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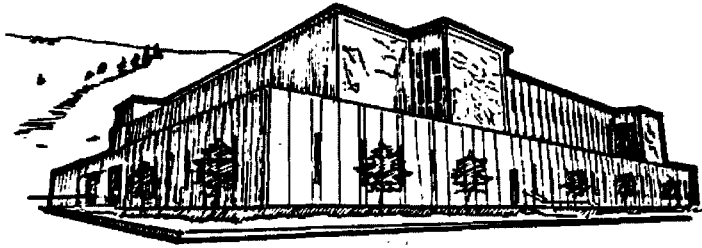
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THE FRANCHISE AGREEMENT:
AN ANALYSIS OF THE CONTRACTUAL ELEMENTS OF FRANCHISING

BY

RENWICK W. RICHARDSON SR.

B.G.S., UNIVERSITY OF SOUTH CAROLINA, 1979

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TABLE OF CONTENTS

LIST OF ILLUSTRATIONS iii

LIST OF TABLES iv

Chapter

1. INTRODUCTION AND HISTORY OF FRANCHISING . . . 1

Problems in Franchising

2. PREVIOUS RESEARCH 6

3. PRESENT STUDY 17

Scope of Research

Research Procedures

4. FOLLOW-UP RESEARCH RESULTS 21

Unfair Provisions

Hypothesis

5. SUMMARY 36

APPENDIX I. FRANCHISE PROVISIONS 40

APPENDIX II. LETTER OF SOLICITATION 99

APPENDIX III. FREQUENCY OF PROVISIONS OCCURRENCE 100

FOOTNOTES 109

BIBLIOGRAPHY 110

LIST OF ILLUSTRATIONS

| Figure | | Page |
|--------|--|------|
| 1. | Franchise Provisions Comparison (1973 vs 1988) . | 28 |
| 2. | Cumulative Totals of National/Regionally Known Franchises | 35 |

LIST OF TABLES

| Table | | Page |
|-------|--|------|
| 1. | Key Concerns Identified in the Previous Research | 16 |

CHAPTER 1

INTRODUCTION AND HISTORY OF FRANCHISING

The following study was conducted in an effort to see what had, or had not changed in the franchising industry from the time the original study concluded in 1973. The original study was conducted by Dr. Gerald G. Udell, who identified 158 contractual provisions as a basis in comparing franchise contracts. This comparison identified the presence of the provisions, and questioned the fairness in the franchisor's application of the provisions. This follow-up study consists of reviewing published literature of the original study, and conducting a survey similar to find out what had changed in the interim years.

Franchising's origin actually began during the Middle Ages. Historically, kings and noblemen granted fiefs land to live and farm on. In return, the fiefs provided revenue from the sale of their crops, and in war, the fiefs would serve as loyal troops. This practice ended in 1562 with the enactment of the Council of Trent, but the basic idea of franchising had been established.

Franchising came to America in 1496, when King Henry VII granted Giovanni Caboto (John Cabot) and sons the following:

We have given and granted to them, their heires and deputies, that all the firme lands, isles, villages, townes, castles, and places whatsoever they be that they shall chance to finde, may not of any other of our subjects be frequented or visited without the license of the foresayd John and his sonnes...¹

Modern franchising began prior to the end of the Civil War when Singer Sewing Machine Company chose franchising as a method of distribution.² As time passed, more business persons used this method of distribution and company names became well known throughout the country. Examples of companies include Rexall Drugs, General Motors, and Pepsi-Cola.

Problems in Franchising

Since World War II, America has experienced exponential growth in business enterprises.³ With this growth came problems in fair trade, fair wages, business ethics and generally deciding what was good for the franchising industry.

To give the reader some idea how big this industry is, the following is a list of the five largest franchise restaurant chains and their sales in 1986 and 1987.

| <u>FRANCHISE</u> | <u>1986 SALES</u> <u>(in billions)</u> | <u>1987 SALES</u> <u>(in billions)</u> |
|-------------------|---|---|
| 1. McDonald's | \$12.4 | \$14.3 |
| 2. Burger King | 5.0 | 5.6 |
| 3. Kentucky Fried | 3.5 | 4.1 |
| 4. Hardee's | 2.7 | 3.0 |
| 5. Wendy's | 2.7 | 2.8 |

Source: Harriet C. Johnson, "Franchise Industry Hungers for Fast Food". (USA TODAY, 11 February 1988 ed.), p. 8B.

According to the 1987 Commerce Department report, sales at fast food establishments are expected to grow more than 11 percent in 1990. They also estimate that 91,000 franchised restaurants will operate in 1988, up 9.2 percent from the 83,331 figure in 1987.

Franchised businesses grew rapidly, and with this growth came indecision, confusion, chaos and contradiction on how to own and operate a franchised business that met standards of fairness. Because of the rapid growth and relative newness of this industry, many opportunities for unfair practices in the daily transactions between franchisor and franchisee existed.

As Dr. Gerald G. Udell stated in a research article, titled, "The Franchise Agreement Handbook".

...franchising represents a compromise between the franchisee's desire for independence and his desire for security (risk reduction). To a degree, these desires are incompatible and mutually exclusive".⁴

Because the relationship between these two elements of security and independence may not be adequately understood by the franchisee, he may be easily deceived by a one-sided franchise agreement. In defining a one-sided franchise agreement, the reader should envision two tribes coexisting on an island. Tribe one, the franchisor, is armed with guns and ammunition, and tribe two, the franchisee, is armed with spears and knives. Because tribe one has superior weaponry, it is able to impose its will upon tribe two. This imposition can produce fear, confusion and a rebellious attitude. In the end, neither party may be well served.

The one-sided franchise agreement brought much attention to the small business community in 1970. Speaking before a U.S. Senate Subcommittee with a prepared text, Harold Brown, a critic of franchising, testified as follows:

There is a marked, intentional, and constantly emphasized disparity in the positions of the parties--the franchisor combining the roles of father, teacher, and drill sergeant, with the franchisee relegated to those of son, pupil, and buck-private, respectively . . . control is buttressed by the contractual requirement that the franchisee must obey the commands of the operating manual as expounded by the franchisor's supervisor, on pain of losing the franchise if he disobeys them and under constant threat of such termination.⁵

And upon termination, or failure to renew the franchise contract, the franchisee is often confronted with the covenant to compete and forfeiture of his equity in the business.

What Harold Brown said to that 1970 U.S. Senate Subcommittee is the essence of what troubles most potential franchisees. As Mr. Brown indicated, if one could obtain an operating manual, one would often find stipulations within that are dubious in nature or in favor of the franchisor.⁶ These types of practices have led to many supposedly significant changes in the franchising industry.

To further examine possible changes in the franchise industry, a hypothesis was formed to determine whether nationally known fast food franchises were being over-controlled through numerous contract provisions when compared to regionally known fast food franchises.

The remainder of this paper contains: Chapter 2, which reviews the previous study in franchise contractual agreements in 1973 by Dr. Gerald Udell. Chapter 3 is a presentation of a present day study in franchise agreements conducted in 1988. Chapter 4 discusses the results of the present day study. Chapter 5 is a summary of the research and the results.

In addition, there are three appendices. Appendix I defines and lists the contractual provisions used in the research. Appendix II is an illustration of a letter soliciting franchisor support of the research. Appendix III compares the numerical occurrence of each provision from the original study versus the present day study.

CHAPTER 2

PREVIOUS RESEARCH

In 1973, Dr. Gerald G. Udell conducted extensive research into the fairness of contractual agreements between franchisors and franchisees in an effort to aid those who seek to understand the franchise agreement and its inter-relationship between franchisors and franchisees.

Dr. Udell used the following four phases to conduct his research:

Phase 1. Solicit franchise agreements

Requests were mailed to franchisors soliciting a copy of the contracts they used to conduct business. Three groups of franchise system were solicited. They were fast foods, convenience food stores, and coin-operated laundries. One hundred forty-three contracts were received from the three groups. Of those contracts received, one hundred twenty-two were from the fast food franchisors.⁷ The remaining contracts were from the laundries and convenience stores.

Aside from the three groups mentioned above, there were approximately 400 other franchised systems that could be grouped into sixty franchise industries. From these

franchise systems, one hundred franchisors were solicited for contracts, only sixteen were received. Thirteen contracts were obtained from other sources, and ten were received after the analysis had been completed, making the total number of contracts observed to be one hundred eighty-two.⁸

Phase 2. Contract analysis and classification of elements.

In this phase, each contract was analyzed to identify the contract elements it contained. The provisions in each contract were entered into a log and were grouped based upon commonality (i.e. advertising, supplies).

These provisions can be further combined into several sections:

Section 1 is concerned with payments to franchisors, indirect payments, special payments, penalties, security deposit, and termination penalties.

Section 2 discusses general contract provisions. This includes length of contract terms, option to renew, exclusive territory, start-up date, franchisor confidential disclosure, franchisee confidential disclosure, independent contractor, hold harmless, act of God, no waiver of default, illegal covenant, legal business, franchisee association forbidden, right to future revision, operating manual, goodwill payments, correction of deficiency, compliance with local laws, franchise disability, arbitration, and site selection.

Section 3 deals with miscellaneous contract provisions. It covers incorporation permitted, trademark restrictions, distinctive architecture, ethical behavior, state of interpretation, venue clause, sub-franchising, civil rights, full time, competitive business, restriction on sale of goods, product service, sales quota, and guaranteed sales.

Section 4 concerns provisions of uniformity. This outlines physical layout, local variations permitted, days open, hours open, product line, price control, and alteration approval.

Section 5 discusses provisions of occupancy. This includes franchisee ownership, franchisor ownership, franchisee lease, franchisor lease, lease approval, notice of non-compliance, lease back, lease loss.

Section 6 covers obligations of the franchisor. This section outlines the franchisor's obligations to analyze reports, to advertise, to account for advertising funds, to advise and consult, inspect, advise franchisee of changes, and grand opening assistance.

Section 7 describes bookkeeping provisions which includes bank approval, bookkeeping system approval, franchisor's bookkeeping system required, annual certified audit, right to audit books, margin of error, federal income tax copy, periodic reports, cash withdrawal, and profit withdrawal.

Section 8 elaborates on employee conduct and training. Covered in this section are employee uniforms, employee

conduct, number of employees, right to hire and fire, franchisee formal training, refresher course, training of subsequent managers, training of key employees, all employee training, and on-the-job training and assistance.

Section 9 defines insurance provisions that deal with franchisor administration, franchisor co-insured, cancellation notice, approval of franchisee's insurance company, proof of insurance, and the different types of insurance to include; business interruption, workers' compensation, personal, employer liability, product liability, and property liability.

Section 10 discusses purchasing provisions which involves the franchisee's purchase of paper goods, operating supplies and services, equipment, signs, price restriction, franchisor/vendor rebate, and vending approval.

Section 11 provides insight to provisions of advertising. This covers franchisor/franchisee advertising, the franchisor's right to enter and destroy, requirements for signs, the franchisor's approval of advertising, and advertising association or committee.

Section 12 covers the provisions in franchise termination and sale. This section discusses the franchisor's right of first approval, the franchisee's right of first refusal, the right of inheritance, the franchisor's approval of sale, no "for sale" advertising, binding upon successors, stock transfer approval, and no goodwill payments.

Section 13 discusses the terms of termination. These terms are failure to pay, franchisee/franchisor right to early termination, termination for any violation, termination for bankruptcy, training failure or violation of standards, immediate cancellation, and grace periods.

Section 14 provides for the franchisee's obligation after termination. These provisions are described in a series of covenants. There are covenants not to compete, not to hire, not to use the franchise system, cease operations, change the building, remove signs, and paying the cost of enforcing these covenants should the franchisee refuse to comply.

Finally, section 15 outlines the provisions for sale after the termination of the franchised business. These provisions describe the procedures used by the franchisor in a buy back of assets from the former franchisee.

To ensure the contracts collected were a representation of the industry's franchise agreements, three steps were taken:

1. A review of the literature was made to identify additional provisions.
2. A test of redundancy was used to determine whether or not a sufficient amount of contracts were gathered from each major group.
3. Panel members in the research were asked during the third phase to mention any provisions not previously listed.

The use of three independent steps, provided a check on the accuracy and completeness of the franchise agreement analysis.⁹

Phase 3. Review Elements with the Panel of Experts, Franchisors, and Franchisees.

In this phase, a panel reviewed each contractual element to: 1) expand the knowledge about the elements by including the experiences of the other panel members; 2) ensure correct interpretation; 3) judge each provision in terms of importance, equitable nature, and legality; and 4) reduce the number of contractual elements to a manageable number.¹⁰

The panel consisted of twenty-nine franchisors, franchisees, franchise consultants, franchise lawyers, representatives of franchise associations, and several state and federal agencies interested in franchising.¹¹

In order to select criteria to be used by the panel during this phase, a total of ten questions were reviewed by a small group consisting of two franchisors, two franchisees, and two faculty members. The ten questions are paraphrased below:

1. Is the provision of importance to either party?
2. Is it essential?
3. Does it create the opportunity for fraud or unfair advantage?
4. Are the demands reasonable?
5. Is the clause enforceable?

6. Does it protect the interests of both parties?
7. Is the provision ethical?
8. Are payments and penalties fair and earned?
9. Does the contract element protect the interests of both parties?
10. Does the provision favor one party or the other?

Phase 4. Mail Survey of Franchisors and Franchisees.

Surveys were mailed to two hundred sixty-nine franchisors, two hundred thirty-four franchisees, and seventy-five franchise experts, which included franchise consultants, lawyers, authors, trade journal editors/publishers, and federal and state agencies.

A total of 588 questionnaires were mailed. Of the 588 surveys sent out, only 160 were returned. Twelve of these were returned too late, thus reducing the sample size to 140. Half of the participants in the survey were chosen from a national, randomly selected, sample of telephone books. The other half was selected from telephone books in the states of Wisconsin, Illinois, and Indiana. The mentioned states were chosen because they were in close proximity to the research site, thus allowing the researchers ample opportunities to conduct interviews with the participants without traveling great distances.

Wherein a true random sample would provide more validity, the previous study did note that a true random sample selection of the franchise industry was virtually impossible due to the unavailability of a list of

franchises. However, it was estimated that there were 500,000 franchises in the United States, with 50,000 new franchise businesses being formed each year.¹²

Phase 5. Analysis of Contract Elements.

In this phase, personal interviews were conducted in the states of Wisconsin, Illinois, Indiana, Washington, Louisiana, Minnesota, and Michigan. The results from the previous four phases and the interviews were incorporated into a composite analysis.

In summarizing the results of Dr. Udell's study, it was revealed that the franchise agreement plays a major role in the relationship between franchisor and franchisee. The results also revealed that much of the unfairness in franchising is found in the franchise agreement. A paraphrased definition of an unfair provision provided by the initial study can be stated as a provision that does not offer the franchisee the same basic rights as extended to the franchisor. Additionally, an unfair provision can be used to manipulate or force the franchisee to perform in a way that may not be conducive for a healthy or profitable business, but it provides larger payments or profits to the franchisor.

