

Glossary of Terms—Franchise Nomenclature

Like so many niche businesses, franchising has a language all its own. Here are definitions for many:

ACH or Automated Clearing House refers to the process used for electronic bank-to-bank transfers of fees due to Franchisor. This means that the Franchisor can automatically withdraw funds from your account to pay for such items as Royalties and advertising fees.

Affiliates means an entity controlled by, controlling, or under common control with another entity. Affiliates are sometimes called “sister” companies.

Arbitration is an alternative dispute resolution mechanism that replaces a state or federal court. In arbitration an “arbitrator” or “arbiter” (acting as a private judge) is called upon to resolve a legal claim between the Franchisor and Franchisee. The decision of the arbitrator is as binding on the parties to the disputes as would be the decision by a court of law.

Area Developer means a person or business entity that agrees as a Franchisee to open multiple franchised businesses within a certain development area. The Area Developer signs a Franchise Agreement with the Franchisor, and then owns and operates each unit developed under the agreement.

Area Representative or Regional Developer means any person or business entity given the right by the Franchisor to locate potential Franchisees (who then sign the franchise agreement with the Franchisor) and/or to whom the Area Representative will provide some or all of the services otherwise required to be delivered by the Franchisor.

Competitive Business is a term used in defining the terms of a Noncompetition Covenant (defined below). To be enforceable any noncompetition covenant must be reasonably limited in its scope. Here, the identity of a competitive business must be reasonably close to the identity of the franchised business you bought. For instance, it is fair for a pizza franchise to deny you the right to compete against it with another pizza business. It would be unfair for the Franchisor however to deny you the right to compete against it with for instance, a burger joint.

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Computer System means the computer hardware and software that the Franchisor requires you to have to operate the franchised business.

Compliance refers to the minimum standards you must meet to remain a Franchisee. Compliance requires that you follow the system described by the Franchisor and that you make all payments to Franchisor on a timely basis. Sometimes the Franchisor will deem you to be out of compliance if you have breached the Franchise Agreement “x” number of times in a 12-month period even though you may have timely cured each such violation. In such a case, the Franchisor may terminate your franchise rights because you fell out of Compliance.

Cure means the right that you have to fix a breach of the Franchise Agreement. For instance, if you fail to follow a certain rule or regulation, the Franchisor may send you a notice of default which will say something to the effect that you have breached the Franchise Agreement by failing to follow a stated rule and which says that you have “x” number of days to fix or “cure” the breach by again following the rule. Most Franchise Agreements have Events of Default (see below) that can be cured and some that cannot be cured.

Default Notice means the notice that the Franchisor will send the Franchisee if Franchisee breaches any covenant of the Franchise Agreement.

Designated Manager refers to the person besides the owner of the franchise that has received the Franchisor’s training and who can operate the franchised business in the absence of the owner. This person may be identified by another title in a Franchise Agreement. The meaning however will be the same.

Due Date usually means the date on which Royalties and other fees are due to Franchisor and is the date that the Franchisor will automatically take money from your operating account through the ACH process.

Financial Performance Representation or Earnings Claim is any oral, visual, or written representation made by the Franchisor to a prospective Franchisee that states or implies any specific level or potential for any sales, earnings, profits, or similar financial gain that could be realized by the Franchisee. Franchisors can make such representations ONLY if the information is disclosed in Item 19 of the disclosure portion of the FDD.

Effective Date usually means the date that the Franchise Agreement was fully executed by the Franchisor and Franchisee.

Event of Default refers to any of a list of breaches defined in the Franchise Agreement. For instance, an Event of Default would be your failure to follow the system. This could be because an employee failed to wear a uniform or because you failed to deliver the quality of product or service required under the Franchise Agreement.

