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REVIEW ARTICLE

"THE ROLE OF FRANCHISE CONCEPT IN ENTREPRENEURSHIP"

(IN CONTEXT OF INDIAN CORPORATE WORLD)

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"The Role of Franchise Concept in Entrepreneurship" (In Context of Indian Corporate World)

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OBJECTIVE

To study the concept of franchise model and perform feasibility study of franchise model in context of Indian subcontinent. In addition, to develop a Franchise Disclosure Document (FDD) suitable for Indian corporate environment.

1. INTRODUCTION:

Franchising is the practice of using another firm's successful business model .The word 'franchise' is of Anglo-French derivation - from franc- meaning free, and is used both as a noun and as a (transitive) verb. For the franchisor, the franchise is an alternative to building 'chain stores' to distribute goods and avoid investment and liability over a chain. The franchisor's success is the success of the franchisees. The franchisee is said to have a greater incentive than a direct employee because he or she has a direct stake in the business.

Except in the US, and now in China, where there are explicit Federal (and in the US, State) laws covering franchise, most of the world recognizes 'franchise' but rarely makes legal provisions for it. Only Australia, various provinces within Canada, France and Brazil have significant Disclosure laws but Brazil regulates franchises more closely.

Where there is no specific law, franchise is considered a distribution system, whose laws apply, with the trademark (of the franchise system) covered by specific covenants.

2. OVERVIEW:

Businesses for which franchising works best have the following characteristics:

- Businesses with a good track record of profitability.
- Businesses which are easily duplicated.

As practiced in retailing, franchising offers franchisees the advantage of starting up quickly based on a proven trademark, and the tooling and infrastructure as opposed to developing them .

The following US-listing tabulates the early 2010 ranking of major franchises along with the number of sub-franchisees. It will also be seen from the names of the franchise that the US is a leader in franchising innovations, a position it has held since the 1930s when it took the major form of fast-food restaurants, food inns and, slightly later, the motels during the first depression. Franchising is a business model used in more than 70 industries that generates more than $1 trillion in U.S. sales annually (2001 study). Franchised businesses operated 767,483 establishments in the United States in 2001, counting both establishments owned by franchisees and those owned by franchisors:

1. Subway (Sandwiches and Salads | Startup costs $84,300 – $258,300 (34500 partners worldwide in 2010).

2. McDonald's | Startup costs in 2010, $995,900 – $1,842,700 (31,000 partners in 2010)

3. 7-Eleven Inc. (Convenience Stores) |Startup Costs $40,500- 775,300 in 2010,(28,200 partners in 2004)

4. Hampton Inns & Suites (Mid-rise Hotels) |Startup costs $3,716,000 – $15,148,800 in 2010

5. Great Clips (Hair Salons) | Startup Costs $109,000 - $203,000 in 2010

6. H&R Block (Tax Preparation and e-Filing)| Startup Costs $26,427 - $84,094 (11,200 partners in 2004)

7. Dunkin Donuts | Startup Costs $537,750 - $1,765,300 in 2010

8. Jani-King (Commercial Cleaning | Startup Costs $11,400 - $35,050, (11,000 partners worldwide in 2004)

9. Servpro (Insurance and Disaster Restoration and Cleaning) | Startup Costs $102,250 - $161,150 in 2010

10. MiniMarkets (Convenience Store and Gas Station) | Startup Costs $1,835,823 - $7,615,065 in 2010

The mid-franchises like restaurants, gasoline stations and trucking stations which involve substantial investment and require all the attention of a business.

There are also the large franchises - hotels, spas, hospitals, etc. - which are discussed further in Technological Alliances.

Two important payments are made to a franchisor: (a) a royalty for the trade-mark and (b) reimbursement for the training and advisory services given to the franchisee. These two fees may be combined in a single 'management' fee. A fee for "Disclosure" is separate and is always a "front-end fee".

A franchise usually lasts for a fixed time period (broken down into shorter periods, which each require renewal), and serves a specific "territory" or area surrounding its location. One franchisee may manage several such locations. Agreements typically last from five to thirty years, with premature cancellations or terminations of most contracts bearing serious consequences for franchisees. A franchise is merely a temporary business investment, involving renting or leasing an opportunity, not buying a business for the purpose of ownership. It is classified as a wasting asset due to the finite term of the license.

A franchise can be exclusive, non-exclusive or 'sole and exclusive'

Although franchisor revenues and profit may be listed in a franchise disclosure document (FDD), no laws require the estimate of franchisee profitability, which depends on how intensively the franchisee 'works' the franchise. Therefore, franchisor fees are always based on 'gross revenue from sales' and not on profits realized.

