

# Likenesses of Licensing, Franchising

*Franchising has great future,  
but unwise legislation and  
over-regulation can slow  
growth*

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Both your fine organization and its individual members have a good deal in common with the International Franchise Association. You and we have, I believe, more in common than either of us may realize. There are a number of franchisors represented in this audience. Some know it; others of you suspect it; still others of you may not harbor the slightest suspicion that you are, or soon will be, up to your ears, but hopefully not over your head, in the system of distribution — variously defined — but generally known as franchising.



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There is no single definition of franchising: there are several versions; legal, economic and organizational. A significant number of IFA members have at various times, and still do, call themselves "licensors," and their agreements with their dealers are denominated "license agreements." The definitions and distinctions are unclear and they will remain unclear through the foreseeable future.

One thing is clear — whatever the number of franchisors in this audience this year, there will be more next year, and even more the year after. This is true not only because it will be a matter of choice. You will be annointed by federal and state laws through the definitions embodied in statutes and in administrative rules.

For example, under a proposed FTC regulation rule, which has been pending for more than five years, you would be engaged in franchising if . . . you have a continuing commercial relationship in which:

1. You permit someone to distribute a product manufactured, processed or distributed by you, or you permit someone to sell services established, organized, approved, or directed by you.

2. You directly or impliedly represent that you will "more than nominally assist" the person in his organization, promotional activities, management,

marketing plan, method of operation, or other business affairs.

3. The operation of the dealer's business is substantially associated with your trademark, service mark, tradename, advertising or other commercial symbol.

The only significant exception is in cases where the continual commercial relationship "involves solely licensing the use of a trademark or service mark." This apparently means giving an "uncontrolled — naked" license, which, in the case of a service mark or trademark, at least, poses the danger of forfeiture of trademark rights for failure to police the quality of products or services sold under the mark.

## Alternative Definition

An alternative definition in the proposed FTC rule would substitute for nominal assistance and use of the trademark, an element in which the "franchisor" has the authority to exert control over the franchisee's method of operation, including but not limited to the franchisee's business organization, promotional activities, management, marketing plan or business affairs." Here again, it appears if you reserve or impose any right to protect the integrity of your trademark, you will become a franchisor.

A FTC rule definition was embodied in a bill introduced in the last Congress (HR.8349, 95th Congress) by Mr. Mikva (D., Ill.). This bill attracted more than 115 cosponsors. It, and a companion Senate bill, were the subject of both House and Senate hearings last spring. Both bills died in subcommittee.

A revised, but similar version of Mr. Mikva's bill, will be reintroduced in the next few days. If enacted in anywhere near the form it took last year, most of the world will be a franchise and you will find that your freedom to exercise sound, reasonable, and essential business judgments with respect to your licensing practices and distribution networks will be taken away.

The proposed legislation deals with your right to select and change firms and people that distribute your product or service. Your licenses would either have to be granted in perpetuity or you would have to pay dearly to buy them back. It is a highly dangerous proposal which has surface appeal to the casual or uninformed legislator. I urge you to be aware of it and to take steps to represent your own legitimate interests. The threat is serious to a wide spectrum of business. You must be aware of it and not underestimate its chances for passage. The danger of the Mikva franchise bill is real, is substantial, and demands your consideration and attention. I cannot em-

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phasize this too strongly.

### State Laws

At present, 22 states have franchise laws, general in nature, which include various definitions of a franchise. Some are extremely broad, others are seemingly irrational in coverage, and all have a wide variety of obligations and penalties.

A franchising arrangement invariably includes licensing of a trademark and some sort of merchandising or marketing assistance and training. It is basically a technique of transferring practical technology. Considering this, some basic questions come to mind:

1. What is franchising?
2. Does it involve a "transfer" of anything? If so, what?
3. What "technologies" are involved?
4. What is its relationship, similarities and differences, to "license"?
5. Is it profitable?
6. Is it "for real"? Will it be around for a while? How developed is it?
7. What might be its advantages? Its disadvantages?

