An assessment to determine how a franchisee's thorough understanding of the disclosure statement would affect potential legal pitfalls in a franchisor-franchisee relationship

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An assessment to determine how a franchisee’s thorough understanding of the disclosure statement would affect potential legal pitfalls in a franchisor-franchisee relationship

Witzman, Scott Hadley, M.S.
University of Nevada, Las Vegas, 1992
AN ASSESSMENT TO DETERMINE HOW A FRANCHISEE'S THOROUGH UNDERSTANDING OF THE DISCLOSURE STATEMENT WOULD AFFECT POTENTIAL LEGAL PITFALLS IN A FRANCHISOR–FRANCHISEE RELATIONSHIP

by

Scott Witzman

A thesis submitted in partial fulfillment of the requirements for the degree of

Master of Science in Hotel Administration

William F. Harrah College of Hotel Administration University of Nevada, Las Vegas July, 1992
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July, 1992
THESIS ABSTRACT

An analysis of a hotel franchisee’s thorough understanding of the franchisor’s disclosure statement was conducted with franchisee participants from four major hotel chains in Southern California and Las Vegas. An assessment of these results was used to determine if there were correlations between the franchisee’s perceived clarity of the document and the number of legal problems subsequently encountered. The results from this paper will give prospective hotel franchisees guidelines to follow that will help them make more informed and intelligent franchise purchase decisions.
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INTRODUCTION

Selecting the right franchise opportunity may be the most important step taken by a prospective hotel franchisee in quest of a successful business relationship. Often, franchisees build in certain high expectations into the proposed business relationship without a complete understanding of that for which they are bargaining.

Also, franchisors, at times, have been known to present a picture of the business that is less than realistic. It follows then, that a wise prospective franchisee would carefully investigate all hotel franchise possibilities, as well as obligations, before signing on.

In 1979, the Federal Trade Commission promulgated rules relating to disclosure requirements and prohibitions concerning franchising and business opportunity ventures. According to the Federal Trade Commission, the rules were issued in response to widespread evidence of deceptive and unfair practices in connection with the sale of franchises and business opportunities. The intended effect of the rules was to reduce the opportunity for abusive practices by franchisors. The newly enacted rules required the disclosure of facts of the type needed by prospective franchisees in order to make an informed decision regarding entering into a franchise relationship (Hjelmfelt, 1984).

The aforementioned rules resulted in the material terms of the franchise agreement being disclosed in a summary form called the disclosure statement. The disclosure statement consists of 20 varying subjects relating to
the franchisor, the franchise business, and the terms of the franchise agreement.
CHAPTER I: THE PROBLEM AND ITS SETTING

Statement of the Problem

The purpose of this study was to determine whether the typical friction points involved in sustaining a positive hotel franchisor-franchisee relationship could be reduced by a franchisee’s more thorough understanding of the franchisor’s disclosure statement.

Hypothesis

Typical friction points in a hotel franchisor-franchisee relationship could be reduced through a franchisee’s thorough understanding of the franchisor’s disclosure statement.

Purpose and Objectives of the Study

The general purpose of this study was to help prospective hotel franchisees gain a more thorough understanding of a hotel franchisor’s business and contractual obligations, as well as his own, in order to reduce potential legal problems. The objectives of this study were as follows:

1. To identify typical points of conflict arising between hotel franchisors and franchisees that concern items discussed in the franchisor’s disclosure statement.
To determine if a hotel franchisee's thorough understanding of a hotel franchisor's disclosure statement could reduce these typical points of conflict.

**Delimitations of the Study**

Delimitations of the study include the following:

1. The survey was limited to hotel franchisees and hotel franchisor legal counsel.
2. The survey was confined to hotel franchisees with properties in Southern California and Las Vegas.

**Limitations of the Study**

Limitations of the study include the following:

1. The researcher's inability to survey large numbers of hotel franchisees and legal counsel throughout the country.
2. The researcher was limited by financial and time constraints.
3. The researcher was limited by his "assumption" that not all of the franchisees and attorneys interviewed would tell "all" about their respective franchisor-franchisee relationships.
4. The researcher was limited in his research by the lack of empirical studies completed on his topic area (disclosure statements).