Various tangibles and intangibles such as national or international advertising, training, and other support services are commonly made available by the franchisor.

Franchise brokers help franchisors find appropriate franchisees. There are also main 'master franchisors' who obtain the rights to sub-franchise in a territory.

According to the International Franchise Association approximately 4% of all businesses in the United States are franchisee-worked.

It should be recognized that franchising is one of the only means available to access venture investment capital without the need to give up control of the operation of the chain and build a distribution system for their services. After the brand and formula are carefully designed, and properly executed, franchisors are able to sell franchises and expand rapidly across countries and continents using the capital and resources of their 'franchisees' while reducing risk.

Franchisor rules imposed by the franchising authority are usually very strict and important in the US and most countries need to study them to help the small or start-up franchisee in their countries to protect them.

Besides the trademark, there are proprietary service marks which may be copyright - and corresponding regulations.

3. OBLIGATIONS OF THE PARTIES:

Each party to a franchise has several interests to protect. The franchisor is most involved in securing protection for his trademark, controlling the business concept and securing his know-how. This requires the franchisee to carry out the services for which the trademark has been made prominent or famous. There is a great deal of standardization proposed. The place of service has to carry the franchisor's signs, logos and trademark in a prominent place. The uniforms worn by the staff of the franchisee have to be of a particular shade and colour. The service has to be in accordance to the pattern followed by the franchisor in his successful operations. Thus, for the franchisee he is not in full control of the business as he would be in retailing.

A service can be successful by buying equipment and supplies from the franchisor or those recommended by the franchisor if they are not over-priced. A coffee brew, for example, can be readily identified by the trademark when its raw materials come from a particular supplier. If the franchisor requires purchase from his stores, it may come under anti-trust legislation or equivalent laws of other countries. So too the purchase of uniforms of personnel, signs, etc. But it also applies to sites of franchise if they are owned or controlled by the franchisor.

The franchisee must carefully negotiate the license. They, along with the franchisor must develop a marketing plan or business plan. The fees must be fully disclosed and there should not be any hidden fees. The start-up and costs and working capital must be known before taking the license. There must be assurance that additional licensees not crowd the "territory" if the franchise is worked to plan. The franchisee must be seen as an independent merchant. He must be protected by the franchisor from any trademark infringement by third-parties. A franchise attorney is required to assist the franchisee during negotiations.

Most often the training period - the costs of which are in great part covered by the initial fee - is too short to operate complicated equipment and the franchisee has to learn on his own from Manuals. The training period must be adequate but in low-cost franchises it would be considered expensive. Many franchisors have set up corporate universities to train staff online. This is in addition to literature and sales documents and reaches by email.

Also, franchise agreements carry no guarantees or warranties and the franchisee has little or no recourse to legal intervention in the event of a dispute. Franchise contracts tend to be unilateral contracts in favor of the franchisor; they are generally protected from lawsuits from their franchisee because of the non-negotiable contracts that require franchisees to acknowledge, in effect, that they are buying the franchise knowing that there is risk, and that they have not been promised success or profits by the franchisor. Contracts are renewable at their sole option. Most franchisors make franchisees sign agreements waiving their rights under federal and state law and in some cases allowing the franchisor to choose where and under what law any dispute would be litigated.

4. REGULATIONS:

A). India

Franchising of goods and services, foreign to India, is in its infancy. The first International Exhibition was only held in 2009. India is, however, one of the biggest franchising markets because of its large middle-class of 300 million who are not reticent on spending and because the population is entrepreneurial in character. In a highly diversified society, McDonalds is a success story despite its fare differing from the rest of the world.

So far, franchise agreements are covered under two standard commercial laws: the Contract Act 1872 and the Specific Relief Act 1963, which provide for both specific enforcement of covenants in a contract and remedies in the form of damages for breach of contract.

B). Australia

In Australia, franchising is regulated by the "Franchising Code of Conduct", a mandatory code of conduct made under the Trade Practices Act 1974.

The Code requires franchisors to produce a disclosure document which must be given to a prospective franchisee at least 14 days before the franchise agreement is entered into.

The Code also regulates the content of franchise agreements, for example in relation to marketing funds, a cooling-off period, termination and the resolution of disputes by mediation.

The federal government is currently considering recommended changes to the Code of Conduct contained in the report, "Opportunity not Opportunism: Improving conduct in Australian Franchising" tabled by a Parliamentary inquiry into franchising on 4 December 2008.

Some experts have warned that any push to increase regulation of the franchising sector, could make it a less attractive means of doing business.

C). Brazil

In 2008, there were about 1,013 franchises with more than 62,500 outlets, making it one of the largest countries in the world in terms of number of units. Around 11 percent of this total is foreign-based franchisors.