The answers to some of these questions can be found in two announcements issued between October 1973, and March 1975, by The Southland Corporation. Examples of many other companies would do equally as well for our discussion. But this represents a mini-case study. Southland is a diversified food company enjoying about \$2 billion in sales annually, and is the franchisor of the 7-Eleven Stores.

In October, 1973, the Southland Corporation issued a press release. In part, it said this.

Southland has reached an agreement in principle, whereby *Ito-Yokado*, one of Japan's fastest-growing retail chains, will be licensed to operate and franchise 7-Eleven Stores throughout Japan. (The agreement) is similar to Southland's other area franchise contracts and Southland will not be required to invest any capital in the Japanese operation.

In addition to licensing the use of the 7-Eleven tradename, Southland will contribute its 46 years of accumulated expertise in operating and franchising the now more than 4,600 7-Eleven Stores, through training and continuing counseling in the 7-Eleven operating system — including site selection, store layout, product determination, merchandising and accounting.

The Japanese transaction will serve as the prototype for any future foreign area license agreements.

This is an interesting release. It provides some answers. What does it indicate or tell us?

1. That the terms "license" and "franchise" are used sometimes interchangeably. Here it relates to a trademark use license with quality controls.
2. That buyers — here the Japanese — the government, the fourth largest trading company in Japan, and a large retailer believe franchising is "for real."
3. That "technologies" of a sort are in fact "transferred."

Here, the technology is transferred in the sense of imparting information relating to methods, techniques, and ways of conducting a business; the know-how and expertise in operating and franchising 7-Eleven Stores. Technology here is not a patent, a for-

mula, or invention; it is management assistance — training and counseling in operations, site selection, store layout, product mix, merchandising, and accounting.

### Annual Report

The next item of information comes from the company's annual report for 1974 (published March, 1975).

Here, under a heading entitled, "Area Licenses," the company says this:

In December, 1973, a license agreement between Southland and Ito-Yokado Co. Ltd., an outstanding Japanese retailing company, was finalized and fees of \$750,000 were received at that time.

The Company's initial obligations to provide technical assistance and training to Ito-Yokado's personnel in the 7-Eleven operating system have now been completed. After deducting expenses and providing for income taxes, \$260,000 from the fees received were taken into earnings in 1974.

Southland, which is not required to invest capital in the Japanese venture, receives a royalty on the sales of each store. Royalties, which were minimal in 1974, will increase as Ito-Yokado's 7-Eleven store expansion program gains momentum.

After taxes, the return on investment was about 35%.

In contrast, the same 1974 annual report reveals that Southland has 50% interest in subsidiary retailing operations in the United Kingdom. In 1974, the return on an investment of nearly \$21 million was \$600,000. This is about a 3% return on investment.

The initial Japanese payment to 7-Eleven was extraordinary — nevertheless, a sound and developed franchise program can produce a return on investment which is spectacular. Not just abroad, but in Chicago, Louisville, and in every town in every state in the country.

What does this tell us?

In this case, the "franchise" consisted of a tradename license plus the transfer of "technical assistance and training."

No capital was invested and continuing royalties on gross sales of each unit were obtained.

A net profit of \$260,000 from the \$750,000 initial fee was realized during the first year as payment for the trademark license and technical assistance. Hundreds of 7-Eleven Stores will be dotting the Japanese landscape in the next few years, grossing millions of dollars and all providing royalty revenue to Southland.

Franchising can be profitable.

### Nature of Franchising

What is franchising?

Let's look at the nature of franchising — about what it is and what it is not. There is a great deal of confusion on the part of the public about this business method. Basically, it's quite simple; it's the applications that can be highly complex. A great deal of the confusion exists because there is no one official definition of franchising. And the term has been misused as well as abused.

Essentially, franchising is a system of distributing goods or services that combines the best features of a large chain operation and an independent small business. It is not a business as such — it is a way of organizing and carrying on a business. Franchising is used in dozens of different ways by many businesses covering a broad spectrum of activities.