**Definition of Terms**

1. Disclosure Statement — In franchising, a statement that includes the financial condition of the franchisor as well as terms of the agreement. The Federal Trade Commission (FTC) requires that the franchisor furnish prospective franchisees with this statement (Sherry, 1984).
2. Earnings Claim Document — Under the FTC Rule format a separate "Earnings Claim Document" must contain all claims about actual or projected sales, revenues or earnings. Earnings disclosures and claims must be relevant to the location where the prospective franchisee anticipates running the franchise (Justis and Judd, 1989).

3. Federal Trade Commission (FTC) — An enforcement agency with broad enforcement powers over federal trade and commerce laws, including such food service areas as food labeling, franchising, and advertising (Sherry, 1984).

4. Franchise — A franchise is a legal agreement in which an owner (franchisor) agrees to grant rights or privileges (license) to someone else (franchisee) to sell the product(s) or services under specific conditions (Khan, 1992).

5. Franchise Advisory Councils — Franchise Advisory Councils, or FACs are generally set up by the franchisor to encourage communication, creativity, ingenuity, and responsiveness from its franchisees. At the same time, FACs are a formalized method of coordinating a relationship between the individual units and the corporate headquarters (Justis and Judd, 1989).

6. Franchisee — The person who has bought into a franchise and has the right to use the products and trade names of the franchisor (Sherry, 1984).

7. Franchisee Associations — Organizations designed to protect franchisees in the franchising system (Meany, 1987).
8. Franchisor — The person or corporate entity that owns trademark product names exclusively, but licenses those rights to others to distribute the products (Sherry, 1984).
CHAPTER II: REVIEW OF RELATED LITERATURE

Introduction

An examination of pertinent literature in franchising was used in this study both to aid the researcher in solving the aforementioned problem statement and to give the reader pertinent background information. A discussion follows concerning the various articles and studies done by other authors who have previously investigated similar subject areas in franchising. A literature review of these former articles and studies includes, but is not limited to such pertinent areas as:

1. A general discussion of the franchising business, including the hotel industry.
5. A discussion of frequently litigated issues between franchisors and franchisees in the hotel industry.
Franchise Overview

Introduction

The term "franchising" may be succinctly defined as a business opportunity by which the owner (producer or distributor) of a service or a trademarked product grants exclusive rights to an individual for the local distribution and/or sale of the service or product, and in return receives a payment or royalty and conformance of quality standards (Justis and Judd, 1989).

Franchising is a unique approach to business with origins traced back through mercantile codes and the common law to the Middle Ages (Justis and Judd, 1989). It is predicted to be the primary method of doing business in the United States by the year 2000 (Justis and Judd, 1989).

Franchising accounted for about 34 percent of all U.S. retail sales in 1990 (Kotite, 1992). Currently there are more then 540,000 franchise businesses in the United States generating more than $758 billion in revenues (IFA Franchise Opportunities Guide, 1992). This represents a 28 percent increase in franchise sales volume from 1987s estimated figures. In addition, the number of franchised outlets has increased by an estimated eight percent over the past five years.

Franchising has become so successful that many franchised businesses have become giants within their respective industries. Hospitality companies such as McDonald's, Holiday Inns and Hertz Rent-A-Car have become distinct leaders.
The basic working relationship of the franchise agreement is set up along simple lines: A franchisor uses the franchisee's community goodwill, financial equity, business location, and personal drive to expand the franchised business. The franchisee uses the franchisor's brand or trademark, proven methods of operation, marketing resources, and technical advice to enter, develop, and maintain consumer demand, and ultimately to succeed as a small business owner/operator within the community. The franchisee is frequently given an opportunity to be part of a "turnkey" operation (site, building, architecture, equipment, work-flow and customer-service plans completely determined and installed by the franchisor), with limited capital and experience, while having a very good chance of becoming successful (Justis and Judd, 1989)

Franchisee business-failure-rates number only about five percent as compared with independent small businesses, who have a failure rate of some 70 percent (Battle, 1986).