Most contracts were one-sided in favor of the franchisor, giving rise to unfair franchisee - franchisor relationship. As an example of the one-sided relationship, the examining panel did not find one contract that dealt with

franchisor's non-performance. The franchisee could, however, heavily penalized or terminated for non-performance.

There were clauses that created situations whereby the franchisor could benefit financially by treating the franchisee unfairly. As examples, there were provisions requiring the franchisee to purchase standard goods or material from specified sources, termination or heavy penalties should the franchisee commit the slightest deviation from contract provisions, or the presence of unreasonable rates of depreciation.

According to Dr. Udell, provisions of this nature create incentives for unfair treatment of the franchisee by the unethical franchisor.

Despite the results mentioned above, the panel did find many ethical franchisors who were diligently trying to provide good services to the franchisees.

Phase 3 found that in the long run, some provisions such as those found during the study, opened the door to unfair treatment of the franchisee. Furthermore, many of the provisions were questionable in ethics and legality. The panel also found that many provisions contributed to suspicion, mistrust, and could be removed or rewritten with little effect on the franchise contract.

Depicted in Table 1 are the sections previously discussed. The table also gives the number of provisions each section contains and also indicates the number of provisions

found to be unfair. The following chapter will identify and discuss the unfair provisions from each section.

In cross-referencing the information in the initial study with current literature, the author did not find any material that performed research or gathered data as the initial study. What was gained from the cross-reference was a different insight to franchising as it appears to others.

TABLE 1

Key Concerns Identified in the Previous Research

| <u>Section</u> | <u>Contract Provisions</u> | <u>No. of Provisions in section</u> | <u>No. of Unfair Provisions in section</u> |
|----------------|---|-------------------------------------|--|
| 1. | Payments to the Franchisor. | 15 | 4 |
| 2. | General Contract Provisions. | 21 | 4 |
| 3. | Miscellaneous Contract Provisions. | 14 | 0 |
| 4. | Provisions of Uniformity. | 7 | 2 |
| 5. | Provisions of Occupancy. | 8 | 2 |
| 6. | Obligations of the Franchisor. | 7 | 0 |
| 7. | Bookkeeping Provisions. | 10 | 1 |
| 8. | Employee Conduct and Training. | 10 | 2 |
| 9. | Insurance Provisions. | 11 | 1 |
| 10. | Purchasing Provisions. | 17 | 4 |
| 11. | Provisions of Advertising. | 5 | 1 |
| 12. | Provisions in Franchise Termination and Sale. | 10 | 1 |
| 13. | Terms of Termination. | 11 | 4 |
| 14. | Franchisee's Obligation After Termination. | 8 | 2 |
| 15. | Provisions for Sale After the Termination. | 4 | 0 |

CHAPTER 3

PRESENT STUDY

This study was designed to follow up on Dr. Udell's research. It was conducted beginning in November, 1987, and ending in January, 1988. The purpose of the follow-up research was to determine the changes in franchise contract provisions during the past fifteen years.

Since the majority of franchise contracts received in the Udell study were from fast food franchised businesses, 67 percent (122 out of 182), it was decided that the follow-up study would focus only on the fast food franchise contracts. If significant changes were identified in this industry, then other industries could be looked at as well.

Scope of Research

Primary research was limited to the data from the franchise contracts received from each franchise home office. Secondary data was drawn from Mr. Terry Sutton, who has been a manager at two nationally known fast food franchises, and from Dr. Udell, who is a member of the faculty at the University of North Dakota in Grand Forks, North Dakota.

The research procedures used in the follow-up study are a derivative of those used in 1973 by Dr. Udell. The judgmental criteria in determining a fair or unfair provision

were abstracted from the analysis of the initial study and were used in the present study. A paraphrased definition of an unfair provision provided by the initial study can be stated as a provision that does not offer the franchisee the same basic rights as extended to the franchisor. Additionally, an unfair provision can be used to manipulate or force the franchisee to perform in a way that may not be conducive for healthy or profitable business, but it provides larger payments, or profits to the franchisor.

Research Procedures

Franchise contracts were requested from the franchisors. In keeping the research manageable, one hundred letters were mailed to franchisors requesting copies of contracts they used in starting new franchisees in their systems. The one hundred franchisors selected to receive the letters requesting copies were obtained from a listing of franchise businesses Dr. Udell kept current. This list included those franchises from the previous study that are still in business today and franchises that have come into existence since that time.

The selection process divided the franchisors into two categories: (1) nationally known franchises and (2) regionally known franchises. A nationally known franchise is defined as a franchise system that is recognized by U.S. consumers from coast to coast. A regionally known franchise is not known nationally, but it may be quite prevalent in a particular region of the United States.

Each category contained fifty franchisors. The selection of franchise systems in each category was by personal recognition and random choice. The intent of categorizing was to try to obtain equal amounts of contracts from both large and small franchise systems in an effort to determine whether large franchises include more provisions in their contracts when compared to the smaller franchise systems.

The letters requesting copies of the contracts were mailed at the beginning of November, 1987. A copy of the letter can be found in Appendix II. Of the one hundred contracts requested, only twenty-six were received by the end of the second week of February, 1988.

In the next phase, each contract was reviewed to see if it contained some, or all of the 158 provisions outlined in Chapter 2. To record the presence of the provisions, a tally sheet was used. After making the appropriate annotations to the tally sheet, the marks in each category of provisions were summed to determine the frequency of its occurrence in the collective group of the twenty-six contracts. This frequency of occurrence is shown in Appendix III.

In addition to finding the frequency of occurrence of each provision, the twenty-six contracts were redefined into two categories of (1) nationally known, and (2) regional franchises.

In this study, the franchises were evenly distributed with thirteen contracts in each category.

It was hypothesized that national franchises may be overcontrolling their systems by using large numbers of provisions in their contracts when compared to the number of provisions found in the regional franchises. This hypothesis was tested by totalling the provisions in each contract to produce a cumulative sum for each category. A comparison of the cumulative sum of each category would be made to determine the accuracy of the hypothesis.

CHAPTER 4

FOLLOW-UP RESEARCH RESULTS

The receipt of twenty-six contracts out of the one hundred requested, was somewhat of a disappointment. The non-responding franchises were either very large and well known, or very regional in their existence. Eleven of the non-respondents had very large franchise systems, and the remaining sixty-four were regional.

Wherein only twenty-six contracts were received, ten of the twenty-six franchises had participated in the original study. The author felt that this would provide ideal data to assess possible change in the contracts employed in franchising. To negate any bias analysis, contracts from the ten franchises that participated in the original study were not compared to contracts received in the present study.

Provisions in the contracts received from the franchisors were compared with the same provisions in Dr. Udell's original study. The provisions were compared to ascertain any changes in the terms used in the wording of the provision. It was noted that contracts from the current and previous study used large portions of legal terminology in their contracts. All of the contracts contained legal terms in one form or another. However, ten of the thirteen

less known franchise contracts had legal terminology that was difficult to comprehend, and they probably require the assistance of a lawyer to decipher their meaning. This is not to say that the other sixteen contracts did not have terms that were difficult to comprehend. Rather it identifies those ten contracts as having a substantial amount of legal terms that may mislead, or confuse a franchisee as to what performance is expected from him, or from the franchisor.

Understanding legal terminology was not the only barrier in comprehending the contract. Three of the ten contracts possessing large amounts of legal terms, also had provisions in small print. The small print was located about halfway through the contract in two instances. The entire print in the third contract was small and hard to read. The comparison also included reidentifying provisions that were considered unfair in the original study. While 15 percent (23 of 158) of the provisions in the original study would definitely be considered unfair, many of the remaining 135 provisions have the potential of being unfair if used to impose the absolute will of the franchisor.

A comparison was made with the 1973 study to see if the follow-up study would have significant differences in the prevalence of the provision. This comparison yielded mixed results. The comparison resulted in some provisions having a range of very little to large difference in occurrence. Of the provisions that were significantly less, 16 percent

were unfair. Of the provisions that were significantly more, 12 percent were unfair. Of the provisions that were unchanged, 25 percent were unfair. The comparison can be seen in Figure 1 at the end of this chapter.

Unfair Provisions

In the original study, 15 percent of the provisions used were considered unfair or had the potential of being unfair. The present study identified five provisions that enhanced opportunities for unfair treatment. The five provisions were: Operating Manual, Lease Back, Franchisor's inspection, Operating Supplies-Must Buy, and Termination for any Violation. Each provision is shown in Appendix I. The provision for the operating manual binds the franchisee to the contents inside of the manual. At no time is the franchisee allowed to review the manual prior to signing the franchise contract. In several provisions, there is reference to possible additional requirements as specified in the operating manual. It is possible to conclude that this condition could produce unknown hardships upon the franchisee. The author was unable to obtain an operating manual, but information from conversations with a former manager of a Burger King and McDonald's, indicated the operating manual contains very explicit instructions as to how the franchised store is to be operated. It was said that the manual would probably be the best contract the franchisor could use. It would provide a wealth of information as to what performance is expected of the franchisee,

and what services the franchisee can expect from the franchisor.

The lease back provision specifies that if a franchisee leases or owns the property he operates his business from, that franchisee must assign or lease the property to the franchisor. In the original study there were some franchisors who required this type of subleasing as collateral for faithful performance. This provision gives the franchisor a large tool in which he may threaten to evict the franchisee, thereby coercing the franchisee into performance dictated by the franchisor. Furthermore, if the franchisee owns the land and is forced from the business, the franchisor retains the lease for the specified period of time, and can operate the franchise business until the end of the lease. The original study identified this as being one of the most unfair provisions.

The inspection of a franchise facility is an undoubted right of every franchisor. The inspections are a means of ensuring equipment, cleanliness, and proper standards are adhered to. These inspections give the franchisor the right to remove from the premises any supplies or equipment for the purpose of testing standards or quality. If equipment is broken during this testing, it is the franchisee who has to pay for repairs or replacement. There are no limits as to how many times a franchisor can remove items from the operating facility. Contracts that contained this provision did not specify the franchisor's responsibility in sharing

repair and replacement costs.

All franchised businesses require operating supplies to function successfully. Purchasing supplies in the franchise restaurant business can be done through the franchisor, or from an independent distributor. To purchase supplies from an independent distributor, the supplies must meet quality standards met by the franchisor. If these standards are too high, the franchisee may be forced to buy his supplies from the franchisor. In a must buy situation, the franchisee is not given the opportunity to seek a distributor for supplies. Instead, he must buy all his supplies directly from the franchisor or through a distributor specified by the franchisor. This situation gives the franchisor complete control in pricing the supplies sold to the franchisee. If the franchisee purchases through an appointed distributor, a surplus charge may be made so that the distributor may give a kickback payment to the franchisor for the business rendered unto him. There can be situations wherein this provision is enforced to maintain quality supplies with reasonable prices for supplies.

The termination for any violation provision gives the franchisor the opportunity to terminate the franchise contract for any violation, no matter how small. This provision does not give the franchisee the opportunity to correct the problem, or explain the circumstances if the situation was something he had no control over. The provision could become quite a tool if there is some strong resentment

between the franchisor and franchisee.

Hypothesis

It was hypothesized that national franchises may be over-controlling their system by using large numbers of provisions in their contracts when compared to the number of provisions found in the regional franchises. The difference between the well-known versus the less-known is sixty-four provisions in favor of the well-known franchises. The average mean number of provisions found in the national and regional franchises was 73 and 68 respectively. The median for national franchises is 74, and 70 for regional franchises.

Because the difference is numerically small in size, the data shown below does not prove that the hypothesis is correct, nor is there conclusive evidence that the theory is wrong. Further study is needed to prove or disprove the theory. In addition, the data in Figure 2 also gives the reader the number of provisions each franchise contract possessed and the percentage of provisions found in relation to the 158 provisions used in the research.

In addition to comparing the original study for reoccurrence of questionable provisions, the current study was also designed to identify provisions not mentioned in the original study. A new provision was discovered and was titled in the contracts as AREA DEVELOPER. The franchised area developer is generally someone who builds the buildings used to house a franchised restaurant. The area developer

does not own the land or buildings, but contracts with a franchisor to build several establishments within a specified area. Usually the area developer is under a time constraint. The contracts for the developer do not differ a great deal from the food franchise except it is geared towards construction terminology.

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
(Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|---|-------------|-------------|
| 1. FRANCHISE FEE | .75 | .100 |
| 2. NON-REFUNDABLE FEES | .00 | .54 |
| 3. ROYALTY | .75 | .88 |
| 4. NATIONAL ADVERTISING | .34 | .88 |
| 5. LOCAL ADVERTISING | .53 | .62 |
| 6. RENEWAL FEE | .09 | .30 |
| 7. SERVICE FEE | .16 | .27 |
| 8. RENTAL/LEASE PAYMENTS | .25 | .31 |
| 9. RENT ADJUSTMENT | .01 | .04 |
| 10. PURCHASE PAYMENTS | .75 | .08 |
| 11. INDIRECT PAYMENTS | .03 | .00 |
| 12. SPECIAL PAYMENTS | .27 | .58 |
| 13. PENALTIES | .22 | .65 |
| 14. SECURITY DEPOSITS | .12 | .00 |
| 15. TERMINATION PENALTIES | .00 | .04 |
| 16. LENGTH OF CONTRACT TERMS | .77 | .88 |
| 17. OPTION TO RENEW | .52 | .69 |
| 18. EXCLUSIVE TERRITORY | .65 | .63 |
| 19. START UP DATE | .11 | .46 |
| 20. FRANCHISOR CONFIDENTIAL DISCLOSURE | .07 | .08 |
| 21. FRANCHISEE CONFIDENTIAL DISCLOSURE | .55 | .58 |
| 22. INDEPENDENT CONTRACTOR | .56 | .81 |

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
 (Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|---|-------------|-------------|
| 23. HOLD HARMLESS | .61 | .69 |
| 24. ACT OF GOD | .14 | .15 |
| 25. NO WAIVER OF DEFAULT | .61 | .73 |
| 26. ILLEGAL COVENANT | .55 | .69 |
| 27. LEGAL BUSINESS | .14 | .08 |
| 28. FRANCHISEE ASSOCIATION FORBIDDEN | .02 | .00 |
| 29. RIGHT TO FUTURE REVISION | .49 | .77 |
| 30. OPERATING MANUAL | .40 | .81 |
| 31. GOODWILL PAYMENTS | .06 | .04 |
| 32. CORRECTION OF DEFICIENCY | .25 | .58 |
| 33. COMPLIANCE WITH LOCAL LAWS | .52 | .58 |
| 34. FRANCHISE DISABILITY | .57 | .50 |
| 35. ARBITRATION | .21 | .46 |
| 36. SITE SELECTION | .09 | .62 |
| 37. INCORPORATION PERMITTED | .93 | .88 |
| 38. TRADEMARK RESTRICTION | .53 | .96 |
| 39. DISTINCTIVE ARCHITECTURE | .28 | .62 |
| 40. GOOD ETHICS | .04 | .46 |
| 41. STATE OF INTERPRETATION | .97 | .73 |
| 42. VENUE CLAUSE | .27 | .15 |
| 43. SUB-FRANCHISING | .64 | .04 |
| 44. CIVIL RIGHTS | .01 | .00 |
| 45. FULL TIME | .15 | .35 |