The Brazilian Franchise Law (Law No. 8955 of December 15, 1994) defines the franchise as a system in which the franchisor licenses the franchisee, for a payment, the right to use a trademark/ patent along with the right to distribute products or services on an exclusive or semi-exclusive basis. The "Franchise Offer Circular" or disclosure document is mandatory before execution of agreement and is valid for all of Brazilian territory. Failure to disclose voids the agreement with refunds and serious damages. The Franchise Law does not distinguish between Brazilian and foreign franchisors. The National Institute of Industrial Property (INPI) is the registering authority. Indispensable documents are the Statement of Delivery (of disclosure documentation) and Certification of Recording (INPI). The latter is necessary for payments. All sums amounts may not be convertible into foreign currency. Certification may also mean compliance with Brazil's antitrust legislation.

Parties to international franchising may decide to adopt the English language for the document, as long as the Brazilian party knows English fluently and expressly acknowledges that fact, to avoid translation (but it follows). The Registration accomplishes three things:

*It makes the agreement effective against third parties

* Permits the remittance of payments

* Qualifies the franchisee for tax deductions

D). China

China has the most franchises in the world but the scale of their operations is relatively small. Each system in China has an average of 43 outlets, compared to more than 540 in the United States. Together, there are 2600 brands in some 200,000 retail markets. KFC was the most significant foreign entry in 1987 and is widespread. Many franchises are in fact joint-ventures, as at their forming the franchise law was not explicit. For example, McDonalds is a joint venture. Pizza Hut, TGIF, Wal-mart, Starbucks followed a little later. But total franchising is only 3% of retail trade which is hungry for foreign franchise growth.

The year 2005 saw the birth of an updated franchise law, "Measures for the Administration of Commercial Franchise". Previous legislation (1997) made no specific inclusion of foreign investors. Today the Franchise Law is much clearer by virtue of the 2007 law, a revision of the 2005 Law.

The laws are applicable if there are transactions involving a trademark combined with payments with many obligations on the franchiser. The Law comprises 42 Articles and 8 chapters.

Among the franchisor obligations are:

- The FIE (foreign-invested enterprise) franchisor must obtain registration by the regulator
- The franchisor (or its subsidiary) must have operated at least operated two company-owned franchises in China (revised to anywhere)for more than 12 months ("the two-store, one-year" rule)
- the franchisor must disclosure any information requested by the franchisee
- Cross-border franchising, with some caveats, is possible (2007 law).

The franchisor must meet a list of requirements for registration, among which are:

- the standard franchise agreement, working Manual and working capital requirements,
- track-record of operations, and ample ability to supply materials, and
- the ability to train the Chinese personnel and provide them
- Long-term operational guidance.
- the franchise agreement must have a minimum three-year term

Among other provisions is:

- the franchisor will be liable for certain actions of its suppliers
- Monetary and other penalties apply for infractions of the regulations.

The Disclosure has to take place 20 days in advance. It has to contain:

- Details of the franchisor's experience in the franchised business with scope of business
- identification of the franchisor's principal officers
- litigation of the franchisor during the past five years
- full details about all franchise fees
- the amount of a franchisee's initial investment
- a list of the goods or services the franchisor can supply, and the terms of supply
- the training franchisees will receive
- information about the trademarks, including registration, usage, and litigation
- demonstration of the franchisor's capabilities to provide training and guidance
- statistics about existing units, including number, locations, and operational results, and the percentage of franchises that have been terminated; and
- an audited financial report and tax information (for an unspecified period of time)

Other elements of this legislation are:

- the franchisee's confidentiality obligations continue indefinitely after termination or expiration of the franchise agreement
- If the franchisee has paid a deposit to the franchisor, it must be refunded on termination of the franchise agreement; and, upon termination, the franchisee is prohibited from continuing to use the franchisor's marks.

E). Europe

Franchising has grown rapidly in Europe in recent years, but the industry is largely unregulated. Unlike the United States, the European Union has not adopted a uniform franchise disclosure policy. Only five countries in Europe have adopted pre-sale disclosure obligations. They are France (1989), Spain (1996), Romania (1997), Italy (2004) and Belgium (2005).

The Code of Ethics of the European Franchising Federation is self-enforced in seventeen European states where their national franchise associations are members of EFF members, and UNIDROIT.

All formal disclosure countries are requiring giving ''Contract Summaries'' to be furnished, highlighting:

- the object of the contract
- the rights and obligations of the parties
- the financial conditions
- the term of the contract

Legal consultation is a must to enter and finalize the agreement(s) as it in all regions. Most often one of the principal tasks in Europe is to find retail space, not so significant a factor in the US. This is where the franchise broker, or the master franchisor, plays a significant role. Cultural factors are also significant as the populations tend to be homogeneous.

