be. (FranchiseWire.com, 2011.) Several metrics such as inventory turnover, gross margins, repeat customers, labor costs, weekly sales, average order per customer, and employee turnover are now strongly recommended to evaluate the financial/economic success of a franchise. (Small Biz Viewpoints, 2010.) By gaining insight into how they are performing financially, franchisees and franchisors alike are in a position to better allocate resources (FranchiseWire.com, 2011) and to work toward the success of the relationship.

## IX. BENEFITS FROM FRANCHISING

There are several general benefits to franchisees who engage in franchising. Franchising offers the opportunity to start a business despite limited capital (in the form of the initial fee) and limited business experience-which typically ranges from 0 to 7 years. Franchising also is based on the existence of that important business intangible-the *goodwill* that results from marketing a nationally or internationally known, high-quality trademark or service mark, which not only benefits the individual franchisees but also raises customer acceptance and recognition throughout the franchise system. (See, e.g., Shell Oil Co. v. Marinello, 1973). Franchising provides a unique access to the franchisor's business expertise in such areas as inventory control, warehousing, advertising, market research, product sourcing, and product innovation. Franchising also provides an assured supply of materials in a distributorship arrangement, the use of bulk-buying techniques based upon the concept of "economies of scale," and access to proven methods of employee training and supervision. (Mendelsohn, 1970; Chisum, 1973.)

On the other side of the equation, the franchisor also reaps enormous benefits from a successful franchise operation. These include a steady stream of income garnered from the franchisee's investment of capital in the business enterprise, generated through the initial franchise fee and collection of on-going franchise fees. The franchisor also will experience the influx of goodwill and other advantages flowing from the franchisee's entrepreneurial abilities, including the enhanced value of the trademark or service mark through its usage and visibility in the market place, resulting from a successful franchise operation. The franchisor will be able to avail itself of an assured distribution network, which also brings about symmetrical "economies of scale" for the franchisor in managing labor costs, producing a more certain demand curve which will also reduce wide fluctuations in sales. (Ungar v. Dunkin' Donuts of America, Inc., 1976.) On a more practical

level, the operation of a franchise also provides an opportunity for employment, albeit at the "entry level," or in recent years, for seniors and younger workers who might be available at the "low end" of wage rates. From a financial point of view, franchising will often provide the franchisor with a larger asset base, the ability to secure a larger line of credit, the possibility of enhanced profits, and the diffusion of financial risks. (Brown, 1982).

## X. MASTER FRANCHISING

A master franchisor has the ability to open numerous franchise locations either individually ("single unit") or by a process called "sub-franchising." (Steinberg & Campbell, 2013.) This practice is especially prevalent in two circumstances: when a "new franchise opportunity" is being created and the franchisor wishes to expand locations rapidly; or, in international franchising, where the franchisor wishes to establish large area (city/region/nation) franchises through one individual or entity which will then be responsible to create sub-franchisees either on the basis of a plan or according to the dictates of the market. (Lozada, Hunter & Kritz, 2005.) It is important to understand the distinction between a "contractual obligation" to create additional locations (which may involve expansion before time or financial realities dictate such expansion) and the "ability" or *option* to open new franchise locations.

Most franchisees awarded by U.S. franchisors to foreign entrepreneurs have been either to award "multiple-unit-franchises" to aggressive entrepreneurs who will be responsible for the development of an entire geographic region (perhaps even an entire country), either through their own efforts and resources; by sub-franchising to third parties; through some form of a "joint venture" (E.g., Weinberg & Shaw, 2012); or a licensing agreement.

### a) Multi-Unit Franchising

The two primary types of multiple-unit franchise development strategies involve *sub-franchisors*, who act as *independent marketing agents* and who are responsible for the recruitment and ongoing support of franchisees within their region-frequently through the use of option-contracts or "rights of first refusal"; or area *developers*, who have no resale rights but rather are themselves responsible for meeting a "mandatory development schedule" in their given region. (Steinberg & Campbell, 2013).

The inclusion of multiple-unit franchises in a franchisor's overall development strategy (through the adoption of a "strategic plan") allows for even more market penetration and less administrative burdens and costs to the franchisor. The key issues in structuring an area development agreement usually revolve around the size of the territory, fees, and the "mandatory timetable"

for development of the units. The franchisor will usually retain certain rights in the event the franchisee defaults on its development obligations. The area developer will usually pay an "umbrella fee" for the development of individual franchises in a region, over and above the initial fee that is due and payable as each unit becomes operational within the territory. The amount of the fee will vary, depending on factors such as the strength of the franchisor's trademarks and market share, the size of the territory, and the term (including any renewal) of the agreement. The *development fee* is essentially a payment to the franchisor that prevents the franchisor from offering any other franchises within that region (unless there is a default, as where the franchisee fails to meet any "mandatory development schedule").