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
(Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|-----------------------------------|-------------|-------------|
| 46. COMPETITIVE BUSINESS | .34 | .81 |
| 47. RESTRICTION ON SALE OF GOODS | .02 | .00 |
| 48. PRODUCT SERVICE | .00 | .04 |
| 49. SALES QUOTA | .00 | .00 |
| 50. GUARANTEED SALES | .00 | .00 |
| 51. PHYSICAL LAYOUT APPROVAL | .33 | .69 |
| 52. LOCAL VARIATIONS PERMITTED | .11 | .12 |
| 53. DAYS OPEN | .53 | .50 |
| 54. HOURS OPEN | .52 | .54 |
| 55. PRODUCT LINE | .70 | .77 |
| 56. PRICE CONTROL | .27 | .08 |
| 57. ALTERNATION APPROVAL | .65 | .62 |
| 58. FRANCHISEE OWNERSHIP | .29 | .12 |
| 59. FRANCHISOR OWNERSHIP | .27 | .19 |
| 60. FRANCHISEE LEASES | .22 | .81 |
| 61. FRANCHISOR LEASES | .34 | .19 |
| 62. LEASE APPROVAL | .14 | .23 |
| 63. NOTICE OF NON-COMPLIANCE | .02 | .31 |
| 64. LEASE BACK | .02 | .27 |
| 65. LEASE LOSS | .14 | .42 |
| 66. ANALYZE REPORTS | .29 | .31 |
| 67. ADVERTISING | .20 | .69 |
| 68. ACCOUNT FOR ADVERTISING FUNDS | .08 | .31 |

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
(Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|----------------------------------|-------------|-------------|
| 69. ADVISE AND CONSULT | .12 | .58 |
| 70. INSPECT | .12 | .92 |
| 71. ADVISE FRANCHISEE OF CHANGES | .34 | .65 |
| 72. GRAND OPENING ASSISTANCE | .24 | .65 |
| 73. BANK APPROVAL | .05 | .04 |
| 74. BOOKKEEPING SYSTEM APPROVAL | .22 | .27 |
| 75. BOOKKEEPING SYSTEM REQUIRED | .49 | .62 |
| 76. ANNUAL CERTIFIED AUDIT | .28 | .46 |
| 77. RIGHT TO AUDIT BOOKS | .48 | .92 |
| 78. MARGIN OF ERROR | .29 | .69 |
| 79. INCOME TAX COPY | .16 | .31 |
| 80. PERIODIC REPORTS | .68 | .88 |
| 81. CASH WITHDRAWAL | .00 | .00 |
| 82. PROFIT WITHDRAWAL | .09 | .00 |
| 83. EMPLOYEE UNIFORMS | .41 | .42 |
| 84. EMPLOYEE CONDUCT | .40 | .27 |
| 85. NUMBER OF EMPLOYEES | .08 | .04 |
| 86. RIGHT TO HIRE AND FIRE | .06 | .04 |
| 87. FRANCHISEE FORMAL TRAINING | .01 | .85 |
| 88. FRANCHISEE REFRESHER COURSE | .12 | .42 |
| 89. SUBSEQUENT MANAGER TRAINING | .19 | .69 |
| 90. KEY EMPLOYEE TRAINING | .19 | .39 |
| 91. ALL EMPLOYEE TRAINING | .98 | .08 |

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
 (Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|---|-------------|-------------|
| 92. OJT AND ASSISTANCE | .21 | .27 |
| 93. FRANCHISOR ADMINISTRATION | .15 | .27 |
| 94. FRANCHISOR CO-INSURED | .50 | .85 |
| 95. CANCELLATION NOTICE | .15 | .73 |
| 96. APPROVAL OF COMPANY | .18 | .46 |
| 97. PROOF OF INSURANCE | .38 | .88 |
| 98. BUSINESS INTERRUPTION | .01 | .19 |
| 99. WORKERS' COMPENSATION | .41 | .69 |
| 100. PERSONAL | .07 | .46 |
| 101. EMPLOYER LIABILITY | .18 | .81 |
| 102. PROPERTY LIABILITY | .67 | .92 |
| 103. PRODUCT LIABILITY | .77 | .81 |
| 104. PAPER GOODS-MAY BUY | .47 | .19 |
| 105. PAPER GOODS-MUST BUY | .00 | .00 |
| 106. PAPER GOODS-VENDOR APPROVAL | .51 | .39 |
| 107. PAPER GOODS-STANDARDS | .40 | .81 |
| 108. OPERATING SUPPLIES - MAY BUY | .48 | .12 |
| 109. OPERATING SUPPLIES - MUST BUY | .00 | .23 |
| 110. OPERATING SUPPLIES - VENDOR APPROVAL | .52 | .39 |
| 111. OPERATING SUPPLIES - STANDARDS | .49 | .69 |
| 112. EQUIPMENT-MAY BUY | .63 | .27 |
| 113. EQUIPMENT-MUST BUY | .00 | .08 |
| 114. EQUIPMENT-STANDARDS | .34 | .65 |

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
(Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|--|-------------|-------------|
| 115. SIGNS-MAY/MUST BUY | .49 | .12 |
| 116. SIGNS-VENDOR APPROVAL | .19 | .23 |
| 117. SIGNS-STANDARDS | .28 | .65 |
| 118. PRICE RESTRICTIONS | .04 | .00 |
| 119. FRANCHISOR-VENDOR REBATE | .02 | .12 |
| 120. VENDING APPROVAL | .16 | .46 |
| 121. FRANCHISOR/FRANCHISEE ADVERTISING | .26 | .39 |
| 122. RIGHT TO ENTER AND DESTROY | .12 | .50 |
| 123. SIGNS REQUIRED | .54 | .65 |
| 124. FRANCHISOR APPROVAL | .65 | .62 |
| 125. ADVERTISING COMMITTEE | .07 | .39 |
| 126. FRANCHISOR RIGHT OF FIRST APPROVAL | .35 | .85 |
| 127. FRANCHISEE RIGHT OF FIRST APPROVAL | .04 | .00 |
| 128. RIGHT OF INHERITANCE | .32 | .50 |
| 129. LIMITED RIGHT OF INHERITANCE | .00 | .31 |
| 130. NO RIGHT OF INHERITANCE | .00 | .00 |
| 131. FRANCHISOR APPROVAL OF SALE | .74 | .77 |
| 132. NO FOR-SALE ADVERTISING | .00 | .04 |
| 133. BINDING UPON SUCCESSORS | .04 | .50 |
| 134. STOCK TRANSFER APPROVAL | .06 | .77 |
| 135. NO GOODWILL PAYMENTS | .00 | .54 |
| 136. FAILURE TO PAY | .21 | .77 |

FIGURE 1

FRANCHISE PROVISIONS COMPARISON (1973 VS 1988)
 (Percent of contracts containing provision)

| | <u>1973</u> | <u>1988</u> |
|---|-------------|-------------|
| 137. FRANCHISEE EARLY TERMINATION | .24 | .35 |
| 138. FRANCHISOR EARLY TERMINATION | .99 | .12 |
| 139. TERMINATION FOR ANY VIOLATION | .00 | .35 |
| 140. TERMINATION FOR VIOLATION/STANDARDS | .05 | .73 |
| 141. TERMINATION FOR BANKRUPTCY | .30 | .85 |
| 142. TERMINATION FOR TRAINING FAILURE | .02 | .15 |
| 143. IMMEDIATE CANCELLATION | .42 | .27 |
| 144. GRACE PERIOD | .66 | .04 |
| 145. 10-DAY | .00 | .39 |
| 146. 30-DAY | .00 | .58 |
| 147. COVENANT NOT TO COMPETE-YEARS | .62 | .73 |
| 148. COVENANT NOT TO COMPETE-MILES | .52 | .69 |
| 149. COVENANT NOT TO HIRE | .26 | .15 |
| 150. COVENANT NOT TO USE SYSTEM | .50 | .46 |
| 151. COVENANT TO CEASE OPERATIONS | .53 | .92 |
| 152. COVENANT TO CHANGE BUILDING | .20 | .58 |
| 153. COVENANT TO REMOVE SIGNS | .26 | .65 |
| 154. COST OF ENFORCEMENT | .22 | .50 |
| 155. EQUIPMENT | .32 | .46 |
| 156. SIGNS | .30 | .46 |
| 157. TRADEMARK SUPPLIES | .27 | .46 |
| 158. REGULAR SUPPLIES | .14 | .46 |

Note: the comparison is made by taking each individual provision and numerically identifying how many times it appears in the collect year group of contracts. The 1973 percentages were from one hundred twenty-two fast food contracts and the 1988 were from twenty-six fast food contracts.

FIGURE 2

CUMULATIVE TOTALS OF NATIONAL/REGIONALLY KNOWN FRANCHISES

| <u>NATIONAL</u> | | <u>REGIONAL</u> | |
|---|---------------------------|---|---------------------------|
| <u>Total # of provisions per contract</u> | <u>% in each contract</u> | <u>Total # of provisions per contract</u> | <u>% in each contract</u> |
| 58 | .37 | 24 | .15 |
| 63 | .40 | 46 | .29 |
| 67 | .42 | 61 | .39 |
| 67 | .42 | 67 | .42 |
| 72 | .45 | 69 | .43 |
| 73 | .46 | 70 | .44 |
| 74 | .47 | 70 | .44 |
| 77 | .49 | 73 | .46 |
| 77 | .49 | 74 | .47 |
| 80 | .51 | 75 | .48 |
| 80 | .51 | 81 | .53 |
| 80 | .51 | 86 | .54 |
| 82 | .52 | 90 | .57 |
| <hr/> | | <hr/> | |
| total | 950 | 886 | |

Note: The symbol # means the number of provisions in each contract. The symbol % means the percentage of provisions found in each contract in relation to the 158 provisions used in the research.

CHAPTER 5

SUMMARY

This research does not offer factual evidence to refute or support any allegations. The function of this research is to provide the reader a basis of evaluating, and understanding franchise agreements. Opinions and/or suggestions made by the author are not intended to sway the reader for, or against, the franchisor, or franchised businesses. The author's intent is to identify the reoccurrence of questionable provisions identified in the original study in anticipation of giving the reader information about provisions that may be detrimental in operating a franchised business.

In conclusion, there is still considerable control applied to franchisees through contractual provisions. Several provisions such as the lease-back clause, wherein the franchisee loses all equity if he should lose his lease on the land, remains questionable.

In this study, the majority of the provisions have the possibility of being unfair if enforced as written. In this study 15 percent of the 158 provisions were identified as being unfair according to the value judgement of Dr. Udell's previous research and provides the franchisor with a powerful tool to control an independent business person. Not all

of the provisions prove to be unfair. There are some that should be present to insure standards and services are applied uniformly throughout the established franchise system.

What may be more alarming and still present is the ever elusive owner's manual. In each contract reviewed, there is some statement binding the franchisee to comply with the owner's manual. Unfortunately, the prospective franchisee will not be allowed to look inside this manual until he has signed the contract. When the manual has been reviewed, the franchisee may feel that he has been misled, and is now unable to withdraw from the contractual agreement without being assessed a substantial penalty.

In all of the reviewed contracts, the franchisor had the right to "revise" the manual. These revisions were to be "within reason", but not once was "within reason" specified in numerical terms. Yet the franchisee will have to abide by the manual as specified in the contract.

It is recommended that the franchisor provide a more in-depth narrative in what the owner's manual requires from the franchisee.

The reader should note that the terms "unfair" and "fair" are derivatives from Dr. Udell's previous study and are value judgments used in this follow-up research. What may be an unfair provision to the author may not be unfair to the reader.

Therefore, the reader should apply his own judgmental values to the material he has read and decide what would be fair or unfair in the provisions that were presented.

Finally, the writer tried to prove a hypothesis that nationally known franchisors apply more control than the regionally established franchises. There were exactly thirteen national and thirteen regional franchises. The cumulative total of provisions from the national franchises numbered 950. The regional franchises' cumulative total numbered 886. While these figures indicate that the national franchisors possessed sixty-four more provisions than the regional franchisors, it should be noted that several of the regional franchises provided little guidance except a reference to the owner's manual. What was found was that smaller franchises used smaller print and more legal words which many people would find hard to understand.

The data gathered from this research provided inconclusive evidence in proving or disproving the hypothesis. This would be an excellent area to look into for a follow-up research.

Although we have seen many questionable provisions during the review of the contract agreements, the recent data gathered from business literature, newspapers, and television news indicate that franchising is on the rise.

This suggests that those unfair clauses are not being enforced or the franchisee considers the profit worth the hassle. Either way, franchising is booming and to answer

the question "why" requires further study into what exactly has changed the industry into a lucrative business.

The information in this follow-up research has indicated that the provisions identified in the original study are still prevalent in contracts used in present day agreements between franchisors and franchisees. Wherein the provisions are still questionable in fairness, the information presented in the USA TODAY, 11 February 1988 edition, indicates franchising is on the rise. Despite the presence of questionable provisions identified in this follow-up research, if the reader has some desire to enter the franchise market, he should conduct an in-depth investigation as to what is expected from him as a franchisor and precise duties of the franchisor before entering an agreement.

APPENDIX I

FRANCHISE PROVISIONS

The 158 franchise provisions used in reviewing the contractual agreements are grouped according to standard sections of a standard contract.

PAYMENTS TO THE FRANCHISOR

1. FRANCHISE FEE - Payment for the privilege of doing business using the trademarks of the franchisor is typically covered by a franchise fee. Franchise fees ranged from \$9,000 to \$85,000. There were two fees that were left open for negotiation.

In some contracts, portions of the franchise fee were used to defray the cost the franchisor incurred for helping in site location, franchisee formal training, opening day supervision, and construction of facilities. For the most part, what the franchisor receives in the franchise fee is profit, even though a few stated in their contracts that this fee defrayed the expense of getting the franchisee started, therefore, no monetary gain is recognized. There is no argument that the franchisor is entitled to the franchise fee to do as he wishes.

But to create a more perfect union between the two, and reduce the suspicion the franchisee has of being overcharged

for inferior service, the franchisor should specify what the fee is for and what areas of service the fee covers.

2. NON-REFUNDABLE FEES - This clause, for the most part, pertains to the franchise fee paid to the franchisor. There were some contracts that would allow the return of portions of fees paid should an individual terminate the agreement either prior to actually operating the business or early in the operation of the business.