**History**

Since the mid-1950s, the public has identified the franchise method of doing business as being associated primarily with food, lodging and other hospitality service industries. However, franchising was first utilized in the United States by the Singer Sewing Machine Company during the 1860s, by General Motors in 1898, and by Rexall Drugs in 1902. Soon afterwards, other companies in the fields of automobile manufacturing, petroleum, soft-drink bottling, auto accessories and a variety of merchandising businesses followed suit.
Since the end of World War II, there has been significant growth, development and adoption of the franchise method of distribution by other industries and companies. This was due to a variety of factors. A prosperous economy and a spiraling population base created an increase in demand for goods and services and an opportunity for entrepreneurs to provide them. The concentration of large business establishments, at the time, further stimulated the evolution of franchising as a form of business organization. Franchising provided the modest, financially-limited company, with a means of rapid entry and broad penetration into the marketplace without the enormous capital and management personnel requirements demanded by traditional expansion through company outlets (Axelrad and Rudnick, 1987).

Hotel Franchising Categories Defined

**Types of Hotel Franchises**

Franchise systems in lodging vary in scope regarding fees, franchisor control and benefits. They can be classified into three basic categories.

The first category is the *true franchise*. A true franchise is characterized by the inclusion of extensive and expensive licensor duties. True franchises usually offer: extensive training and retraining programs; extensive consulting services; detailed specifications for the interior and exterior of the hotel, testing facilities to evaluate furniture, fixtures and equipment before they are specified; purchasing programs to help franchisees buy required products; detailed operating manuals; strong national advertising; substantial help with legal franchising; strong national reservation systems, and regular, sometimes vigorous inspections (Henderson and Schlade, 1987).
Often in true franchise agreements, the franchisor reserves the right to require renovations or new equipment at the franchisee's expense. This right is often exercised since it maximizes system uniformity, and tends to prevent poorer franchisees from hitching a "free-ride" on the goodwill created by franchisees who dutifully maintain their properties. It can be a problem for those hotels not generating enough profits to pay for renovations (Henderson and Schlade, 1987).

The true franchise category can be an excellent choice for the owner/operator with limited business experience, particularly if that individual wants or needs franchisor support in marketing, design, operations, and quality control. It can also be a good choice for a real estate developer who needs a well-known brand name to help him or her sell syndications or to obtain financing to build or acquire a hotel. However, a true franchise could be a poor choice for a person who wants flexibility and complete control in design and operations of his or her hotel business.

At the other end of the spectrum is the second category of franchises, the bare licensee system. With this category, licensees receive little or no training, and are virtually free to operate independently as long as minimum operating standards are met. Quality controls are minimal or non-existent with this system. Participating hotels may have nothing in common except for a service mark or reservation system with limited national advertising (Henderson and Schlade, 1987).

A bare licensee system may be a good choice for someone with an older hotel who does not want to invest large amounts of money on renovations, but seeks the benefits of a national advertising program.
The final franchise category, the quasi-franchise system, falls between the true franchise and the bare licensee systems on the franchise spectrum. The quasi-franchise offers fewer services and less controls than the true franchise and provides lower fees and greater flexibility. Depending on location, target market, and prior experience, the quasi-franchise may prove to be a beneficial balance between costs and license services (Henderson and Schlade, 1987).

The Franchise Selection Process

Selecting the right type of franchised business may be the most important step taken by a prospective franchisee. A poor selection of a franchise may create problems for both the franchisee and franchisor. Currently, because there are no laws requiring a franchisor to grant a franchise, the franchisor has the freedom to choose as a franchisee, whoever would appear to be best for the franchising organization. With this "edge" in mind, it is then up to the prospective franchisee to investigate carefully all franchise possibilities, and then determine where the best opportunity lies before signing on with a franchise. In this way all risks may be identified and the franchisee can move forward with the greatest understanding of the limitations and potential of each franchise option (Justis and Judd, 1989).

Franchisor Qualifications of the Franchisee

No typical profile of a successful franchisee currently exists. Successful franchisees are of all ages and of both sexes. Franchisees are primarily entrepreneurs who have a desire to go into business for themselves. This does not necessarily mean that they will be adaptable to any type of business
or any type of franchise. Entrepreneurs may have enough money to invest but may not be suitable for a particular franchise.

A successful franchise operation may get many more applications from prospective franchisees than are franchises available. Therefore, the franchisor must establish criteria for franchisee selection. Each franchisor has his or her own method of franchisee selection. Typical qualifications considered desirable by franchisors in the hospitality industry, are discussed below.

