

THE HISTORY AND REGULATION OF FRANCHISING

By Greg Roquet

Did you know that franchises are regulated by federal law (FTC) and state law in fourteen states including California? [California is regarded as having very strict regulations, which Murphy Business and Financial - N CA supports.](#)

Did you know the regulations have been in place for a long time - since 1971 in California, and at the federal level since 1979? Did you know that franchises are one of the most heavily regulated investments in America?

Did you know that some regard a good franchise as a "[BUSINESS IN A BOX](#)," with everything in place for a franchisee to build a great business?

These regulations are in place to allow prospective franchise investors access to a huge amount of information about the franchise, including [THE ABILITY TO PERSONALLY CONTACT ALL THE FRANCHISEES ALREADY IN THAT BUSINESS!!](#)

Please find below some information regarding the history of franchising and information about franchise regulations. Please read this thoroughly. Regulations are in place to benefit prospective investors in franchised business ownership. At Murphy Business and Financial - N CA we feel that it is very important that you have an understanding of the regulations when looking at franchise opportunities. I will be pleased to discuss this important information with you, and how to use it to your advantage.

Regards,

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HOW DID FRANCHISING GET STARTED?

Have you ever thought about how the whole concept of franchising began? The word "franchise" comes from old French meaning "privilege" or "freedom." In the middle ages a franchise was a privilege or a right. In those days, the local sovereign or lord would grant the right to hold markets or fairs, to operate the local ferry or to hunt on his land. This concept extended to the king granting a franchise for all manner of commercial activities such as building roads and the brewing of ale. In essence the king was giving someone the right to a monopoly for a certain type of commercial activity. Over time the regulations governing franchises became a part of European Common Law.

Over the centuries the franchising 1840's concept has evolved as the economies of the nations of the world have evolved. In the in Germany certain major ale brewers granted franchises to certain taverns, giving those taverns the exclusive right to sell their ale. This was the beginning of the concept of franchising, as we know it today.

In 1851, the Singer Sewing Machine Company began granting distribution franchises for their sewing machines. Singer had written franchise contracts, which were the forerunners of modern franchise agreements. In the 1880's cities began to grant monopoly franchises to streetcar companies and utilities for water, sewerage, gas and later electricity.

Around the turn of the century, soft drink bottlers, the oil refinery companies and the automobile manufacturers began to grant the right to sell their products. At this stage in the evolution of franchising it was essentially just the granting of the right to distribute and sell a manufacturers products, today called "product franchises."

"Business format franchising," which is the dominant mode of franchising today, came into the economic scene after World War II with the return of the millions of US servicemen and women and the subsequent baby boom. There was an overwhelming need for all types of products and services, and franchising was the ideal business model for the rapid expansion of the hotel/motel, restaurant, automotive service, real estate brokerage, auto rental, and fast food industries.

During the explosion of the 60's and 70's there were many problems and some abuses in franchising. Some companies got into trouble because of poor management or lack of capital. But there were a few totally fraudulent franchise companies that literally took peoples money and ran. Whatever the causes, the results were the same: a trail of failed franchisees who lost everything. Therefore, the need for regulation was inevitable, and has since helped provide potential franchise investors the information they need to make an informed and safe decision.

It became clear that the franchise industry had to change in order to remain a viable business concept. On the **INDUSTRY SIDE**, The International Franchise Association (IFA)



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was created with the specific intent of uplifting the professionalism of the entire industry. The IFA holds training in all aspects of franchising which greatly enhances the industry. Members of the IFA are required to adhere to the IFA's Code of Ethics, which sets a high standard. The IFA works closely with the US Congress and the Federal Trade Commission on improving how the industry relates to the franchisees. Murphy Business and Financial - N CA is a proud and active member of the IFA!

On the **GOVERNMENT REGULATORY SIDE**, the State of California was the first to enact regulations in 1971. In 1973, some Midwestern states enacted strict regulations. Finally, in 1978 the Federal Trade Commission (FTC) required that all franchisers submit to all potential franchisees a document formerly called the Uniform Franchise Offering Circular or UFOC and now called the Franchise Disclosure Document (FDD) before receiving money.

The FDD provides very detailed information on the franchise company, such as its history, information about the officers, litigation history, audited financial statements, the franchise agreement, which is the contract between the franchiser and franchisee and a current list of franchises with owners names and telephone numbers.

The intent of the FDD is that it provides enough information so that the prospective franchisee can make an informed decision. Also there are today a total of **FOURTEEN STATES** called "registration states," which have their own requirements that must be met before a franchiser is allowed to sell franchises in their states. In some states, especially Illinois and California, these requirements are more stringent than the FTC's! In just a moment, we will go into some detail about the Offering Circular.

Today, franchising is a highly regulated industry, which offers a great opportunity to those individuals who truly want to realize their dream and go into business for themselves.

HOW DO FEDERAL AND STATE REGULATIONS HELP PROSPECTS?

This is the basic definition of a franchise, but only a partial one:

A franchise is an investment in a long term (5 years to 25 years or more) business license.