There are some instances where the franchise fee was large and the franchisee would pay an initial portion upon signing the contract. The remaining balance would be paid at some specified period during the life of the contract. Should there be an early termination, or termination occurred prior to the operation of the business, it would be the initial payment that would not be refundable. There were five controls that stated that under no circumstances would any portion of fees paid be refunded once the contract had been signed. Those contracts that stipulate no refund, should be modified to allow refund of monies when termination occurs under circumstance beyond the franchisee's control.

In all fairness to the franchisor, there should be a deduction from the refund for actual expenses incurred during the operation of the franchise up to termination.

3. ROYALTY - This payment is derived from the franchisee's gross receipts from sales, and it is considered a payment

for services the franchisor provides during the life of the contract. The franchisee is usually required to report gross sales to the franchisor. This report gives the franchisor the tool to evaluate whether the franchisee has paid the correct amount of royalty payment.

In this research, the fee ranged between 2 and 8 percent of gross sales. The payment is normally made on a monthly basis and is compounded with additional charges if the franchisee is late in making the payment to the franchisor.

Wherein this payment is designed to pay the franchisor for services rendered, there were no provisions in any of the contracts reviewed specifying stoppage of payments should there be a conflict in what the franchisor is to provide and what the franchisee is to receive in services. This could be a questionable practice if not modified to allow some protection for the franchisee if the franchisor does not provide the service specified in the contract. Otherwise, the franchisee has to continue to pay for what he is not getting. A viable solution would be the establishment of an escrow account, wherein the franchisee would deposit the royalty payment if a dispute were to occur and neither party would have access to it until the dispute is settled.

4 - 5. NATIONAL AND LOCAL ADVERTISING PAYMENT - Many franchisors take the responsibility in advertising and promoting the franchised business. In doing this, the franchisor

requires participation of all franchisees in an advertising program.

The program is not voluntary in most cases and does include advertising both nationally and locally. Franchisees are required to pay specified sums based upon gross sales to the franchisor to cover the expense of promoting the franchise name. It should be understood that in this study, all franchisees within the franchised business contribute to this fund.

From the franchisor's perspective, this type of program provides a uniform presentation of the franchised business to the public. When traveling, you may see advertising boards by the side of the road displaying the location of your favorite hamburger establishment to be approximately two miles down the road. Being hungry and knowing the quality of food is good because this establishment is in your home town, you will probably stop there in lieu of the "mom and pop" cafe you just passed. Because of the national and regional advertising, we become familiar with the establishment and come to expect the same good quality service no matter where we are.

This is what standardization in advertising can do for a franchise business. Perhaps at this time many readers would be wondering just how the franchisor accounts for the advertising expenditures? Several franchisors provide detailed reports as to what was spent and how. This report format is similar to an accounting balance sheet and is

either provided to the franchisee or readily available upon request. There are some franchisors that have a matching fund. This matching fund is essentially a one for one dollar deposit by the franchisor for each deposit made by the franchisee. Every franchisee is supposed to pay his equal and fair share. There are, however, some franchisors who do not feel it is anyone's business to know where the money collected from the franchisee is going or how it is spent. This kind of behavior has the potential of opening the doors of mistrust between the two parties because the franchisee may feel he has the right to know what he is spending his money for.

6. RENEWAL FEE - This payment is made by the franchisee to the franchisor for the renewal of the franchised business at the end of a specified period. The payments were sometimes a percentage of the original franchise fee or a set amount for each renewal period. Under certain circumstances where more than one franchise establishment was owned by a franchisee, franchisee would only have to pay a renewal fee for one franchise business and something of a token payment for the second and additional franchise business. The renewal period ranged between ten additional years to infinity.

7. SERVICE FEES - Service fees were generally payments for some service the franchisor provided to the franchisee. This particular provision appeared in seven contracts.

Perhaps the reason for the limited occurrence could be linked directly to the large franchise fees paid at the initial contractual agreement.

It was noted that three franchisors did state in their contracts that formal and OJT training were included in the franchise fee. These and many other types of services provided by the franchisor seem to be distributed throughout the 158 provisions making it impossible to focus the payments into Service Fees.

8. RENT OR LEASE PAYMENTS - The franchisee is given the option to rent or lease property, equipment, or signs from the franchisor within the terms of the lease or rent specified in the contract.

In this study, there was no provision requiring the franchisee to lease or rent from the franchisor.

Renting or leasing from the franchisor could increase the control the franchisor has over the franchisee. For example, a franchisee rents his equipment from the franchisor. The franchisee is required to upgrade or change the equipment upon notice from the franchisor.

If the franchisee is responsible for the expense of this change and there is not a written agreement as to how many times the upgrades or changes will occur in a specific time period, the franchisee could be liable for several changes within a year. The cost of these changes could be a financial burden to the franchisee.

This situation can be controlled by having a very descriptive clause in the initial agreement as to how often equipment changes or upgrades can be made by the franchisor in a specific time frame.

9. RENT/LEASE ADJUSTMENT - If the franchisee rents from the franchisor he/she could be susceptible to an increase in rent or lease payments. The term rent adjustment is self explanatory and may be considered fair or unfair depending on how it is administered in each individual contract. The franchisor has the right to adjust the payment, but the question of fairness rests in why there is an increase and how much.

The franchisor could provide an explanation and details to the franchisee in justifying the increase in payments. This sort of cooperation could create mutual respect and understanding from both parties since both are business persons in a common line of work.

10. PURCHASE PAYMENT - Under this provision, the franchisee may be required or given the option to purchase inventory, operating supplies, and/or equipment from the franchisor. With one exception, there were no cases of franchisees being required to purchase from the franchisor. The one exception involved required purchase of ingredients that were trade secret to each respective franchised business. This exception can be related to maintaining the competitive edge and trade secrets.

In a financial light, the cost of the initial start-up could be quite large, therefore, some franchisors allowed installment pay periods for the initial purchase of equipment , inventory, or supplies.

Others included the initial purchase cost in the estimate of initial capital necessary to begin the business.

On an interval type basis or as purchase becomes necessary , the franchisee would have to pay for equipment, inventories, or supplies received from the franchisor according to the agreed terms which usually specified when the payment would have to be received.

Usually late payments incurred some percentage of interest for each day after the due date.

11. INDIRECT PAYMENTS - This payment sometimes involves a third party. The franchisee makes payments to the franchisor who, in turn, makes payments to a supplier. The problem occurs when the franchisee has to pay extra amounts to reimburse the expense or gratuities the franchisor incurs when doing business with the supplier (third party). The franchisee may perceive he is being overcharged by the franchisor.

This practice is questionable in that the franchisor is the one who conducted the business between himself and the supplier and not the franchisee. It should be the franchisor who is responsible for expenses incurred in this

exchange. Research findings indicate there was no visible evidence that this was a common practice.

12. SPECIAL PAYMENTS - These payments are one time payments for specific services provided by the franchisor, such as grand opening or a specific promotion. Of the 26 agreements, 15 provided provisions for these types of services. If the franchisee pays for services mentioned above and the franchisor fails to complete the service, the franchisor could refund all monies with no penalties. What the franchisees fear is possible termination should they demand the refund for non-performance by the franchisor.

If there is a question of non-performance, a system whereby payment is withheld and deposited into a neutral account should be established. With this system, the money has been paid. Therefore, the franchisee is not liable for nonpayment charges and the money will not be received by the franchisor until the service is done or the dispute resolved.

13. PENALTIES - This particular provision was levied against the franchisee for various reasons ranging from late payment to erroneous bookkeeping. Late payment penalties are self-explanatory. The franchisee is liable for unannounced periodic inspection of the financial books. If the franchisee's actual gross income differs from the gross income reported to the home office, a penalty is assessed in the form of a requirement to pay all that is due to the

franchisor, plus a percentage of interest on the amount that was not reported. Sometimes the percentage was based on the number of days the additional amount of gross income had not been reported. The assessment of penalties becomes questionable in the dollar amount required in fair value to the business and the standard assessment of these penalties under mitigating circumstances beyond the franchisee's control.

14. SECURITY DEPOSITS - This deposit deals with the initial start-up of the business. The security deposit was designed to induce faithful performance by the franchisee.

The franchisee makes the initial deposit of the franchise fee with installments thereafter. Should there be some breach of contract, the franchisee essentially loses all monies in the account. At best, this provides the franchisor with security, but what of the franchisee?

In most cases little to nothing is mentioned in the event the franchisor defaults in some aspect of the contract. This leaves a dispute as to what is owed to the franchisor.

The franchisor claims the deposit is rightfully his for doing business under the franchised trademarks. The franchisee claims he is making payments for services not received. In addition to losing the deposit, there is the possibility the franchisee will have to pay a penalty for early termination.

15. TERMINATION PENALTIES - This penalty is assessed should the franchisee terminate the agreement early or some violation by the franchisee causes early termination. The termination is no more than a liquidating charge that, in some cases, is not assessed according to the fair market value of the going concern.

It could be used as an ax over the franchisee's head. Many times early termination is unforeseen and far beyond the control of the franchisee. Yet, without regard to this fact, a penalty could be used by the franchisor to gain a slight profit. Fortunately, only one contract contained this provision.

GENERAL CONTRACT PROVISIONS

16. LENGTH OF CONTRACT TERMS - The majority of the contracts provided the length of the time the terms would be enforced. The average time ranged between 15 to 20 years with options to renew the contract for additional years. There were, however, three contracts that did not specify definite time periods or allowed the time span to vary according to negotiation. The only concern that warrants close evaluation deals with long-term leases and short contract periods, especially when the franchisee leases from the franchisor. In this particular situation the franchisee could be forced to give up his business because he is not given the option to renew the contract on a profitable business. This situation can take another shape where the

lease is short and the contract period is long. In this situation the franchisee could lose the business because the franchisor will not renew the lease.

17. **OPTION TO RENEW** - At the end of the contract period, the franchisee may be given the option to renew the agreement for a specified additional number of years. The renewal may be under the old terms or, in most cases, the renewal will be made under terms that are used for current contractual agreements.

18. **EXCLUSIVE TERRITORY** - This provision is probably the most mutually beneficial for both franchisee and franchisor. Exclusive territory provides a specified area where a particular franchised business can operate without having to compete with a going concern from the same franchise in the same geographical area. The specified area is usually designated in writing at the initial review and signing of the contract. Under normal circumstances, the franchisor cannot breach this provision without prior permission of the franchisee whose area is affected. While this provision favors the franchisee, the franchisee should understand that this area is fixed and cannot be extended without prior permission from the franchisor.

19. **START-UP DATE** - Franchisors frequently require the business to be operational by a specific date. In some cases, if the franchisee has not opened by the specified date, immediate termination and forfeiture of partial or all

fees paid could occur. Franchisors can be strict in applying this provision, but allow for delays if the delay is requested within a reasonable time prior to the projected opening day.

There are some who can visualize a franchisor orchestrating deliberate delays just to cause termination whereby keeping the money paid by the franchisee and possibly constructed facilities.

20. FRANCHISOR CONFIDENTIAL DISCLOSURE - This clause holds the franchisor to a promise that he/she will not disclose information pertaining to the franchisee's personal financial position or business operations except when necessary in the conduct of business. This clause is seldom seen. Only two contracts contained this provision.

21. FRANCHISEE CONFIDENTIAL DISCLOSURE - There is not much difference with this provision and #20 with the exception it is applied to the franchisee and is most common in the contractual agreement. To breach this clause more likely will bring about a law suit and possible fines levied as a penalty. The clause involves a lot of do's and don'ts the franchisee must adhere to. Franchisors do not have as many rules to abide by.

22. INDEPENDENT CONTRACTOR - The franchisor separates himself from the franchisee with the provision. The provision identifies the franchisee as his own agent and attempts to ensure the franchisor is not held responsible for the

action of the franchisee. There is a question of validity in the franchisor's disclaimer. The franchisor cannot disclaim actions that were directives from the franchisor.

23. HOLD HARMLESS - The hold harmless clause is the same as the independent contractor, except this clause is considered to have a clearer definition of non-responsibility on behalf of the franchisor.

Throughout the research, the majority of the contracts had provisions to cover the entire spectrum of who is responsible for actions that may cause damage.

24. ACT OF GOD - In the event some agreed upon action could not be accomplished because there was an event beyond the control of the franchisor or franchisee that prevented the completion of the action, it was generally considered as an act of God. There was very limited application of the provision among the twenty-six contracts reviewed. Four contracts had this provision.

25. NO WAIVER OF DEFAULT - In some cases, a franchisor may not penalize a franchisee for some defaults of the contractual agreement. The no waiver of default provision, however, stipulates that if the franchisor did not penalize the franchisee for a previous default, the action does not negate a penalty for the same default in the future. The key issue is the "sometimes factor". Sometimes it is enforced and sometimes not.

The classic application occurs when there has been several defaults by the franchisee and the franchisor does nothing. Then one day, the franchisor decides to enforce the provision against the previously overlooked defaults, which usually results in heavy penalties or termination. In the previous study conducted by Dr. Udell, he suggested registered mail be used to notify the defaulting franchisee. Therefore, receipt could be documented and recorded. Along with this suggestion, it is imperative that franchisors become consistent in the application of this provision if they are not trying to send a signal that says defaults are tolerated.

26. ILLEGAL COVENANT - Typically, the franchised business is not always located in the same state as the home office. By virtue of independence, each state has its own laws to govern business practices. Many contracts have standard agreements that, at times, may be invalid within the state the franchised business is operating. If there is a dispute and some part of the agreement is found to be illegal within the specific state, the entire agreement could possibly be considered invalid.

To preclude nullification of the entire contract, the illegal covenant provision states that if any part of the agreement is found to be in violation of some law, the remaining portions of the contract shall remain valid and will be enforced.

27. LEGAL BUSINESS - This provision stipulates that the franchised business will engage in lawful business only. The research found only two contracts that included this clause. It is believed the small occurrence of the provision may be linked to vague statements made in the Independent Contractor and/or Hold Harmless clauses. Within these two clauses, many statements could be interpreted as a legal business provision. It would behoove the franchisor to be more clear in this provision.

28. FRANCHISEE ASSOCIATION FORBIDDEN - Fortunately, within the scope of this research, no franchisors forbid group association of company franchisees or with franchisees outside the company. In fact, many encouraged group association through annual franchisee conventions and group advertising.

29. RIGHT TO FUTURE REVISION - This provision gives the franchisor the unlimited right to make changes in the way the franchisee operates the business. Normally the changes apply to all the stores in the franchised operation. The majority of the contracts reviewed specified that the changes would be within reason. What constitutes "within reason" needs to be clarified. Changes in operation sometimes mean the acquisition of new equipment. While it is understandable that modernization is necessary, what is financially timely for the franchisor may not be timely for the franchisee. For the more distrustful, the unlimited

right to make changes presents the picture of total control by the franchisor. If contested in court, both parties may find it difficult to define "changes within reason". A more in-depth clause that provides specific limits on how many times changes can be made within the life of the contract could be a viable solution. The clause might also provide limits on money the franchisee has to spend on each charge. By doing this, mistrust and ill will can be reduced and a more mutually beneficial relationship established.