F). U.S.

Isaac Singer, in the 1850s, who made improvements to an existing model of a sewing machine, was among the first franchising efforts in the United States, followed later by Coca-Cola, Western Union, etc. and agreements between automobile manufacturers and dealers.

Modern franchising came to prominence with the rise of franchise-based food service establishments. In 1932, Howard Deering Johnson established the first modern restaurant franchise based on his successful Quincy, Massachusetts Howard Johnson's restaurant founded in the late 1920s. The idea was to let independent operators use the same name, food, supplies, logo and even building design in exchange for a fee.

The growth in franchises picked up steam in the 1930s when such chains as Howard Johnson's started franchising motels.[The 1950s saw a boom of franchise chains in conjunction with the development of the U.S. Interstate Highway System.

In the United States, the Federal Trade Commission has oversight of franchising, rather than the US Securities and Exchange Commission. The FTC administrates oversight via the FTC Franchise Rule.

In the U.S. the (FTC) Federal Trade Commission requires that the franchisee be furnished with a Franchise Disclosure Document (FDD) by the franchisor at least fourteen days before money changes hands or a franchise agreement is signed. The final agreement is always a negotiated document setting forth fees and other terms. Where elements of the disclosure may be available from third parties. only that provided by the franchisor can be depended upon. The U.S. Franchise Disclosure Document (FDD) is very lengthy (300-700 pp +) and detailed (see Uniform Franchise Offering Circular (UFOC) for elements of disclosure), and generally provides audited financial statements of the franchisor in a particular format, although audited financial statements may not be required under some circumstances, such as where a franchisor is new. It will include data on the names, addresses and telephone numbers of the franchisees in the licensed territory (who may be contacted and consulted before negotiations), estimate of total franchise revenues and franchisor profitability. The States may require the FDD to contain specific requirements but the requirements in the State disclosure documents must be in compliance with the Federal Rule that governs federal regulatory policy. There is no private right of action of action under the FTC Rule for franchisor violation of the rule but fifteen or more of the States have passed statutes that provide this right of action to franchisees when fraud can be proven under these special statutes. The majority of franchisors have inserted mandatory arbitration clauses into their agreements with their franchisees, in some of which the U.S. Supreme Court has dealt with.

There is no federal registry of franchises or any federal filing requirements for information. States are the primary collectors of data on franchising companies, and enforce laws and regulations regarding their presence and their spread in their jurisdictions.

Where the franchisor has many partners, the agreement may take the shape of a business format franchise - an agreement that is identical for all franchisees.

5. FRANCHISE AGREEMENT

A Franchise Agreement is a legal, binding contract between a franchisor and franchisee, enforced in the United States at the State level.

Prior to a franchisee signing a contract, the US Federal Trade Commission regulates information disclosures under the authority of The Franchise

Rule. The Franchise Rule requires a franchisee be supplied a Uniform Franchise Offering Circular (UFOC) or Franchise Disclosure Document (FDD) prior to signing a franchise agreement, a minimum of ten days before signing a franchise agreement.

Once the Federal ten day waiting period has passed, the Franchise Agreement becomes a State level jurisdiction document. Each state has unique laws regarding franchise agreements.

A franchise agreement contents can vary in content depending upon the franchise system, the state jurisdiction of the franchisor, franchisee, and arbitrator.

A typical franchise agreement contains;

1. Uniform Franchise Offering Circular (UFOC) or FDD Franchise Disclosure Document (FDD)
2. Disclosures required by state laws
3. Parties defined in the agreement
4. Recitals, such as Ownership of System, and Objectives of Parties
5. Definitions, such as Agreement, Territory Area, Area Licensee, Authorized deductions, Gross Receipts, License Network, The System Manual, Trademarks, Start Date, Trade name, Termination, Transfer of license.
6. Licensed Rights, such as; Territory, Rights Reserved, Term and Renewal, Minimum Performance Standard
7. Franchisors Services, such as Administration, Collections and Billing, Consultation, Marketing, Manual, Training
8. Franchisee Payments, such as Initial License Fee, Training Fees, Marketing Fund, Royalties, Renewal fee, and Transfer fee
9. Franchisee Obligations, such as Use of Trademarks, Financial Information, Insurance, Financial and Legal responsibility
10. Relationship of Parties, such as Confidentiality, Indemnification, Non-Compete
11. Transfer of License, such as Consent of franchisor, Termination of license, Termination by licensee, Termination by licensee
12. Other provisions like Governing law, Amendments, Waivers, Arbitration and Severability

6. REFERENCES:

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