There are some elements that must be present, though, for a business to be a true franchise, rather than a simple distributorship, a bare "naked" licensed dealer arrangement, a wholesaler, retailer or something else. These include the authorized use of a trademark and a long-term, on-going interdependent relationship between the franchising company and the franchised businessman. Throughout the term of the relationship, both agree to abide by certain rules of business conduct designed to make the total franchise operation successful.

The Federal Trade Commission says: "The essence of any franchise system is the establishment of quasi-independent businessmen subject to various controls respecting their business operations, the nature of which depends in part on the philosophy of the franchisor and the nature of the products and services furnished." I would add that controls are also required by the Lanham Act to assure quality of the licensed business so that the consuming public will not be misled.

### Three Classes

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Some divide franchising into three broad classes: franchises which distribute a particular product under the manufacturer's name, such as brand name dealerships for appliance stores, and other retailers; entire format franchises which combine the use of a tradename and a method of doing business, like the fast food restaurants, motels and business services; and those which combine elements of both these types, like soft drink bottlers.

Franchises cover an extremely wide range of activities. In addition to the well-known fast food outlets and motels, there are convenience store franchises, specialized auto service centers, tax and business consultants, employment agencies, printing, tools and even employee motivation franchises. Real estate brokers, pharmacists and accountants are joining franchise programs.

However you look at it, franchising is big — a major part of this nation's marketing system. There are nearly 1,200 government-identified franchising companies with over 463,000 franchised business units. The Department of Commerce estimates that franchising companies will account for 31% of all retail sales in the United States this year. That amounts to \$218 billion. Add in services, and the total swells to \$238 billion. We're talking about a substantial portion of the national economy.

Now, it is true that the bulk of these impressive totals come from the traditional kinds of franchises that have been with us for the past half century — automobile dealerships, gasoline stations and soft drink bottlers. But the growth segment of the industry is the newer kinds of businesses. Nine of every 10 franchising companies is less than 20 years old. Yet in that

short time, these companies have assisted in the birth of nearly 246,000 franchise businesses. Franchised outlets, for example, now account for one-third of all restaurant sales. As a whole, the franchising system provides badly needed jobs for 3½ million Americans.

Why does the franchise system exist? The answer is that this particular manner of doing business provides compelling advantages in the right circumstances for the company with a product or service to sell and for the individual or investor group seeking an opportunity.

Let's look at it from the individual's viewpoint. He's worked hard, accumulates some capital and is tired of working for someone else. He thinks he can make it on his own and he's willing to take the risks involved. Perhaps he wants to operate a motel or auto muffler center. Are his chances of success greater as a lone, inexperienced business operator, or as the franchisee of a company with an instantly-recognizable trademark and a national reputation that can provide him with management expertise and sophisticated advertising? The answer is obvious.

Franchising gives the little guy and the investing group as well a chance to compete with giant, vertically-integrated corporation.

### Company Side

The other side of the coin is the company with a product or service or idea it wants to market quickly and as widely as possible. Franchising is equally attractive here. It provides the best means for rapid expansion, without depleting capital, going heavily into debt or diluting ownership through sales of equity stock. The franchisee helps provide the capital required to open his outlet. Moreover, it allows for an agreed-upon, uniform method of marketing of the product or service which would not be possible under a simple bare-bones licensing procedure or ordinary dealership agreement. The franchisor can reasonably expect that the operator of one of his franchises — since he is in business for himself — will be more highly motivated and entrepreneurial in spirit than a salaried employee. This has been proven. In most businesses, franchise owners are more productive than manager employees.

They also contribute to advertising programs, both locally and nationally.

The result is a combination of the best of both worlds — the spirit and hustle of an individual businessman linked to the proven products and managerial experience of the franchisor. It's an arrangement that can make good economic and business sense.