Exclusive Territory is a franchise term of art and means that the Franchisor is giving you a certain geographic area in which you (and no other Franchisee) can sell the franchised goods or services. An Exclusive Territory could be as small as a city block or as large as an entire city, county, or state. Some franchise systems offer Exclusive Territories while others do not. By law, if the Franchisor offers no Exclusive Territory it must state the following in Item 12 of the Franchise Disclosure Document:

“You will not receive an exclusive territory. You may face competition from other Franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.”

Expiration of Franchise Agreement means the date on which the term of the franchise agreement ends. For instance, if the term of the franchise agreement is 10 years, it expires on the last day of the ten-year period. Compare this to “Termination.”

Fair Market Value means the value that a reasonable person who is under no duress or obligation to buy, would pay to a seller who is under no duress or obligation to sell. In the franchise setting, this measure is often used when valuing the Franchisee’s interest in his furniture, fixtures, and equipment, and the value of the Franchisee’s interest in the franchise itself. As is often the case, the buyer and seller may not agree on the Fair Market Value, and as a result, most Franchise Agreements will provide a mechanism to resolve the impasse through the use of an independent and disinterested appraiser. As is most often the case, the goodwill of the business attributable to the Franchisor’s Marks will not be valued because it belongs to the Franchisor and is not “owned” by the Franchisee.

Federal Trade Commission is the governmental authority that regulates franchising on a national level. The FTC (with the help of the North American Securities Administrators Association the “NASAA”) dictates the content of the FDD.

Force Majeure refers to so-called “acts of god” or other matters of which you have no reasonable control. In most Franchise Agreements, an event of Force Majeure usually excuses both the Franchisor and Franchisee from performing certain obligations until the event has passed. Many times Force Majeure will NOT excuse a Franchisee from making monetary payments. If you cannot offer a certain service or good because of serious weather, you will be excused from what otherwise would be an Event of Default until the weather has cleared up.

Franchise means “. . . any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

“(1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trade mark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trade mark;

“(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and

“(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.” 16 Code of Federal Regulations, Section 436.1(h) (2007).

Franchise Agreement means the actual contract between the Franchisor and you. The “FDD” (as defined below) is NOT a contract. Instead, it is a federally mandated disclosure document that contains an exact copy of the Franchise Agreement, and of all other agreement that the Franchisor may require you to sign.

Franchisee means the person or business entity that is granted the right to operate the franchised business. The Franchisee may be a natural person though most often the Franchisee is a business entity (e.g. a corporation or a limited liability company). If Franchisee is a business entity, the definition may also include all of Franchisee’s directors, officers, shareholders, members, managers, and partners. In addition if the Franchisee is a business entity, the Franchisor will often demand that one or more of the officers, directors, shareholders, members, managers and partners sign a guaranty which in turns states that each such person is equally responsible for the performance of the Franchisee under Franchise Agreement.

Franchise Disclosure Document or FDD means the disclosure document required by the Federal Trade Commission to be delivered to you at least 14 calendar days before you sign any agreement or pay any money to the Franchisor. The FDD contains several parts. The first part of the FDD is the disclosure portion that comprises 23 “Items.” The FTC dictates that all Franchisors offering a franchise in the United States *MUST* follow the exact

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same format when drafting the disclosure portion of the FDD. The disclosure portion is then followed by other mandatory disclosures including the Franchise Agreement and any other documents you will be required to sign.

Franchisee Manual or Manual means the operations manuals (that may be more than one manual, booklet, or handout), that will be delivered to you before you open for business. The Manuals usually explain how to operate the business and include topics on such matters as accounting, customer service, preparation of goods to be delivered to the customer (e.g. the way to cook a burger), quality control, and the like.

Franchisee National Advertising Fee or National Advertising Fee means the fee usually collected by the Franchisor to be used to create a national advertising campaign around the franchised product or services.

Franchisor means the person or entity identified as the Franchisor. It usually includes not only the Franchisor's business entity, but also may include also include Franchisor's predecessors, any Affiliate, or any parent and each such business entity's shareholders, directors, officers, managers, members, employees, and agents, and all successors, and assignees.