30. OPERATION MANUAL - Twenty-one of the twenty-six contracts had provisions for the operations manual. The manual itself is the bible for operating a franchised business. Yet it is the most obscure provision in all the contracts reviewed. In each contract, the franchisee was required to operate within the guidelines of the manual that was provided. In each franchised business, the manual and its contents are secret and will be revealed only to the franchise manager and pertinent managing staff. Revelation of the manual occurs only after the franchisee has signed the agreement. Once the agreement has been signed, the franchisee is liable for any and all requirements within the operation manual. This situation is equivalent to being blind and walking in the middle of the street in downtown New York City. The impression one gets is that many demanding issues can be hidden within the confines of the manual. Failure to follow the manual provisions can result in penalties or immediate termination.

This point was made quite clear in each of the twenty-one contracts. There is possible danger in agreeing to something you have not seen! In the initial study conducted some ten years ago, it was thought that the passing of the Wisconsin Senate Bill 784, which would likely require disclosure of franchise agreements, would negate the secretive nature of the manual. The present research found the secretive manual is still alive and prevalent among franchisors.

31. GOODWILL PAYMENTS - The most descriptive phrase for this provision is "almost nonexistent". During the operation of the franchised business, the franchisee, if successful, may acquire an intangible asset known as goodwill.

Research revealed only one franchisor that made payments for goodwill. In justifying non-payment of goodwill, the franchisor is claiming that the franchisee is not entitled to said payments because the trademarks are owned by the franchisor. The question that may be asked by the franchisee is, "what good is the franchise and the trademark without the quality service of the franchisee?"

32. CORRECTION OF DEFICIENCY - At some point in time during the life of the contract, the franchisee may have a "less than desirable" operation of the franchised business according to the provisions of the franchisor. Typically, a provision allows a grace period in which the problem should be corrected. Normally the deficiency is discovered by a visiting representative of the franchise home office. A

written or verbal notice is given and from the time the notice is given, the franchisee has a specified period of time to correct the problem. If the problem has not been corrected at the end of the grace period, penalties or termination could be assessed. In all 15 contracts, this provision appeared. The franchisor had the option to send a home office representative to the troubled business if the deficiency has not been corrected at the end of the grace period. The representative's salary, room and board is charged to the franchisee. The problem with this provision is proper notification of a deficiency and the time allowed for correction. Some problems may take more than 3 or 5 days to correct due to the nature of the problem. Most contracts were strict in citing the precise number of days to make the correction. Before the franchisee has to pay for the forced help sent by the franchisor and possible additional penalties, both parties should discuss the realities as to how long it takes to fix the problem.

33. COMPLIANCE WITH LOCAL LAWS - Under most contractual agreements, the franchisee is held responsible for all provisions. Franchised companies were designed to branch out in different locales. This expansion of units puts each franchised business in different townships, cities and states. This provision relieves any conflicts between contractual requirements and local laws. The local laws take precedence.

34. FRANCHISEE DISABILITY - Should a franchisee become seriously ill or die, this clause states that the franchisor will operate the business on behalf of the franchisee until a suitable replacement is found. Monies or profits earned during the period the franchisor runs the business is usually placed in a separate account except the amounts the franchisor needs to actually run the business. Potential disagreement exists in the franchisor's determination of who is suitable for replacing the disabled franchisee. The majority of contracts with this provision grant the sole right to the franchisor to choose who is suitable to run the business. This means the candidate has to meet an unspecified number of requirements known only by the franchisor.

35. ARBITRATION - Some contracts allow arbitration should there be some conflict between the franchisor and franchisee. Most adhere to rules of the American Arbitration Association. All decisions of the arbitrator are final. In Dr. Udell's previous study, this provision was strongly recommended.

36. SITE SELECTION - Franchisees are required to receive prior approval from the franchisor before making the final selection in the site of the franchised business. Many contract provisions give the franchisor the option of helping franchisee select the site, but specifically make it clear that the franchisor is not obligated in providing this service. Contracts that specify start up dates, usually do

not start their counting of days toward mandatory opening until final site selection has been made. Implementation of this clause can take place prior to the actual signing of the contract wherein signing of the contract is delayed until final approval of the site is made. The second method of implementation occurs after signing the contract and the franchisee is given an average of 90 days to find and get final approval for a selected site. The second method presents a slight problem in that if a site has not been approved within the 90 days, there is a possibility the entire contract could be nullified and void unless specific conditions are made.

MISCELLANEOUS CONTRACT PROVISIONS

37. INCORPORATION PERMITTED - The franchisee is allowed, if not encouraged to incorporate the business as long as controlling interest rests with the franchisee. A list of all share owners is normally required to be submitted to the franchisor to include how many shares each shareholder owns. Each shareholder is held responsible for adherence to the contract covenants. Shareholders are required to receive prior consent from the franchisor before selling their shares.

38. TRADEMARK RESTRICTIONS - Trademarks belong to the franchisor and are leased/loaned to the franchisee through the life of the contract. This provision clarifies that the

franchisee is licensed to use the trademark only for the operation of the franchised business. The trademarks cannot be used after termination or for business outside of the realm of the franchise operation without prior consent of the franchisor. The provision reaffirms the franchisor ownership of all trademarks, trade secrets, and service marks. It also stipulates that the franchisee cannot contest ownership at any time.

39. **DISTINCTIVE ARCHITECTURE** - To make each franchised business unique and distinctive, franchisors require the outside of the building of occupation and inside decor meet layouts and color schemes specified by the franchisor. Most franchisors require prior approval if a franchisee wants to deviate from set layouts or color schemes. The provision also clarifies franchisor ownership to the layouts and color scheme, so at termination, the franchisee will not be able to copy or use the designs and plans.

40. **GOOD ETHICS** - This provision requires ethical operation of the business on behalf of the franchisee to the consumer. It has been questioned whether this provision can be enforced. Many feel franchisors cannot enforce this provision and it should not be entered into the actual agreement if enforceability cannot be done. Most franchisees want a successful business and most likely will practice high ethical standards. The franchisor should demonstrate ethical behavior when dealing with the franchisee, thus perpetuating ethical standards within the franchised business.

41. STATE OF INTERPRETATION - This clause specifies the state in which the contract will be interpreted. The state of interpretation is usually the state in which the franchisor's home office is based.

41. VENUE CLAUSE - This provision is sometimes indistinguishable from the preceding provision. The provision identifies the specific state, and at times, cities in which all legal matters or disputes will be heard or settled. There are some contracts that will make a neutral location or the nearest arbitrator the place to settle problems. What is unfair in this and the previous provision is when the franchisee has to travel to the home state of the franchisor. The cost for travel is out-of-pocket money for the franchisee, who is not reimbursed. The neutral location is the best choice because each will bear the cost of some type of travel.

43. SUB-FRANCHISING - Within this study, sub-franchising of the fast food business was almost non-existent. What was noticed was a new type of franchising of buildings and land to be used for fast food franchising. If the franchisor did not want direct dealings in passing out franchise portions, he would franchise with one person and give him the authority to portion out the franchise business. The dealer is called an area franchisee. This type of splitting creates a middleman with whom the franchisee has to do business along

with the franchisor. Communication between all three parties be hampered and there is some risk in the competency of the middleman.

44. CIVIL RIGHTS - Most contracts never address this provision because of the interpretation. Generally most franchisors get around this by requiring franchisees obey all State, Federal and local laws.

45. FULL TIME - Franchisors require full time participation or best effort from the franchisee in the operation of the franchise business. It is understandable the franchisor wants successful operation of the franchise business, but "full time" participation may be somewhat unreasonable. Besides, what are assistant managers for? More realistic is the "best effort". It still holds the franchisee responsible for operation but allows flexibility for events like extended time for personal business.

46. COMPETITIVE BUSINESS - This provision prevents the franchisee from entering a business that is similar to the one he is already operating during the life of the contract. Many contracts specify that a former franchisee may not participate in a similar franchise business for a specific amount of years and/or miles from a former site. This may also include international businesses. At times this provision can be vague in the interpretation of what is competitive business. Some may think that if one is operating a hamburger business, and desires to open a chicken business

within the same geographical area, the chicken business would be competitive because it may take some of the profit that would have otherwise gone to the hamburger establishment. The competitive business provision needs to be clearly defined to preclude possible over-restriction and denials.

47. RESTRICTIONS ON SALE OF GOODS - This clause is included to eliminate the possibility of unauthorized selling of trade mixes and material. In the fast food business, this is highly unlikely because the franchisor, not the franchisee distributes the trade mixes, batters and material. The absence of the provision in any of the 26 reviewed contracts is indicative of this.

48. PRODUCT SERVICE - This provision outlines the terms and conditions under which the franchisee will honor guarantees on products sold or work done by another franchisee of the system. This provision was not present in any of the contracts reviewed.

49. SALES QUOTA - This provision requires the franchisee to meet and maintain a sales quota. There were no contracts with this provision present.

50. GUARANTEED SALES - The previous provision put pressure on the franchisee to maintain sales. In this provision the franchisor has placed himself under pressure by telling the franchisee, or indicating that the franchisee is guaranteed

a certain sales volume in that particular franchise system. As in the previous provision, it would be highly foolish to make such guarantees and so none were found within the scope of the research.

PROVISIONS OF UNIFORMITY

51. PHYSICAL LAYOUT APPROVAL - As mentioned in the distinctive architecture provision, fast food franchises normally require a specific design to the inside and outside of the facility. The provision requires the franchisee request permission from the franchisor to change any aspect of the facility in which they operate. The possible event of unfairness generally occurs when the franchisor withholds his permission without just cause or delays in giving permission for the change.

52. LOCAL VARIATIONS PERMITTED - This provision provides the franchisee some flexibility in making changes without prior approval from the franchisor. Examples of this would be requirements from local law or building codes where the franchisee has no choice but to make the change or close down. Although it would seem that this provision would be beneficial for both franchisor and franchisee, only three contracts contained this clause.

53 - 54. DAYS AND HOURS OPEN - Under this provision the franchisor specifies what hours and days the franchisee has to operate. A typical clause will state, "Licensee shall

operate seven days per week during the hours of 10:00 a.m. to 11.00 p.m. Monday thru Sunday". Operating under these conditions could actually cause profit loss if the franchisee is made to operate the business in unprofitable hours or days. The decision when to operate should be left to the franchisee. Such directives create questions as to the franchisor's motives in specifying exact dates and hours the franchisee has to operate. The most sensible explanation would probably be to maximize the franchisee's sales which in turn increases the franchisor's royalties. Who else knows what is right for the business?

55. PRODUCT LINE - To ensure uniformity throughout the franchise system, the franchisor institutes standards in the preparation of the product to be sold. In the fast food industry this means that a home office representative visits a store and tests the products to ensure they meet required standards specified by the company's standards. The purpose of this provision is to maintain adequate quality in the product that is sold.

56. PRICE CONTROL - This provision grants the franchisor control in setting price on the products sold by the franchisee. This condition could actually cause the business to fail. This condition is most unfair in not allowing the franchisee the chance to be competitive as deemed appropriate for the geographical market. Once again the motive

for a franchisor to include this provision would be to maximize royalties.

57. ALTERATION APPROVAL - This provision states that the franchisee cannot make any addition or alteration to the building, parking lot of surrounding area without prior approval from the franchisor. While it is understandable that the franchisor wants uniformity in the franchise system, this provision could be used as a tool to overcontrol franchisees. Great care should be exercised in the application of this provision if it is to be mutually beneficial to both parties.

PROVISIONS OF OCCUPANCY

58. FRANCHISEE OWNERSHIP OF PROPERTY - In this agreement, the franchisee may own the land and/or building. If the franchisee has the resources, it may be appropriate to own the property as it provides an additional incentive to succeed.

59. FRANCHISOR OWNERSHIP OF THE PROPERTY - This agreement allows the franchisor the right to own the land and/or building. In this situation the franchisee will have to rent or lease from the franchisor. This, however, will allow the franchisor an opportunity to exert a little more control over the franchisee. If the franchisee is willing

to accept the additional control, this provision could be more economical in the long-run.

60. FRANCHISOR LEASES PROPERTY - Frequently the franchisor will own the land and lease it through a third party through a sublease with the franchisee. The terms of the lease generally run concurrent with the term of the contractual franchise agreement. Wherein the franchisor holds the master lease, the franchisee may be subjected to greater control. However, this arrangement could also be beneficial to the franchisee by having the franchisor assume the risks involved in leasing property.

61. FRANCHISEE LEASES PROPERTY - This provision provides the franchisee the opportunity to lease land and/or buildings from a third party. The franchisor may or may not be part of the lease agreement.

62. LEASE APPROVAL - If the franchisee elects to lease property from a third party, the franchisor may insist upon prior approval. The franchisor generally has greater expertise in evaluation terms in lease agreements which may work to the benefit of the franchisee. The provision can be unfair if the franchisor uses the provision to insert conditions in the lease agreement that would be unfavorable to the franchisee.

63. NOTICE OF NON-COMPLIANCE - In addition to requiring franchisor approval of the franchisee's lease, the franchise

agreement may also require the lessor (franchisee) to notify the franchisor of any lease violation. A similar clause provides that the franchisor may correct the lease violation at the franchisee's expense and, in some cases, without his approval. If the franchisee fails to reimburse the franchisor, the franchise agreement can be terminated. This provision should be included whenever the franchisee holds the lease. In addition, the same privilege should be extended to the franchisee when the franchisor holds the lease.

64. LEASE BACK ARRANGEMENTS - This provision specifies that if the franchisee either owns or leases the property from a third party, the franchisee will either assign the lease or lease the property to the franchisor. The terms and conditions of this provision may vary. A variation of this provision requires "assignment of said lease or sublease which shall be held by the franchisor as collateral for the faithful performance by franchisor of . . . the covenants of the franchise agreement".¹³ Such assignment permits the franchisor, at its option, to assume the franchisee's position thereunder; and the lessor may rely upon the franchisor's written statement that it has done so without confirmation by the franchisee.

Lease back arrangements are among the most potentially unfair of all the provisions found in franchise agreements.

It seems the purpose of this agreement is to increase the franchisor's control over the franchisee. The fran-

chisor can use the provision to increase his control by threatening to evict the franchisee from the premises which the franchisee owns or leases. The franchisor may elect to take over the operation and continue payments under the terms of the lease. This provision should be totally eliminated from contract agreements.

65. LEASE - LOSS - If the franchisee violates or loses his lease, the franchisor may terminate the agreement, according to this provision. In effect, this provision makes the lease a part of the franchise agreement. In some cases, termination of the agreement is immediate upon the loss of the lease. The franchisee is not given the opportunity to find another suitable location. Under such terms the franchise is valid for only one location and upon loss of that location, the franchise relationship is ended.

