Have No Fear

The thought of reading a franchise agreement got you shaking in your boots? Knowing what to expect can make it less intimidating.

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A franchise agreement isn't exactly light reading, but buying a franchise without poring over the agreement first could spell disaster. Fortunately, while the size, shape and style of franchise agreements vary according to each system, many of their basic features are universal.

A franchise agreement grants you the right to operate a business in the franchisor's system. It's a complex commercial contract designed to create a business relationship that could span 20 years or more. It grants a panoply of intellectual property rights, describes product and service standards, and sets the ground rules for the transfer, renewal and termination of the business relationship.

Since franchise agreements aren't easy to understand, it makes sense to have an attorney help you decipher what your prospective franchisor expects of franchisees--and what you can expect in return. Here are some of the basics:

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Intellectually Speaking

Franchise agreements have been described as trademark licenses in overdrive. They grant you the limited right to use a franchise company's intellectual property, which includes the trademarks, techniques, procedures, uniforms and expertise that comprise the franchise system. These rights are limited to allow the franchisor to preserve ownership of its trademarks, copyrights and trade secrets.

As a franchisee, you have the right to use and display the franchisor's trademark (or family of trademarks) only as the franchisor authorizes. All signs displaying the mark, all printed materials, all vehicles and even all Web sites you use must be approved in form, color and design by the franchisor.

Although it's a point of contention in the franchising community, the bottom line is that trademarks and other intellectual property belong to the franchisor, not to franchisees.

Getting Flexible

U.S. businesses can change dramatically over a span of 10 to 20 years. Look at a photo of a McDonald's restaurant or a Holiday Inn from 1978, and you might not recognize it.

Franchisors must allow for market changes over time, and they do so by incorporating a changing set of policies, standards and procedures in a confidential set of documents usually called "operating manuals." These manuals, which are separate from the franchise agreement, are typically updated as changes in the system occur or new policies are adopted. Franchise agreements themselves are also written to accommodate future changes, while assuring franchisees that the basic rights of the contract remain the same.

Product Standards

The genius of franchising is the delivery of consistent products or services by sometimes hundreds of independent businesses licensed to operate under a single business name. If you think about all that's involved, it's somewhat remarkable that a Big Mac sandwich purchased at a McDonald's in Atlanta tastes the same as one bought in Australia. What's more amazing is that McDonald's Corp., the franchisor, does not manufacture or sell any portion of that sandwich--all the sandwich components are provided to the McDonald's system by unaffiliated, third-party suppliers.

Franchise agreements address the question of supplying materials differently, depending on how much control the franchisor has. In some systems, the franchisor manufacturers the system's product line, and the franchise itself is a "product franchise" through which independent franchisees distribute the line.

In contrast, most business format franchise systems require you to purchase goods from suppliers that have the company's prior approval. If you want to buy products from an unapproved supplier, you need the franchisor's permission. This way, the franchisor assures its product standards will not be eroded through poor supplier selections made by franchisees (often driven purely by price considerations).

Pass It On

What if you want to sell your franchise to another person? In most systems, you can sell your franchise with the franchisor's written permission.

The transfer or "assignment" section of the typical franchise agreement is the longest in the contract, filled with dense legalese. But don't nod off here! It's crucial that you pay close attention because your ability to sell your business and retrieve your sweat equity is critical to your decision about whether to purchase the franchise.

Many franchise agreements give the franchisor the right of first refusal. If you receive a formal offer to purchase your business, you must first offer the franchisor the opportunity to purchase your business on the same terms. This helps the franchisor maintain control over the buying and selling of its franchises. Unfortunately, it may hamper a franchisee's ability to attract a serious buyer. What buyer wants to spend time putting together a detailed purchase offer, only to have the franchisor buy it out from under them?

This part of the franchise agreement also addresses your right to transfer your interests to a corporation or other legal entity, such as a partnership or limited liability company, and the rights of your successors should you die. Your attorney can help you understand what to do if a major transfer opportunity comes along.

The End Is Near

Ironically, the termination section of a franchise agreement is endless. It rattles on *ad nauseum*, listing dozens of situations in which the franchisor may terminate the relationship--and often not one instance in which franchisees may do so. Franchisors generally have only one enforcement tool: the threat of termination. They describe it at length, but use it gingerly.

The agreement enables franchisors to protect their trademarks, systems and other intellectual property if franchisees abuse, misuse or misappropriate any portion of the franchise. This section also allows the franchisor to protect other franchisees. If a franchisee in your small town is running a slovenly, rat-infested operation, your business will suffer, too. You operate under the same trademark as many other franchisees whose businesses are indistinguishable from yours in the eyes of customers. You may dislike the overbearing language of the franchise agreement, but you'll be the first to insist that the franchisor enforce its standards against owners who are slacking on the job and casting your business in a negative light.

The franchise laws of about 16 states and the District of Columbia allow for termination or nonrenewal only where the franchisor has "good cause." These statutes apply if you get into a tangle with the franchisor and are notified that the franchise agreement is canceled.

Solving Problems

Let's face it: Franchising tends to generate disputes. The interests of the franchisor and its franchisees are at odds in a number of ways. One measure of excellence in franchising is how effectively the franchisor avoids the courtroom when it wants to enforce the terms of its franchise agreements.

The contract may contain a provision that requires parties to submit all disputes to arbitration before any lawsuit can be filed. That could mean some travel in your future: Many franchise agreements require arbitration to occur at the American Arbitration Association office closest to the franchisor's headquarters.

The franchise agreement may also specify where a lawsuit must be filed if either party makes a legal claim. Your attorney will probably resist accepting language that requires legal actions to be filed in the home jurisdiction of the franchisor.

Expert Advice

No prospective franchisee should attempt to comprehend a franchise agreement without the benefit of legal counsel. Your attorney will be familiar with the complexities of contract law and can advise you about your rights and obligations.

For all the attention the contract receives at the start of the relationship, it will not likely loom large in your daily operations. When your franchise is succeeding and your relationship with the franchisor is on solid footing, that carefully evaluated franchise agreement, the foundation of your business investment, won't even come out of the drawer. Solid foundations are all supposed to work that way.