Grand Opening means the celebration you fund at the time of the opening of your franchised business. The **Grand Opening Cost** is the amount you spend on your Grand Opening.

Indemnification means you agree to pay the Franchisor for any loss the Franchisor suffers because of your breach of the Franchise Agreement. For instance, if you injure a customer and if the customer sues you and the Franchisor, you agree to cover not only your legal costs and losses but also those of the Franchisor.

Initial Franchise Fee and IFF means the fee you pay the Franchisor for the award to you of the Franchise Agreement.

Initial Term means the number of year from the Effective Date of the Franchise Agreement to the last day of Franchise Agreement. The Initial Term may be a length of time from a few years to a decade or longer. The Initial Term does not refer to any renewal or extension that may be granted. Such additional term is often called the "Renewal Term" Successor Franchise Term" or words to the effect.

Late Fee means the fee that the Franchisor may charge for your failure to timely make payments. If the ACH method is used, you may incur a Late Fee if there is not enough money in your account to pay what is owed to the Franchisor.

License in the franchise setting means the right granted to the Franchisee by the Franchisor to use the Franchisor's trademarks, trade names, logos and other intellectual property. All franchise agreements are licenses, but all licenses are not franchises.

Local Advertising Fee or words to that effect refers to the minimum amount of money that the Franchisor may require you to spend on advertising in your Exclusive Territory or in your local market.

North American Securities Administrators Association, Inc. or NASAA is the group of state securities regulators that work with the FTC to create rules, regulations, and guidelines that control many aspects of the franchise industry. For instance, the format of the FDD and the guidelines for creating the FDD have been drafted by the NASAA.

Noncompetition Covenant is a part of the Franchise Agreement that states you may not invest in, or work in a Competitive Business. Since such covenants seek to deny you the right to work in a certain industry, virtually all of the states will strictly construe this covenant against the Franchisor. Indeed, in some states such as California, such covenants are deemed unenforceable. To be enforceable at all, covenant must be reasonable in its definition of a Competitive business, in the time period during which you are denied the right to participate in a competitive

business, and in the identity of geographic area in which you are denied the right to compete. If you operate a restaurant, a reasonable covenant may for a period of between 6 months and five years prohibit you from operating a similar restaurant (being one that serves the same type of food in the same type of atmosphere) within your Exclusive Territory (if one was given to you), within the Exclusive Territory of another Franchisee or company-owned restaurant, or with “x” miles of the perimeter of any such Exclusive Territory.

Opening Period means the date by which you must be open for business.

Principal Operator means the person authorized by the business-entity Franchisee to receive the Franchisor’s training, to operate the franchised business, and to act as the contact between Franchisor and Franchisee. For instance, if the Franchisee is a corporation, the Principal Operator may be its president.

Proprietary Information, Confidential Information, Trade Secret Information or words to that effect refers to the secrets of the Franchisor that make its franchise unique and different. It often includes all of the Marks, the Manuals, the training methods and materials delivered to you, recipes, and financial aspects of the business. This information is never to be shared with anyone except employees and then only if he or she needs the information to perform his or her work.

Reasonable Business Judgment refers to the standard that a Franchisor will use to evaluate changes to the system, requests made by you to deviate from the system, or to determine whether to offer you renewal rights. Often use of the Franchisor’s Reasonable Business Judgment will mean that Franchisor’s determination on a matter will prevail even where other alternatives are also reasonable if Franchisor is intending to benefit, or are acting in a way that could reasonably benefit any component of the System and/or the Marks, any one or more of the Franchisees, or any other aspect of the franchise system. Such decisions may include, but will not be limited to, decisions that may: enhance and/or protect the Marks and the System; increase Student satisfaction; increase the use of the services all Franchisees offer; and matters that correspond with Franchisee satisfaction. Franchisor will not be required to consider any Franchisee’s particular economic or other circumstances when exercising our Reasonable Business Judgment. Reasonable Business Judgment decisions will not affect all Franchisees equally, and some may benefit while others will not.