OBLIGATIONS OF THE FRANCHISOR

66. TO ANALYZE REPORTS - The franchisor agrees to analyze the franchisee's reports and to advise him of any deviations from the norm. If the franchisor requires the franchisee to submit regular reports, the franchisor should be required to analyze those reports and make a report of the analysis to the franchisee. This information can be extremely valuable to the franchisee who wishes to improve his operation. Needless to say, analyzing the reports would probably occur

without this provision. The value of this provision is the requirement of the franchisor to report his findings.

67. TO ADVERTISE - This provision states that the franchisor agrees to advertise on behalf of the franchisee. The franchisor can stipulate that the franchisee has no right, claim, or interest of any kind in or to any advertising fee paid to the franchisor. In other cases the franchisor may agree to allocate the fee paid by the franchisee on a reasonable basis for the promotion of the System for the benefit of all franchisees. Allocation may be determined by percentage of gross sales based on the number of franchisees in the System.

68. TO ACCOUNT FOR ADVERTISING FUNDS - Under this agreement, the franchisor has to account for the expenditure of all advertising fees paid by the franchisee. The terms generally require the franchisor to report to the franchisee on a regularly scheduled basis. This agreement may specify how the funds may be spent, i.e., for national or regional advertising.

69. TO ADVISE AND CONSULT - Many franchisors agree to advise and consult with the franchisee on the operation of the franchise business. Some agreements place specific limits on the number of requests that can be made by the franchisee and areas advice can be given. Franchisees may

be required to reimburse franchisors when consultation sessions exceed the allotted number.

70. TO INSPECT - This clause requires the franchisor to inspect the franchisee's operation. Some provisions require the franchisor to give the franchisee a written notice of findings while other allow verbal notice. If this clause did not exist, in all probability the franchisor would inspect the operation anyway. The difference is that with this provision the franchisor gives formal results.

71. TO ADVISE FRANCHISEE OF CHANGES - This provision states that the franchisor will make available to a franchisee all services, facilities, privileges made to all other franchisees, keep the franchisee advised of all new developments, improvements and innovations in methods, processes and systems. While this provision has no inherent unfairness, it is the Operations Manual that often receives these changes. This clause could be potentially detrimental by giving the franchisor unlimited latitude to make changes or no changes at all, thus limiting the franchisee's competitiveness.

72. GRAND OPENING ASSISTANCE - Franchise agreements may specify that the franchisor provide grand opening assistance to the franchisee. To the new franchisee, the opening day may be most critical. If the franchisor does not provide support at this time, the relationship may be permanently damaged. The franchisor may bear the cost of supplying the

assistance or the franchisee may be required to pay for the help. Many contracts extracted the cost of assistance from the initial franchise fee. Most provisions of this type are vague in outlining the number of days and hours assistance will be provided at no cost to the franchisee.

It would be best if the franchisor stated exact daily or hourly rates to be charged. Unfortunately, many franchisors promise assistance and do not execute their promise. The franchisee is then forced to accept non-compliance or take legal action.

BOOKKEEPING PROVISIONS

73. BANK APPROVAL - A few franchise agreements require that the franchisee must use a bank designated by the franchisor. The franchisee may be required to deposit all daily receipts of the business in a bank designated by the franchisor. In this review, only one franchisor applied this provision.

74. BOOKKEEPING SYSTEM APPROVAL - If a franchisee desires to implement a bookkeeping system of his own or the franchisor has not designated one, the franchisee has to let the franchisor review the system for approval prior to using the system. Some agreements only require the franchisee use a system in accordance with generally accepted accounting principles.

75. FRANCHISOR BOOKKEEPING SYSTEM REQUIRED - The franchisee is required to use a bookkeeping system determined by the

franchisor. The provision should not be considered unreasonable if the purpose is to facilitate the analysis of the franchisor's operation. But if the system does not play an integral role in helping the franchisee to manage his franchise, the provision is questionable.

76. ANNUAL CERTIFIED AUDIT - Many franchisors require their franchisees to submit certified audits of their records on an annual or bi-annual basis. This agreement does two things; it forces the franchisee to keep some form of records, and secondly, it reduces the opportunity for the franchisee to understate his sales to the franchisor.

77. RIGHT TO AUDIT BOOKS - This provision gives the franchisor the right to audit the books of the franchisee. Some agreements set the frequency of audits as "at any time"; "at any reasonable time"; or "during the normal business hours of the franchisee's operation". This provision is reasonable as long as the audits are not a form of harassing the franchisee.

78. MARGIN OF ERROR - Certain penalties are doled out if the records are found in error compared with the report submitted by the franchisee. The error can be defined as a fixed amount or a percentage of what was reported to the franchisor. If the franchisee's records are found to be over the specified amount or percentage, he usually is required to pay all unpaid royalties with interest for the days the unpaid portion was outstanding. Repeated negli-

gence on the part of the franchisee is a substantial violation of the agreement and could be grounds for termination.

79. FEDERAL INCOME TAX COPY - This provision forces the franchisee into supplying the franchisor a copy of his federal income tax return. Some agreements may specify that only the portion of the tax return pertaining to the franchised business be furnished to the franchisor. This provision is based on the assumption that some franchisees may attempt to cheat the franchisor but be reluctant to lie to the Internal Revenue Service. The agreement has caused some controversy because many franchisees feel that their personal financial matters are private. According to the Internal Revenue Service, there is nothing illegal about this provision because the individual is free to do as he pleases with his copy of the tax return.

80. PERIODIC REPORTS - Franchisors frequently require the franchisee to submit monthly profit and loss statements, sales reports, balance sheets, inventory reports, etc. From the franchisor's point of view, these reports are essential in evaluating the franchisee's progress. On the other hand, the franchisee may feel some discontent because it seems the reports are the result of the franchisor's failure to properly analyze the already required reports and communicate their result back to the franchisee.

81 - 82. CASH AND/OR PROFIT WITHDRAWAL - This provision limits the amount of cash and profits that the franchisee

may take out of his franchised business within a specific period of time. This provision was not found in any of the contracts reviewed.

EMPLOYEE CONDUCT AND TRAINING

83. EMPLOYEE UNIFORMS - Most common in the fast food industry is the desire for uniformity within the company system. The employee's uniform must conform to the specified color and design set by the franchisor. The franchisee is responsible for providing the uniform to all employees. Many contracts will designate this clause while others are vague or say very little at all. Most often, the franchisee will find that employee uniforms are mentioned in the operations manual and not within the contract provisions. This is unfair since the franchisee will not see the manual until after he has signed the agreement. The franchisor should state all provisions within the contract and not give the franchisee additional requirements hidden in a document not furnished during the initial signing of the agreement.

84. EMPLOYEE CONDUCT - This clause simply relates to how the franchisee and his employees will conduct themselves while on duty. For example, the franchisor will state "the employee shall at all times while on duty represent a neat and clean appearance and render competent, sober, and courteous service". There are some provisions that venture in the arena of ethical behavior. The trouble with these types

of agreements is the interpretation of what or how clean is clean. What meter does one use to gauge competent service?

85. NUMBER OF EMPLOYEES - Some franchisors retain the right to specify the number of employees that must be on duty at any time. There are some franchisors who think their franchisee may reduce the number of employees on duty to cut costs and that such cost cutting would result in poor service. It should be understood that good service is not guaranteed just because there is a full staff on duty. It would be most unfair to require the franchisee to maintain a staff larger than necessary.

FRANCHISEE:

86. RIGHT TO HIRE AND FIRE - This provision provides that the franchisor may dismiss the franchisee's employees. In some cases this right is extended to the hiring of employees as well. Another contract requires the franchisee to consult with the franchisor on hiring of employees. This provision is most demeaning to the franchisee. If one is running a business, he/she has the right to hire and fire as they see fit.

87. FRANCHISEE FORMAL TRAINING - The majority of the contracts require formal training of the franchisee prior to actual operation of the business. This provision normally states the location, length of time, and conditions under which the training will be administered. There may be some stipulations to this provision regarding completion of the formal training by the franchisee. Some agreements will

specify, "If the franchisee fails to complete the formal training, a competent individual will be designated to attend the formal training and this individual will manage the franchised business". Franchisees may have to pay for travel and meals in most cases, but the training itself is part of the package deal. Some contracts will use some of the franchise fee as payment for the training, but the franchisee bears the travel and lodging expense. There are a few agreements that are extreme and stipulate termination if the franchisee fails the formal training.

88. REFRESHER COURSE - This provision requires the franchisee to attend a refresher course similar to the initial formal training or to attend periodic conferences sponsored by the franchisor. The franchisee pays for travel, food and lodging, and sometimes the franchisee is required to pay fees for guest speakers.

89. TRAINING OF SUBSEQUENT MANAGERS - Frequently, the franchise agreements provide that if the manager of a franchise operation is replaced, the replacement manager will attend the formal training course. Once again, the franchisee is responsible for all salary, travel, and lodgings expenses. In addition, the franchisee may be required to reimburse the franchisor for training expenses.

90. TRAINING OF KEY EMPLOYEES - This provision mirrors the previous one, except it pertains to those personnel who

would be considered key figures in the operation of the business.

91. ALL EMPLOYEE TRAINING - This agreements requires the franchisee to train all employees. In most systems, the employees are not required to attend formal training. Instead, a training program in operation of the business may be given at the actual location of business.

92. ON-THE-JOB TRAINING AND ASSISTANCE - Some franchisors do not require their franchisees to complete a formal training program, but instead provide on-the-job training. Such training may take place at the franchisee's place of business, at company headquarters, or at any company owned operation designated by the franchisor.

INSURANCE PROVISIONS

93. FRANCHISOR ADMINISTRATION - This provision makes the franchisor responsible for ascertaining that the franchisee has adequate insurance. Under the terms of this provision the franchisor may procure and maintain insurance for the franchisee at the franchisee's expense. If the franchisor is in a position to benefit financially by administering the franchisee's insurance programs, there is a conflict of interest, and an unfair situation may exist. However, since there are other methods of ascertaining that the franchisee is adequately insured, this provision is not recommended. Group insurance can be administered by the insurance company

and should be free from franchisor intervention.

94. FRANCHISOR CO-INSURED - Frequently the franchise agreement requires the franchisee include the franchisor as an additional policy holder at the option of the franchisor. Generally the franchisor is given the right to designate and determine the type of insurance policies and the coverage there under which the franchisee shall purchase to protect the interests of the franchisee and franchisor. This protects the franchisor in the event that he is named in any lawsuit rising out of the franchisee's contact with customers. Some franchisors may compensate the franchisee for the additional expenses. However, in either case, the provision appears to be fair, reasonable, and justifiable.

95. CANCELLATION NOTICE - This agreement requires the franchisee to include a requirement of notice to the franchisor of any violation or any termination of the franchisee's insurance. The franchisee's insurance company may be required to provide from five to thirty days' notice to the franchisor. Should the franchisee default on the insurance, some agreements give the franchisor the authority to make premium payments and/or procure and maintain the insurance. This provision is an effective method of guaranteeing that the franchisee maintains a proper level of insurance. Cancellation notices are superior to actual administration of the franchisee's insurance because there is little question of a conflict of interest.

96. APPROVAL OF FRANCHISEE'S INSURANCE COMPANY - Terms of provision require the franchisee to obtain insurance from a company the franchisor approves. As long as the franchisor's approval is limited to approving the insurance company according to stated and recognized standards, such as Best's "AAA", the provision is fair.

97. PROOF OF INSURANCE - Some franchisors require the franchisee furnish proof that he has obtained the required insurance. This provision is frequently used in lieu of franchisor administration of the franchisee's insurance program. Proof of insurance requirements often accompanies provisions dealing with cancellation notices and administration. This provision requires less administration by the franchisor and exerts less control than direct administration, yet it accomplishes the same objective.

98 - 103. TYPES OF INSURANCE - This provision requires the franchisee to keep in force several types of insurance, including business interruption, Workers' Compensation, and personal, employer, property, and product liability insurance. The amounts and types vary from one contract to another. While there is some possibility that the franchisor may require the franchisee to be overinsured, required insurance is in the best interest of both parties.

PURCHASING

This group of provisions is concerned with the conditions and circumstances under which the franchisee purchases the

various products and supplies needed for the operation of the franchise. There are several conditions that may be optional or mandatory when purchasing items. Some franchisors will make it clear that they are not a supplier, but supplies the franchisee purchases must meet standards set by the franchisor. Some franchisors give the franchisee the option to purchase supplies from the home office, or seek an independent dealer, so long as the supplies meet company standards. Other franchisors require the franchisee to buy all supplies from the home office. This last condition, although not unethical, can be and sometimes is no more than an opportunity for the franchisor to profit from the purchases made by the franchisee. As this could become a conflict of interest, the franchisor should be careful that he/she is not profiteering at the franchisee's expense. To eliminate distrust, conditions where the franchisee must buy from the franchisor should be totally banned from the agreement. The exception would be when the item is a unique specialty such as batter and mixes.

104 - 107. PAPER GOODS - Paper goods include all the specialty paper products used in quantity by the franchisee. Normally, these products carry the identification of the franchise system. They include paper cups, plates, and napkins used in the fast food operation.

108 - 111. OPERATING SUPPLIES AND SERVICES - Operating supplies and services are products and services used by the

franchisee on a daily basis to provide his customers with the products or services appropriate to his franchise. While some operating supplies may be common to almost all franchisees, others may be restricted to a single franchise system, i.e. special spices and branded products. These are known as common and specialized products, respectively.

Between the two extremes are the relatively standardized products or services used by most of those engaged in providing the same type of products or services.

112 - 114. EQUIPMENT - The franchisee's equipment needs may also be divided into common, specialty, or standardized equipment needs. Some franchise systems have been constructed around an equipment package manufactured or sold by the franchisor. These items may be classed as specialty equipment. Branded products which are not unique to the system, may be categorized as either standardized or common equipment needs.

115 - 117. SIGNS - Signs include indoor and outdoor display and sales promotion devices which are permanent or semi-permanent. They, too, may be grouped according to the preceding three-way classification system. Most signs are custom-made for a particular franchise system and can be classed as either custom or standardized.

118. PRICE RESTRICTION - If the franchisee is required to purchase common or standardized goods from the franchisor or his designated suppliers, the franchise agreement may

contain a provision limiting the prices and pricing policies of the franchisor. The purpose of this provision is to reduce the possibility that the franchisor will use his position to charge the franchisee higher prices than can be justified.

119. FRANCHISOR-VENDOR REBATES - Most franchise agreements are silent on the issue of franchisor-vendor rebates. The rebate is somewhat like a kickback from the supplier to the franchisor when the franchisee buys the vendor's supplies. The rebate may tempt some franchisors to make their franchisee purchase higher priced goods, thus a larger rebate. The franchisor's practice of taking rebates needs to be eliminated because it creates an opportunity for the franchisor to take unfair advantage of the franchisee.

120. VENDING APPROVAL - This provision requires franchisor approval for the installation of vending machines on the premises of a franchised establishment.