#### b) Structuring Sub-Franchising Agreements

Sub-franchising agreements present a variety of issues and problems that are not raised in the sale of a single-unit franchise or an area development agreement. In most sub-franchising relationships, the franchisor will share a portion of the initial franchise fee and ongoing royalties with the sub-franchisor, in exchange for the sub-franchisor *assuming many responsibilities associated with the "quality control" function in the given region*. The proportion in which fees are shared usually has a direct relationship to the exact responsibilities of the sub-franchisor. In addition, the sub-franchisor will receive a *comprehensive regional operations manual* that covers sales and promotions, and training and field supervision over and above the information contained in the operations manuals provided to the individual franchisees.

A sub-franchisor will enter into what is typically referred to as a *Regional Development Agreement* (RDA) with the franchisor, under which the sub-franchisor is granted certain rights to develop a particular region. The RDA is not in itself a franchise agreement to operate any individual franchise units; rather, it grants the sub-franchisor the *right* to sell franchises to individuals using the franchisor's system and proprietary marks solely for the purpose of recruitment, management, supervision, and support of individual franchisees. To the extent that the sub-franchisor itself develops units, then an individual franchise agreement for each unit must be executed.

The relationship between the franchisor and sub-franchisor is unique and complicated. The advantages to the franchisor ("Master Franchisor") include rapid market penetration, the delegation of obligations the franchisor would otherwise be required to fulfill to each franchisee in its "network," and the ability to collect a percentage of the initial franchise fee and the ongoing royalty fee from each franchisee, generally without the same level of effort that would be required in a single-unit relationship.

#### c) Joint Ventures

In the franchising context, many American franchisors have entered into foreign markets through a joint venture agreement in which parties have co-ownership and are responsible for co-development of the market. (Weinberg & Shaw, 2012). A good example is China. U.S. franchisors are continuing to play the leading role in China's franchise market since its inception in 1987 when KFC's first Chinese outlet was opened in Beijing. Major U.S. franchisors in China include:

- Catering sector: KFC, McDonald's, Pizza Hut, T.G.I. Friday's, Subway, Haagen Dazs, Starbucks Coffee;
- Retailing sector: Wal-Mart, 7-Eleven;
- Real estate brokerage: Century 21;
- Photo developing: Kodak;
- Printing service: Kinko's; and
- Footwear: Athlete's Foot. (Franchising Industry in China, 2013.)

Risks are shared by both joint venture partners and the trade marks/systems are licensed by the franchisor to the joint venture entity. A joint venture may also be established when the existing franchisor wishes to offer products or services to an existing franchise.

Before a joint venture (or partnership) can be undertaken, the following preliminary questions should be addressed:

- Exactly what type of tangible and intangible assets will be contributed by each party? Which party will possess ownership rights to the property?
- Who will own property developed as a result of the joint development efforts?
- What covenants of nondisclosure or non-competition will be expected of each joint venture partner during the term of the agreement and thereafter?
- What timetables or performance quotas for completion of the projects contemplated by the joint venture will be included in the agreement? What are the rights and remedies if these performance standards are not met?
- How will the issues of management and control be addressed in the agreement?
- What are the procedures for resolving disputes, disagreements, or deadlocks between the joint venture partners?

## XI. SOME CONCLUDING REMARKS

According to the forecast of the *Franchise Business Economic Outlook* (Haller & Weisbord, 2013), the number of franchise establishments in the United States will increase by 1.5 percent in 2013. The number of jobs in franchise establishments will increase 2.0 percent in 2013, following a gain of 2.2 percent in 2012. The output of franchise establishments in nominal dollars in 2013 will increase 4.3 percent, following a 4.9

percent increase in 2012. The gross domestic product (GDP) of the *franchise sector* is projected to increase to \$472 billion in 2013.

James Gillula, of *HIS Global Insights*, noted: "We continue to expect that the economy is headed for another 'spring swoon,' this time brought on by the federal government's spending sequester." However, he continued: "The primary sources of the expected slow pace of GDP growth in 2013 will have a less direct impact on the franchise sector, and we expect the franchise sector will continue to outperform within many of the industries where franchises are concentrated." (Haller & Weisbord, 2013.)

What might be expected is that *Business Services and Commercial & Residential Services* will rank as the top two sectors in both franchise employment growth and growth of the number of establishments in 2013. Surprisingly, *Real Estate* (making a remarkable comeback from the depths of 2008-2009) will rank first in output growth and will be among the top three in franchise growth for establishments and employment. *Quick Service Restaurants*-the largest franchise business line-will rank third in the growth of output. While growth of *full-service restaurant* sales industry-wide slowed in the first quarter of 2013, the 2013 forecast for full service restaurants was revised downward slightly.

It seems as if franchising is and will remain an important sector of the American economy.

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