Registration States refers to that states that require the Franchisor to have the FDD reviewed and approved by state authorities prior to selling in that state, states that require yearly notification filings with the state to affirm that Franchisor is selling in the state, and states require Franchisor to file for an exemption. The Registration States are: California; Hawaii; Illinois; Indiana; Maryland; Michigan; Minnesota; North Dakota; New York; Oregon; Rhode Island; South Dakota; Virginia; Washington; and Wisconsin. Florida, Kentucky, Nebraska, Texas, and Utah require some form of registration or exemption filing. In the Registration States, the Franchisor must amend the FDD to conform to the state’s rules or regulations.

Royalty means either a flat fee charged by the Franchisor for each transaction done through your franchised business, or means a percentage of your revenue (most often a percentage of your Gross Revenue). Royalties can range from 1% to 10% or more. Royalties are an ongoing revenue stream for the Franchisor and is one area in which Franchisors must compete with other franchise opportunities.

Subfranchisee means the person or entity that is sold a franchise opportunity by a Subfranchisor. The subfranchisee thus has a contract not between the Franchisor and the franchisee, but instead has a contract between the Subfranchisor (who has stepped into the shoes of the Franchisor) and the Franchisee (now called the Subfranchisee).

Subfranchisor means the person or business entity that is granted the right by the Franchisor to sell franchises under Subfranchisor’s signature in a defined geographic area. The Subfranchisor in the past has been called a “Master

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Franchisee.” In this arrangement, the Subfranchisor steps into the shoes of the Franchisor by locating prospective Franchisees, by signing the franchise agreement as the franchisor, and by performing all of the duties of the Franchisor. These arrangements are most often seen where the Franchisor sells opportunities internationally or where the Franchisor grants subfranchise rights to a person or entity that will operate in one or more states.

Successor Franchise Fee or Renewal Fee means the fee that the Franchisor may charge when you seek to renew the franchise at the end of the Initial Term.

Successor Franchise Term means the number of years that the renewal lasts. It may be a term equal to the Initial Term or it may be a shorter period.

System means the Franchisor’s manner and method without limitation: the manner and method of training delivered to the Franchisee; the operations, standards, and procedures the Franchisee will use in the day-to-day operation of the franchised business; the advertising programs to be used in promoting the franchised business; the economic and financial characteristics of the Franchised Business; any Proprietary Information owned by Franchisor; any of its Marks; and all other copyrighted, trade secret or confidential information.

Term means the length of the franchise agreement. This is expressed in years and can be as short as three to 5 years, or it can be ten years or longer.

Termination means that the franchise agreement has ended on a date earlier than the Expiration date. Termination usually occur because of breach by the franchisee of the franchise agreement.

Trademarks or Marks means all trademarks, trade names, logos, service marks, and similar commercial symbols that the Franchisor requires you to use in identifying your franchised business. In virtually all cases, the Franchisor will have a trademark registered with the United States Patent and Trademark Office (USPTO). The presence (or absence) of this registration is found at Item 13 of the disclosure portion of the FDD.

Trade Name means the name under which a business chooses to operate.

Training refers to the training that the Franchisor gives you before you open for business. Training must be defined in detail in Item 11 of the disclosure portion of the FDD.

Transfer means the act of transferring your interest in the franchised business, your interest in the assets of the franchise, or your interest in the business entity that owns the franchise rights to another person or entity. Transfers usually include transfers that are made by gift, by order of a court (as in a divorce or bankruptcy), and in most situations where the Franchisee seeks to divest himself of a material interest in the franchise, its assets, or the business. Transfers are almost always strictly controlled by the Franchisor.

Transfer Fee is the fee that most Franchisor’s charge at the time of the transfer of the business from the current Franchisee to a new Franchisee.