The agreements specify what percentage of the vending income is to go to the franchisor and the vending company. Other agreements may require the franchisee to include the vending income in the gross receipts of the franchise business thus be subject to any royalty payments based on a percentage of sales.

ADVERTISING

121. FRANCHISOR/FRANCHISEE ADVERTISING - The franchisor may exert partial or total control over all of the franchisee's advertising or a portion of it. The franchisor may also allow the franchisee total advertising freedom. Generally, the franchisor is better qualified than the franchisee to plan and carry out national, and perhaps local, advertising programs. In some agreements, the franchisor and franchisee may share responsibility in both concepts and financial contributions of the advertising program. The franchisor may apply a one-for-one dollar contribution for each dollar the franchisee applies to advertising. The franchisor may let the franchisee design his own regional advertisement and submit it for approval by the franchisor.

122. RIGHT TO ENTER AND DESTROY - This provision gives the franchisor or his agent the right to enter a franchised establishment and remove any advertisements considered objectionable without being charged with trespassing or having to pay for what was removed. This provision is one of the most high-handed and offensive provisions found in franchise agreements. While the impact of this provision is relatively minor, the negative effect upon the franchisee's mind could be considerable.

123. SIGNS REQUIRED - We have all seen the signs inside and outside our favorite fast food establishment. Generally, all franchisees are required to have these signs constructed

to dimensions specified by the franchisor. The franchisee may have to purchase the signs from the franchisor or, given the option, to purchase signs from an independent dealer. If the franchisee wishes to use a substitute sign, he/she must have prior approval from the franchisor.

124. FRANCHISOR APPROVAL OF ADVERTISING - Franchisees may be given the freedom to prepare their own advertising, but may be required to first obtain the franchisor's approval. Because much local advertising is multi-market in its reach, this provision appears to be appropriate under normal conditions. Thus, some coordination would seem to be in order. Provisions of this type should carry the condition that franchisor approval will not be unreasonably withheld.

125. ADVERTISING ASSOCIATION OF COMMITTEE - This provision stipulates that the franchisee must join either a national or regional advertising committee or association. The provision may also outline the respective roles that the franchisor, the committee, and the franchisee will play in carrying out the system's advertising program. Programming through participation may be the best approach to centralized advertising. Unfortunately, only a few franchisors have learned that participation management can be a highly effective way to centralize advertising and to develop a sense of involvement on the part of the franchisee. If the franchisor alone is responsible for all advertising, he is

open to criticism and ill feeling. Active participation can increase communication and do much to reduce ill feelings.

PROVISIONS OF SALE OR TRANSFER

126. FRANCHISOR'S RIGHT OF FIRST REFUSAL - Both the franchisee and the franchisor may be given the right of first refusal in the franchise agreement. Under the terms of the franchisor's right of first refusal, if the franchisee wishes to sell his franchised business, he must first offer to sell to the franchisor. In addition to these terms, the right of refusal may also state that, "In the event that the franchisor shall not exercise its option for purchase as herein provided . . ." the franchisee may sell to a third party provided that he/she has had approval of the sale from the franchisor. The franchisee may be required to give notice to the franchisor of any offer to sell. Included in this notice is the name, address, and all terms and conditions of a bona fide offer. If the franchisor is willing to match any bona fide offer from a third party, including goodwill payments, there does not appear to be anything unfair about this provision.

127. FRANCHISEE RIGHT OF FIRST REFUSAL - If the franchisor wishes to establish an additional franchise within the franchisee's exclusive territory or within a territory stated in the franchise agreement, this provision may specify the conditions under which the franchisor may issue

a new franchise, the price of the new franchise, the terms and conditions of the sale, and the protected territory of the original franchise. However, the criteria upon which the new franchise unit is justified should be reasonable. Unfortunately, this does not always appear to be the case. In some cases franchisees are forced to open new franchises where they are not warranted.

128 UNLIMITED RIGHT OF INHERITANCE - Under this provision, if the franchisee dies, his heirs have virtually an unlimited right of inheritance to the franchise business. The franchisor, however, may require the heir enter into a written agreement with the franchisor under the current contract conditions. This interferes with the original purpose of the provisions because the business is not inherited as is, but under a new contract as if the heir is a new franchisee. Other agreements allow inheritance as long as it is limited to members of the franchisee's family. In some cases, gifts or transfers by reason of death are not to be considered a transfer or assignment, thus not requiring fees for transfers. The basic question appears to be, do both the franchisor and franchisee have rights that should be protected in the event of the franchisee's death? The question does cause conflict, but if the heirs are competent managers or can hire competent managers, they should be permitted to inherit the franchised business.

129. LIMITED RIGHT OF INHERITANCE - This provision is the same as the preceding one except the heirs have to pay a transfer fee or receive the franchisor's approval, thus limiting the right of inheritance.

130. NO RIGHT OF INHERITANCE - As the provision title indicates some franchisors state flatly that the franchisee's heirs have no right to inherit the business because the agreement is a personal one between the franchisor and franchisee. Some agreements state that the heir must sell the operation to the franchisor at the franchisor's option. Most franchisees find this provision objectionable. It strips the franchisee of the right to pass the business along and forces the heir to sell the business to the franchisor at a price possibly below market value.

131. FRANCHISOR RIGHT OF APPROVAL OF SALE - If the franchisee has an opportunity to sell his franchise, he may be required to obtain the franchisor's approval of the prospective buyer. The franchisor may further stipulate that the purchaser be reputable and financially responsible and complete the company training program. Some require the franchisee pay a sum to defray the franchisor's expenses incidental to the transfer of the franchise and the training of the new franchisee. Ironically, there is practically no franchisee right of first approval of sale. Many franchisors are silent on this point, in fact most state that the franchisor has the right to sell the franchise system

any time he/she chooses. There seems to be a conflict of interest. If the franchisee is to have his freedom, the franchisor must be restricted. On the other hand, if the franchisor's rights are totally protected, the franchisee must suffer. A compromise is in order. In addition, if the franchisee has to gain approval, the approval should not be unreasonably withheld.

132. NO FOR SALE ADVERTISING - Under this provision the franchisor prohibits the franchisee from making any public offer to sell, transfer, assign, lease, or sublet of the franchise business through any medium of public advertising. Many franchisees feel this provision is unfair in that it lowers the selling price to the franchisor under the right of first refusal because the franchisee cannot advertise for a competitive price for the business.

133. BINDING UPON SUCCESSORS - If the franchisor wishes to sell his franchise to a third party, that person is generally bound by the terms of the franchise agreement. This may also apply to the heirs of the franchisee. In some cases, either the heir or the purchaser may be required to sign a current franchise agreement. This provision is a just and perhaps an essential protection of the franchisor's rights. There seems to be no chance for this provision to be used in an unfair manner. It may be included at the franchisor's option.

134. STOCK TRANSFER APPROVAL - This provision sets forth the conditions under which the franchisee may assign an interest in the franchise or transfer stock if the franchisee has incorporated his business. In some cases the franchisee may transfer up to ten percent of the stock or interest in the franchise without approval, while other agreements state that transfer is allowable as long as the franchisee has the controlling interest of 51 percent. Still other contracts require franchisor prior approval before any portion of stock or interest is transferred. Most franchisors require a list of all stockholders and that the stockholders sign an agreement not to compete.

125. NO GOODWILL PAYMENTS - Should the franchisee elect or be forced to sell the franchise or its physical assets to the franchisor, this provision stipulates that the franchisee is prohibited from including payment of goodwill in the selling price. This provision may be implied and not specifically stated in the contract. It is obvious that the purpose of this agreement is to reduce the repurchase price of an ongoing franchise.

CONDITIONS AND TERMS OF TERMINATION

136. FAILURE TO PAY - Under this provision, many franchisees agree to pay all bills, debts and financial obligations. Should the franchisee violate the agreement to pay, it is considered a material breach of the contract and grounds for

termination. If strictly interpreted, this provision may be used to cut off the franchisee's defense of withholding payments from his franchisor in case of non-performance on the part of the franchisor. The provision may even be extended to the franchisee's suppliers in some contracts. This is an unfair provision because it eliminates the franchisee's most effective tool for correcting inequities.

137 - 138. FRANCHISEE-FRANCHISOR RIGHT TO EARLY TERMINATION

The right to terminate the franchise agreement is sometimes extended to the franchisee. This provision states the conditions and terms under which the franchisee may terminate the contract. In some cases the franchisee's right is relatively unrestricted. In other cases the franchisor may specifically deny the franchisee's right to early termination. In these types of cases, the franchisee's termination may be treated as a default. Generally, if the franchisee desires to terminate the contract, he is subject to numerous conditions pertaining to the termination. On the other hand, the franchisor is also allowed to terminate the contract early, but with fewer stipulations applied compared with the franchisee. There is a marked difference between the franchisee's and the franchisor's right to early termination. Some franchisee termination provisions can be about 22 percent of the entire contractual agreement, while the franchisor's termination provisions in some contracts take up 48 percent of the entire contract. The franchisee

may be required to give a thirty day notice of early termination and in most contracts, the franchisor does not have to give any notice at all. This provision provides the right of early termination to both parties, but the franchisor is not required to give the same notices or be subject to the same stipulations as the franchisee. To make the entire provision fair, the franchisor should have the same requirements as the franchisee.

139. TERMINATION FOR ANY VIOLATION - This provision gives the franchisor the unlimited right to terminate the contract for any violation, large or small, that the franchisee commits. This provision may disallow discussions or compromises. The franchisee is given no course to redress the issue, one is given no chance to make corrections. Termination can be for any violation of one or more of the provisions previously reviewed. If tested in a court of law, such provisions may prove to be unenforceable.

Even if this provision is not used against the franchisee, its presence in the agreement is unfair and undesirable for two reasons. First, the franchisor may use the threat of termination to force his will upon the franchisee. Second, franchisees may feel oppressed and threatened by the presence of such a provision.

140 - 143. TERMINATION FOR BANKRUPTCY, VIOLATION OF STANDARDS, TRAINING FAILURE - These provisions provide the means of termination should the franchisee become bankrupt,

or violate set standards. The franchisee is usually not terminated for one violation of set standards. Normally, the franchise is guilty of several violations. Termination due to failing the training program is not common since most franchisors require the prospective franchisee assign an alternate person should the franchisee fail the training program. This provision can be unfair if the franchisor does not specify the exact conditions and terms under which the franchisee may be terminated.

144 - 146. IMMEDIATE CANCELLATION AND GRACE PERIOD - Under this provision, the franchisor can terminate the franchise agreement without prior notice or without the benefit of a grace period. In some cases, immediate cancellation is sometimes limited to specific events or violations. The grace period is the amount of time the franchisee has to correct a deficiency after notification of violation before the franchisor can terminate the agreement. The length varies from sixty days to twenty-four hours. This provision is unfair in that the franchisee should have the right to an appeal. Under this provision, the franchisee has no such right.

FRANCHISEE OBLIGATION AFTER TERMINATION

147 - 148. COVENANT NOT TO COMPETE - When the franchisee's agreement has been terminated, this provision stipulates that the franchisee will not engage in a similar business for a stated period of time and/or within a stated distance

from his former franchise business. The distance may range from one to fifty miles and the time from one to ten years. While it does not seem to be unreasonable for the franchisor to receive protection from the direct competition of former franchisees, this provision may strip the franchisee of his means to a livelihood. This provision may not be enforceable in a court of law since it does strip the former franchisee of some possible livelihood. Besides, the franchisor has no more right to this kind of protection than any other businessman whose employees leave to enter a competitive business.

149. COVENANT NOT TO HIRE - This provision deals most with business ethics. It states that if some other franchise terminates within the system, the franchisee will not hire the employees or agents of either the franchisor or other franchisee. This is understandable if employee stealing is to be averted. The provision may be enforced during the life of the agreement, not just at termination.

150. COVENANT NOT TO USE SYSTEM - This provision is similar to the covenants not to compete. However, it is somewhat more limited in scope. Whereas a covenant not to compete may forbid the franchisee to engage in a similar business, this covenant specifically prohibits the franchisee from using the franchisor's system. Note that this provision does not prohibit the franchisee from opening a similar, but

independent business or from joining another, but similar, franchised system.

151. COVENANT TO CEASE OPERATIONS - If the franchise agreement is terminated for any reason, this provision may require that the franchisee cease all operations immediately. Coupled with an immediate cancellation clause or a very short notice of termination, this provision is extremely harsh on the franchisee and his/her employees. However, if the franchisee has had a proper thirty day notice, this provision is less harsh giving the franchisee the opportunity to liquidate or adjust his operation and/or allow his employees to look for employment elsewhere.

152. COVENANT TO CHANGE BUILDINGS - After termination, the franchisee may be required to change the color scheme, layout or interior furnishing to reflect no association with the former franchise business. Normally the franchisee is given a specific time limit to make these changes after termination.

153. COVENANT TO REMOVE SIGNS - Under the terms of the covenant, the franchisee agrees to cease using any trademarks, service marks, emblems, displays or advertisements with the franchisor's name imprinted on them upon termination. The franchisee also agrees to remove any of the items mentioned above from the premises. This provision appears to be fair and appropriate, provided that the party respon-

sible for the termination pays the cost of removing the signs.

154. COST OF ENFORCEMENT - This provision provides that if the franchisee defaults or fails to satisfactorily perform any of the preceding covenants, the franchisor may cure any such breaches at the franchisee's expense. If the agreement has been fairly terminated, provisions of this type appear to be relatively reasonable. There is, however, one exception. If the franchise agreement has been terminated by the franchisor for reason of franchisor non-performance, this provision and the preceding covenants should not apply. The franchisor, by his act of non-performance should forfeit his right to these protections.

PROVISIONS OF SALE AFTER TERMINATION

Frequently, the franchise agreement will specify that after termination the franchisee may or must sell specified physical assets to the franchisor. In some cases these provisions permitted the franchisor to purchase the franchisee's on-going business by purchasing the physical assets. For example, if the franchisor holds the master lease or the lease is assignable, the franchisor may purchase the equipment, signs, and supplies of a terminated franchise and continue the operation.

155 - 158. THE BUY BACK PROVISIONS - These final provisions are sometimes referred to as "buy back" clauses because they

set the terms and conditions under which the franchisor may purchase the physical assets of a terminated franchise. Some "buy back" clauses are all-inclusive and can be fair or unfair. The assets can be all or portions of equipment, signs, trademark supplies, or regular supplies. Financial terms may be from book value, straight line depreciation, fair market value or double declining balance in establishing selling price. Many contracts give the franchisor the right to deduct any portion the franchisee owes to the franchisor from outstanding debts. Since the franchisor sets the price of the buy back, one may feel there is some unfair dealing when the franchisee has some outstanding debts. It is believed that the franchisor sets the buy back price so that after deducting the franchisee's outstanding debts, there is a very small dollar amount paid for the equipment and supplies in the buy back. It should be understood that the franchisor does not have to buy back any item.