One of the hallmarks of franchising is its dynamism and flexibility. For every type of business that reaches a growth plateau, there is another just starting up the ladder with a new product or service or some new wrinkle on an established product. A good illustration is the franchised printing and copying services. Sales here are expected to jump 37% from 1975 — to a total of \$129 million in 1977. Another prime growth sector is franchised business services. They can look forward to a 15% sales increase this year.

Another factor that will help franchising stay on the growth track is the increasing number of people

seeking to go into business for themselves. Many are individuals — often highly trained professionals — who have grown tired of being small cogs in large, impersonal organizations. They are all potential franchisees, as are growing numbers of capable people who have been forced into, or opted for, early retirement. And there are the thousands who annually leave the armed services. Top management of franchisors are leaving to take franchises from their former employers.

To many of these people, the appeal of having a hand in one's own destiny; of knowing that success and security are a measure of personal performance is most attractive. Franchising is not for every individual; it's not for every company. Both must have the personality and temperament to function within the relationship.

Nor does franchising end at the nation's border. The same factors that fostered franchising's surge in the United States are becoming more and more common overseas: rising per capital income, increased demand for consumer goods and services and the evolution from a manufacturing to service-oriented economy. At the end of 1975 — the latest figure available — 222 franchising companies had close to 11,000 franchise outlets beyond our borders. Canada accounts for the bulk of these operations, but American franchising companies have franchisees operating in Europe, South America, Africa, Australia and Japan.

So the future, despite the challenges we face today, is bright for the system we call franchising. As former Federal Trade Commissioner Mary Gardiner Jones has said: "The franchising system offers one alternative to growth in (economic) concentration since it can enable a company to expand its business through contract relationships with small businessmen. At the same time, it provides the small businessman an opportunity to operate as a healthy and viable enterprise to compete effectively and expand his operations."

#### Overview

This is an overview of franchising today.

It is an established, effective, and profitable way to transfer technology.

It has its strengths, and its limitations.

It is not suitable to every company or individual.

It's become highly complex due to the increase in laws and regulations. The costs of starting a program have increased too.

The future will see more franchise arrangements established; but with larger, better-financed parties. Only unwise legislation and over-regulation can slow the progress.

Certain business practices common to the franchising system have drawn the attention of the legislatures and the courts. Specific issues include: (1) franchise termination and renewal; (2) disclosure of information and registration of franchise offerings; (3) exclusive territorial arrangements for franchisees; and (4) tie-in claims relating to equipment, signs, real estate and supplies sold by the franchisor, or his designated suppliers, to the franchisee.

Another controversial area is the location clause which limits the use of trademark to one place only. This method of limiting the number of franchised locations, often referred to as "selective distribution," "spacing of dealers," or "allocation of exclusive territories," is a focus of attention in the Congress, in the courts, and in the Federal Trade Commission.

Legislation was introduced in the 94th Congress to resolve uncertainties in existing law by declaring that exclusive territorial arrangements, under circumstances specified in the bills, should not be deemed per se unlawful. Limited to the franchised soft drink and food products, that legislation would have permitted territorial agreements when the product involved is in substantial and effective competition with other similar products made, distributed, and sold by others. Although the legislation failed to pass last year, it is expected to be reintroduced in the 95th Congress.

In the courts, the issue of location clauses is critical. Early last year, a Federal appellate court rejected a lower court's decision (the GTE-Sylvania case) which held that location clauses in franchise agreements are per se illegal. Considered to be a landmark franchising case, it has been accepted for review by the U.S. Supreme Court.

Finally, tying arrangements, which have been challenged as an anticompetitive practice, still represent a major unresolved issue facing franchising. Again, the increasing awareness of franchisors of the legal implications of such contractual arrangements has led to significant reduction in required purchase agreements.

One lower federal court decision would have prohibited franchisors from selling to franchisees. But the franchisor's right to compete with others through a policy of persuading franchisees to buy equipment and supplies from the franchisor was upheld on appeal in the Dunkin' Donuts case.

There are other highly important and interesting issues confronting the franchise system but they are beyond the scope and space available here. I'm sure, however, you will become more involved as the dynamics of franchising spread into your industry.