The licensor/franchisor grants you a license to distribute goods and services using his trademarks, trade names, trade styles and business systems. It is a complete system of doing business. Indeed, the word "system" is the key concept in franchising. A franchisee receives assistance with site selection, personnel training, business set-up, advertising, and product supply. The franchisor will have manuals and training in place to teach the systems to the new franchisee. In a nutshell, a franchisee is investing in a license that gives him access to someone else's expertise, experience, and method of doing business.

But a franchise is a special kind of business license, because during the term of the franchise,



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the franchisor has some control (which allows it to charge royalties) or provides significant assistance. So, "control and assistance" are what distinguish a franchise business license from all other business licenses.

WHAT DOES A FRANCHISE COST?

Now, what do you pay for the license? It takes two forms. First, there is an "initial franchise fee" usually in the \$20,000 to \$30,000 range. This is what you pay for the license, the training, and for getting into the system. *This is the price of admission.*

Secondly, almost every franchise charges on some ongoing payment, usually called a royalty, and typically in the range of 4 to 7% of sales. There is considerable variation, however. This is what you pay to stay in the system -- and royalties are usually the franchisor's main revenue stream. This, of course, ties the franchisor's revenues to the performance of the franchisee.

Finally, there is the investment it takes to open the business, franchised or not. If it is a retail business, it will need inventory, shelving and cabinets, cash registers and so on.

WHAT KINDS OF FRANCHISE REGULATIONS ARE IN PLACE?

Franchise regulations are in place for the benefit of a person considering buying a franchise, a prospective franchisee. Murphy Business and Financial - N CA believes our clients must understand these regulations.

Federal law, and state law in 14 states, including California, require that a franchise prospect receive a current copy of the 75 - 150 page (or more) document formerly known as the Uniform Franchise Offering Circular (UFOC) and now called the Franchise Disclosure Document at the first meeting with a representative of the franchise company. Further, a current copy of the FDD must be in the possession of the prospect for 14 calendar days before the prospect may sign any commitment or make any deposits. Finally, the franchise contract, with all blanks filled in, must be in the possession of the prospect for five business days before he/she may sign it.

The law requires that the almost the entire UFOC be written in "plain English."

The only exceptions are contracts and financial statements. In my opinion, you do not need an attorney to read the FDD for you; unless there is some term you do not understand. Murphy Business and Financial - N CA strongly recommends, however, that a qualified franchise attorney be retained by you to explain the franchise contract and any other legal document, such as a lease, that might be included. You may also wish to have an accountant review the three years of audited financial statements from the franchiser.



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CONTENTS OF THE UNIFORM FRANCHISE OFFERING CIRCULAR

1. History: description of the industry, the competition, the history of the franchise company, and the business biographies of the directors, officers, and key managers.
2. Litigation: any lawsuits between the franchisor and franchisees, or franchisor and regulators. (Which franchise has the most lawsuits disclosed in the UFOC?)
3. Money: the estimated initial investment and all fees, including the initial franchise fee, on-going royalties, advertising fees, site fees, transfer fees, etc.
4. Restrictions: any restraints on the sale of products and services, and also on their sources.
- 5 Obligations: franchisor's obligations and the franchisee's obligations, and where they are found in the franchise contract.
6. Financing available through the franchisor, if any, and territory rights. This last is so important that Murphy Business and Financial - N CA feels no one should buy a franchise that does not provide territorial protection.
7. Franchisee's obligation to participate in the operation of the business. (Can you be an absentee owner? Or must you attend to the business?)
8. Regulations on franchise renewal, termination, and transfer. Also the process for resolution of disputes between the franchisor and franchisees. (Lawsuit? Arbitration?)
9. Earnings and/or sales claims, if made, must be published in the Circular. (Only one in four franchises publish any sales or earnings claims.)
10. List of outlets and franchisees -- names addresses, telephone numbers. Last known address of all franchisees who left in the last year, for whatever reason: failure, sale, retirement, or death. By state, three years history of open/closed units, plus, by state, three years plan for new unit openings.

UP TO THIS POINT, BY LAW, THE TEXT MUST BE IN PLAIN ENGLISH

Now, there are two "technical" parts, and you may want an accountant to advise you on item 11, and you *must* have a franchise attorney advise you on item 12.

11. Three years of audited financial statements of the franchisor.
12. Copies of any contracts: the Franchise Agreement, leases, and any other documents a franchisee may be asked to sign.



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13. Receipt of the Circular, to be signed by the prospect, so the franchisor has evidence for the regulators that they have complied with the disclosure regulation.

My own view is this:

If you take advantage of all the data the law requires you to receive and interview franchisees already operating within a franchise system, you can make a more informed investment decision about a franchise than any other investment.

HOPE THAT THIS INFORMATION WILL HELP YOU MAKE A
SAFE AND INFORMED DECISION AS TO WHETHER A
FRANCHISE BUSINESS IS RIGHT FOR YOU.

Good luck!!

**"IF YOU DON'T FOLLOW YOUR OWN DREAM, YOU WILL END UP
WORKING FOR SOMEONE WHO DID."**



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