APPENDIX II

LETTER OF SOLICITATION

Dear (Company),

Seventeen years ago the Small Business Administration (SBA) sponsored a study of Franchising. A spin-off of that effort was an analysis of the contractual elements of franchising. Since then franchising has changed considerably.

We are currently engaged in an effort to find out how these changes have affected the franchise agreement. We intend to compare the agreements of the late 1960s to those currently in use.

In order to do this we need your cooperation in the form of one of your present agreements that would be issued to a prospective franchisee. This information will be kept confidential and no franchisor will be identified with specific provisions reported in our final report. The methodology will be similar to that used in the Franchise Agreement Handbook published by Purdue Univ. in 1971.

I am a Captain in the United States Air Force assigned to Grand Forks AFB, North Dakota. In addition to my duties as a Command Post Controller, I am currently working on a Master of Business Administration. This study is part of the final requirement for my graduation.

This study is being supervised by Dr. Gerald G. Udell, who was part of the study team for the original SBA sponsored study at the University of Wisconsin at Madison. Dr. Udell also authored the Franchise Agreement Handbook.

This study is endorsed by the International Franchise Association and your cooperation would be greatly appreciated.

APPENDIX III

FREQUENCY OF PROVISIONS' OCCURRENCE (Based upon contracts of 26 franchisor organization)

PAYMENTS TO THE FRANCHISOR PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|---------------------------|--------------------------------|----------------|
| 1. FRANCHISE FEE | 26 | 100 |
| 2. NON-REFUNDABLE FEES | 14 | 54 |
| 3. ROYALTY | 23 | 88 |
| 4. NATIONAL ADVERTISING | 23 | 88 |
| 5. LOCAL ADVERTISING | 16 | 62 |
| 6. RENEWAL FEE | 10 | 30 |
| 7. SERVICE FEE | 7 | 27 |
| 8. RENTAL/LEASE PAYMENTS | 8 | 31 |
| 9. RENT ADJUSTMENT | 1 | 4 |
| 10. PURCHASE PAYMENTS | 2 | 8 |
| 11. INDIRECT PAYMENTS | 0 | 0 |
| 12. SPECIAL PAYMENTS | 15 | 58 |
| 13. PENALTIES | 17 | 65 |
| 14. SECURITY DEPOSITS | 0 | 0 |
| 15. TERMINATION PENALTIES | 1 | 4 |

GENERAL CONTRACT PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|---|--------------------------------|----------------|
| 16. LENGTH OF CONTRACT TERMS | 23 | 88 |
| 17. OPTION TO RENEW | 18 | 69 |
| 18. EXCLUSIVE TERRITORY | 17 | 63 |
| 19. START UP DATE | 12 | 46 |
| 20. FRANCHISOR CONFIDENTIAL DISCLOSURE | 2 | 8 |
| 21. FRANCHISEE CONFIDENTIAL DISCLOSURE | 15 | 58 |
| 22. INDEPENDENT CONTRACTOR | 21 | 81 |
| 23. HOLD HARMLESS | 18 | 69 |
| 24. ACT OF GOD | 4 | 15 |
| 25. NO WAIVER OF DEFAULT | 19 | 73 |
| 26. ILLEGAL COVENANT | 18 | 69 |
| 27. LEGAL BUSINESS | 2 | 8 |
| 28. FRANCHISEE ASSOCIATION FORBIDDEN | 0 | 0 |
| 29. RIGHT TO FUTURE REVISION | 20 | 77 |
| 30. OPERATING MANUAL | 21 | 81 |
| 31. GOODWILL PAYMENTS | 1 | 4 |
| 32. CORRECTION OF DEFICIENCY | 15 | 58 |
| 33. COMPLIANCE WITH LOCAL LAWS | 15 | 58 |
| 34. FRANCHISE DISABILITY | 13 | 50 |
| 35. ARBITRATION | 12 | 46 |
| 36. SITE SELECTION | 16 | 62 |

MISCELLANEOUS PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|-------------------------------------|--------------------------------|----------------|
| 37. INCORPORATION PERMITTED | 23 | 88 |
| 38. TRADEMARK RESTRICTION | 25 | 96 |
| 39. DISTINCTIVE ARCHITECTURE | 16 | 62 |
| 40. GOOD ETHICS | 12 | 46 |
| 41. STATE OF INTERPRETATION | 19 | 73 |
| 42. VENUE CLAUSE | 4 | 15 |
| 43. SUB-FRANCHISING | 1 | 4 |
| 44. CIVIL RIGHTS | 0 | 0 |
| 45. FULL TIME | 9 | 35 |
| 46. COMPETITIVE BUSINESS | 21 | 81 |
| 47. RESTRICTION ON SALE OF GOODS | 0 | 0 |
| 48. PRODUCT SERVICE | 1 | 4 |
| 49. SALES QUOTA | 0 | 0 |
| 50. GUARANTEED SALES | 0 | 0 |

UNIFORMITY PROVISION

| | <u>Number of Contracts</u> | <u>Percent</u> |
|--------------------------------|--------------------------------|----------------|
| 51. PHYSICAL LAYOUT APPROVAL | 18 | 69 |
| 52. LOCAL VARIATIONS PERMITTED | 3 | 12 |
| 53. DAYS OPEN | 13 | 50 |
| 54. HOURS OPEN | 14 | 54 |
| 55. PRODUCT LINE | 20 | 77 |
| 56. PRICE CONTROL | 2 | 8 |
| 57. ALTERNATION APPROVAL | 16 | 62 |

OCCUPANCY PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|------------------------------|--------------------------------|----------------|
| 58. FRANCHISEE OWNERSHIP | 3 | 12 |
| 59. FRANCHISOR OWNERSHIP | 5 | 19 |
| 60. FRANCHISEE LEASES | 21 | 81 |
| 61. FRANCHISOR LEASES | 5 | 19 |
| 62. LEASE APPROVAL | 6 | 23 |
| 63. NOTICE OF NON-COMPLIANCE | 8 | 31 |
| 64. LEASE BACK | 7 | 27 |
| 65. LEASE LOSS | 11 | 42 |

OBLIGATIONS OF THE FRANCHISOR PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|--------------------------------------|--------------------------------|----------------|
| 66. ANALYZE REPORTS | 8 | 31 |
| 67. ADVERTISING | 18 | 69 |
| 68. ACCOUNT FOR ADVERTISING FUNDS | 8 | 31 |
| 69. ADVISE AND CONSULT | 15 | 58 |
| 70. INSPECT | 24 | 92 |
| 71. ADVISE FRANCHISEE OF CHANGES | 17 | 65 |
| 72. GRAND OPENING ASSISTANCE | 17 | 65 |

BOOKKEEPING PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|------------------------------------|--------------------------------|----------------|
| 73. BANK APPROVAL | 1 | 4 |
| 74. BOOKKEEPING SYSTEM APPROVAL | 7 | 27 |

| | <u>Number of Contracts</u> | <u>Percent</u> |
|------------------------------------|--------------------------------|----------------|
| 75. BOOKKEEPING SYSTEM REQUIRED | 16 | 62 |
| 76. ANNUAL CERTIFIED AUDIT | 12 | 46 |
| 77. RIGHT TO AUDIT BOOKS | 24 | 92 |
| 78. MARGIN OF ERROR | 18 | 69 |
| 79. INCOME TAX COPY | 8 | 31 |
| 80. PERIODIC REPORTS | 23 | 88 |
| 81. CASH WITHDRAWAL | 0 | 0 |
| 82. PROFIT WITHDRAWAL | 0 | 0 |

EMPLOYEE CONDUCT AND TRAINING PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|------------------------------------|--------------------------------|----------------|
| 83. EMPLOYEE UNIFORMS | 11 | 42 |
| 84. EMPLOYEE CONDUCT | 7 | 27 |
| 85. NUMBER OF EMPLOYEES | 1 | 4 |
| 86. RIGHT TO HIRE AND FIRE | 1 | 4 |
| 87. FRANCHISEE FORMAL TRAINING | 22 | 85 |
| 88. FRANCHISEE REFRESHER COURSE | 11 | 42 |
| 89. SUBSEQUENT MANAGER TRAINING | 18 | 69 |
| 90. KEY EMPLOYEE TRAINING | 10 | 39 |
| 91. ALL EMPLOYEE TRAINING | 2 | 8 |
| 92. OJT AND ASSISTANCE | 7 | 27 |

INSURANCE PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|-------------------------------|--------------------------------|----------------|
| 93. FRANCHISOR ADMINISTRATION | 7 | 27 |
| 94. FRANCHISOR CO-INSURED | 22 | 85 |
| 95. CANCELLATION NOTICE | 19 | 73 |
| 96. APPROVAL OF COMPANY | 12 | 46 |
| 97. PROOF OF INSURANCE | 23 | 88 |
| 98. BUSINESS INTERRUPTION | 5 | 19 |
| 99. WORKERS' COMPENSATION | 18 | 69 |
| 100. PERSONAL | 12 | 46 |
| 101. EMPLOYER LIABILITY | 21 | 81 |
| 102. PROPERTY LIABILITY | 24 | 92 |
| 103. PRODUCT LIABILITY | 21 | 81 |

PURCHASING PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|--|--------------------------------|----------------|
| 104. PAPER GOODS-MAY BUY | 5 | 19 |
| 105. PAPER GOODS-MUST BUY | 0 | 0 |
| 106. PAPER GOODS-VENDOR APPROVAL | 10 | 39 |
| 107. PAPER GOODS-STANDARDS | 21 | 81 |
| 108. OPERATING SUPPLIES - MAY BUY | 3 | 12 |
| 109. OPERATING SUPPLIES - MUST BUY | 6 | 23 |
| 110. OPERATING SUPPLIES - VENDOR APPROVAL | 10 | 39 |

| | <u>Number of Contracts</u> | <u>Percent</u> |
|--|--------------------------------|----------------|
| 111. OPERATING SUPPLIES - STANDARDS | 18 | 69 |
| 112. EQUIPMENT-MAY BUY | 7 | 27 |
| 113. EQUIPMENT-MUST BUY | 2 | 8 |
| 114. EQUIPMENT-STANDARDS | 17 | 65 |
| 115. SIGNS-MAY/MUST BUY | 3 | 12 |
| 116. SIGNS-VENDOR APPROVAL | 6 | 23 |
| 117. SIGNS-STANDARDS | 17 | 65 |
| 118. PRICE RESTRICTIONS | 0 | 0 |
| 119. FRANCHISOR-VENDOR REBATE | 3 | 12 |
| 120. VENDING APPROVAL | 12 | 46 |

ADVERTISING PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|---|--------------------------------|----------------|
| 121. FRANCHISOR/FRANCHISEE ADVERTISING | 10 | 39 |
| 122. RIGHT TO ENTER AND DESTROY | 13 | 50 |
| 123. SIGNS REQUIRED | 17 | 65 |
| 124. FRANCHISOR APPROVAL | 16 | 62 |
| 125. ADVERTISING COMMITTEE | 10 | 39 |

SALE OR TRANSFER PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|--|--------------------------------|----------------|
| 126. FRANCHISOR RIGHT OF FIRST APPROVAL | 22 | 85 |
| 127. FRANCHISEE RIGHT OF FIRST APPROVAL | 0 | 0 |

| | <u>Number of Contracts</u> | <u>Percent</u> |
|--------------------------------------|--------------------------------|----------------|
| 128. RIGHT OF INHERITANCE | 13 | 50 |
| 129. LIMITED RIGHT OF INHERITANCE | 8 | 31 |
| 130. NO RIGHT OF INHERITANCE | 0 | 0 |
| 131. FRANCHISOR APPROVAL OF SALE | 20 | 77 |
| 132. NO FOR-SALE ADVERTISING | 1 | 4 |
| 133. BINDING UPON SUCCESSORS | 13 | 50 |
| 134. STOCK TRANSFER APPROVAL | 20 | 77 |
| 135. NO GOODWILL PAYMENTS | 14 | 54 |

TERMINATION PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|---|--------------------------------|----------------|
| 136. FAILURE TO PAY | 20 | 77 |
| 137. FRANCHISEE EARLY TERMINATION | 9 | 35 |
| 138. FRANCHISOR EARLY TERMINATION | 3 | 12 |
| 139. TERMINATION FOR ANY VIOLATION | 9 | 35 |
| 140. TERMINATION FOR VIOLATION/STANDARDS | 19 | 73 |
| 141. TERMINATION FOR BANKRUPTCY | 22 | 85 |
| 142. TERMINATION FOR TRAINING FAILURE | 4 | 15 |
| 143. IMMEDIATE CANCELLATION | 7 | 27 |
| 144. GRACE PERIOD | 1 | 4 |

| | <u>Number of Contracts</u> | <u>Percent</u> |
|-------------|--------------------------------|----------------|
| 145. 10-DAY | 10 | 39 |
| 146. 30-DAY | 15 | 58 |

FRANCHISEE OBLIGATION AFTER TERMINATION PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|---------------------------------------|--------------------------------|----------------|
| 147. COVENANT NOT TO COMPETE-YEARS | 19 | 73 |
| 148. COVENANT NOT TO COMPETE-MILES | 18 | 69 |
| 149. COVENANT NOT TO HIRE | 4 | 15 |
| 150. COVENANT NOT TO USE SYSTEM | 12 | 46 |
| 151. COVENANT TO CEASE OPERATIONS | 24 | 92 |
| 152. COVENANT TO CHANGE BUILDING | 15 | 58 |
| 153. COVENANT TO REMOVE SIGNS | 17 | 65 |
| 154. COST OF ENFORCEMENT | 13 | 50 |

SALE AFTER TERMINATION PROVISIONS

| | <u>Number of Contracts</u> | <u>Percent</u> |
|-------------------------|--------------------------------|----------------|
| 155. EQUIPMENT | 12 | 46 |
| 156. SIGNS | 12 | 46 |
| 157. TRADEMARK SUPPLIES | 12 | 46 |
| 158. REGULAR SUPPLIES | 12 | 46 |

FOOTNOTES

¹Henry S. Commager, Documents of American History (New York; Appleton-Century-Croft, 1962), p.5.

²R.M. Rosenberg and M. Bedell, Profits from Franchising (New York; McGraw-Hill Inc., 1969), p.9.

³Robert M. Goldenson, ed., "The Franchise Guide", Princeton: Resource Publications, INC., 1969, p.116 FF.

⁴Udell, 11-15, see Turabian, 9.137, p.161.

⁵U.S. Congress, "Senate Subcommittee on Urban and Rural Economic Development of the Select Committee on Small Business, 95th Congress", 2nd Sess., 1970, pp. 49-50.

⁶Ibid.

⁷Udell, 4-8.

⁸Ibid.

⁹Ibid.

¹⁰Ibid.

¹¹Ibid.

¹²James A. Murphy, "Franchising: New Problems With an Old Concept", Bulletin of Business Research, Ohio State University, Vol XVI, No. 6, June 1971, p.1.

¹³Udell, 69-70

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