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A Franchisor's Legal Guide

Thinking about branching out into franchising?
Start with some basic legalities.

YOUR DAY SPA PROVIDES STELLAR PRODUCTS AND services and your good reputation has spread to a number of nearby communities from which you now draw clientele. It's time to grow. Do you expand by establishing other locations yourself or should you consider franchising, joining the ranks of Cinnabon, Church's Chicken and Blimpie Subs? Creating a franchise is giving others an ownership stake in the success or failure of a new location. This article will discuss the legal aspects of starting a franchise and becoming a franchisor.

First, let's define some terms. The "franchisor" is the person creating and offering the franchise. The "franchisee" is the boots-on-the-ground person applying for and operating the spa. As franchisor, your relationship with a franchisee will be governed by the franchise agreement. This binding contract defines the legal relationship between you and the franchisee. What should be included? A lot.

Franchise agreements are always lengthy documents, often extending to more than 50 pages. In addition, certain other documents may be associated with the franchise agreement, such as noncompetition agreements. In other words, franchising is a long, complex process and the assistance of qualified attorneys and consultants is essential. No matter whom you choose to hire, some basic information will make you a better consumer of legal and consulting services.

Clause and Effect

The franchisee is motivated by the desire to own a profitable franchise, and will expect the franchise agreement to include a clause granting him or her a **protected territory**. This is usually defined as a geographic area designated by maps that are included as exhibits to the franchise agreement. This prevents you, the franchisor, from placing a competing franchise so close to the first that neither is profitable.

This is fine, but keep in mind that the franchisor is in a very powerful bargaining position and can often set the terms of the agreement. The franchisor is motivated by the desire to place as many franchises as possible, but still keep them profitable. Let's imagine there's a franchisor who, in 2006, grants the franchisee a protected territory of four square miles surrounding his spa. At that time, this territory contains a population sufficient to provide a profitable client base for the franchise. Flash forward to 2011, and the population of the four square miles has doubled due to a high rate of development. It would easily support an additional spa franchise. Wouldn't you as a franchisor like to have the right to place another spa? If so, reserve that right in the agreement. State that the **boundary of the protected area may be modified** upon notice. However, to protect the interests of the franchisee, stipulate that in no case will the modified protected area contain less than, for example, 50,000 people.

The very essence of franchising is to keep the



success formula of your business from being modified by the franchisee. The success formula may be divided into two aspects: the look and feel of your business, and the quality of the services you provide. The two are strongly connected; your customers have come to recognize your signage, logo, building architecture and floor plan as associated with a certain level of quality in the delivery of spa services.

In franchising, you seek to clone the look and feel of your spa. Therefore, too much creativity from the franchisee—read, doing things differently—isn't a desirable trait. Consider what the public would think if a franchisee's McDonald's golden arches were purple and pink paisley. Your franchise agreement must provide specifications for the construction, appearance and public representation of the spa. Furthermore, the agreement should call for you to be able to review, modify and approve all construction and design documents, and should stipulate that you either provide the advertising in all media formats, or set guidelines and have the franchisee-created advertising approved by you before dissemination. This will ensure that your trademarks are being used as you wish. You may also want to set a minimum amount of money the franchisee must spend on advertising during the year. This could be specified as a percentage of gross sales.

Your agreement should stipulate your power to retain **control over what services are provided and how they're provided**. You may require a franchisee's employees to receive training that you provide. You'll certainly want to provide operations manuals and have a mechanism in place to ensure compliance. The franchisee should not object to this. In fact, it's a selling point: You have a proven formula, of which the franchisee should want to take advantage. If the franchisee thinks he can do it better by doing it differently, he needs to do his own thing and not trouble you.

You should determine exactly what kind of **insurance** the franchisee is required to carry. Here are some examples: broad-form comprehensive general liability coverage; products liability coverage; broad-form contractual liability coverage; business interruption coverage; workers' compensation and employers' liability insurance. You should be named as an additional insured on the franchisee's policies and require that the insurance be secured from a company with an A.M. Best Rating of "A." Also, be



Having a concept that's successful and repeatable is a selling point for a franchise.

sure to stipulate the amount of such coverage.

Your franchise agreement must set an **agreement term**. I've seen agreements that specify 20 years with an automatic 10-year renewal.

Now to the important part ... the money, namely **franchise fees**. Many established franchises require an up-front, nonrefundable payment plus a percentage of the gross. This is just to get in the door. In one franchise agreement for a sports bar, the franchisor required \$75,000 up front and 6% of the gross revenue. You also need to determine how you, as franchisor, can verify the continuing income of the franchisee. Today any business sales terminals can be hooked up to the franchisor's server to monitor franchisees' transactions on a minute-by-minute basis. You can require the franchisee to enter all expenses in software programs you provide and monitor.

On the Up-and-Up

Handing over pieces of your hard-won business to near-strangers can be a frightening endeavor. Fortunately, you can make sure your franchise agreement provides that a franchisee must give you permission to conduct a **franchisee background check**. You can search court documents and credit history. You can conduct an asset search to attain a personal guarantee that the terms under the franchise agreement can be secured by the franchisee's assets. Your franchisee should have a minimum

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net worth. Your franchise agreement should outline just how you'll verify the franchisee's assets.

The franchise agreement should also include a ***noncompete clause***

prohibiting the franchisee from:

- Engaging in any other competing business.
- Directly or indirectly diverting any business or customers to

any competitor.

- Employing or seeking to employ any person employed by another franchise.
- Upon termination of the franchise, engaging in any similar business within a geographic radius and during a particular time period.

To be enforceable, the noncompete clause must be reasonable in duration, scope and area. In one chicken franchise agreement, the radius was 10 miles, the time was two years and the scope was, of course, the chicken restaurant business.

Confidentiality is an important part of any franchise agreement—so important that it may be contained in a separate, lengthy document attached as an exhibit. You don't want to share your success formula with a franchisee and then have him or her spill the beans to a competitor.

You'll want to ***limit the franchisee's ability to sell or transfer his interest*** in the franchise to a third person. You've done the background on this particular franchisee so you know him or her, but this third party is an unknown. Without insisting on preapproval for sale of the franchise you might wind up with a drug lord owning a spa franchise with more than towels being laundered.

So far we've reviewed about 20 pages' worth of issues generally covered in a 50-page franchise agreement. Plus, keep in mind that franchising regulations vary from state to state. Use this information as a springboard as you seek help in navigating this complicated and specialized area of the law. ●

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