Franchisee Selection Criteria

It is unrealistic to assume that all of the franchisor qualification factors discussed herein be present in franchisee applicants. However, the following attributes help in determining franchisor expectations, as well as procedures in the selection of franchisees:

Overall Business Experience

Previous business experience of the franchisee is considered a primary selection factor by many franchisors. This experience need not necessarily be in the hotel industry. Since the hotel business involves people, a strong business background with special emphasis on people-handling skills and management is desirable. Experience should preferably be in human resources management such as recruiting, training, supervising, and communicating (Khan, 1992).

Financial Qualifications

Although business experience is the forer. ost qualification, it is not the only one desired in a franchisee. Franchising requires substantial investment
from franchisees, therefore financial qualifications must be carefully assessed. The prospect must be financially able to provide the initial cash investment with additional resources available thereafter, particularly for a possible financial emergency.

Franchisors normally assess the net worth of an individual excluding some personal possessions such as home and car. Many franchisors provide a range of minimum investment capital required since desired amounts of money may vary from location to location.

It is not expected that all finances required should be paid by the franchisee. A financial assessment of the franchisee will indicate an individual’s borrowing capacity. Anywhere from 20 percent to 40 percent of the total cost of a franchise opportunity is typically required to be funded from non-borrowed personal resources.

A franchisee’s financial capability for further development is also assessed early. This is done by the franchisor to ensure that the franchisee’s capital is not spread too thin.

To determine financial status, confidential statements are an integral part of the franchise application. They primarily include listing personal assets, liabilities, and net worth. Additional information desired may include a listing of cash on hand and in the bank, securities, bonds/debentures, notes/accounts/mortgages receivable, loans/notes/accounts payable, stocks and bonds, cash value of life insurance, real estate owned, cash value of equipment or furniture owned, taxes due, business interests, other assets, and other debts and liabilities (Khan, 1992).
Proven Track Record

The track record of previous undertakings and business ventures provides a valuable assessment of the franchisee's capacity for success. However, success in one venture does not necessarily guarantee success in other ventures. It does, however, provide an idea of the entrepreneurial nature of the franchisee. Franchisees with an established record in business have proven to be better franchisees than those who are new in business (Khan, 1992).

An Entrepreneurial Spirit

Franchising demands an entrepreneurial spirit coupled with a strong desire to succeed on the part of all parties involved. It is not only the efficient running of the unit, but also the motivation to succeed that makes a franchisee successful.

Franchisees should possess general business knowledge and know how a business operates. For example, it is important for a successful franchisee to be able to deal with the local community, bargain for choice locations, be an effective communicator, and be aware of the local zoning laws and building codes. A variety of talents is both desirable and essential (Khan, 1992).

Franchise Legal Documents

Franchising is a legal contract between franchisor and franchisee. Therefore all laws pertaining to contractual agreements apply to franchising. Certain specific legal aspects pertain only to franchising, and there is legislation that deals with franchises and the franchisor-franchisee relationship. Specific laws at the federal and state level are directed toward
franchising. The major trade regulation under the jurisdiction of the Federal Trade Commission (FTC) is referred to as the "Franchise Disclosure Rule," to be discussed later in this chapter.

The Disclosure Statement in General

Because of the many frauds and failures of franchisors during the 1950s and 60s, a series of franchise laws were established during the 1970s to insure full disclosure by the franchisor to all prospective franchisees. The Franchise Disclosure Rule, established in 1979, requires franchisors to disclose their operations to prospective franchisees. It is evident that the disclosure rules provide increased knowledge for the perspective franchisees, although not all franchisors adhere to the spirit and letter of the law (Justis, Chang and Haynes, 1991).

The franchise disclosure requirements have been designed to help the franchisor explain the operations to a prospective franchisee. There is a great deal of information which a franchisee should carefully glean from the franchise documents (Justis, Chang and Haynes, 1991).

For example, a prospective franchisee should see that sufficient information is provided about the administrative, financial, and contractual obligations of the franchisor. A prospective franchisee should also have a good knowledge of the operations in which he or she will soon be engaging. The franchisee prospect should read carefully all disclosure documents and review them for their accuracy and content (Justis, Chang and Haynes, 1991).

The franchise disclosure documents have been prepared to help improve the franchisor/franchisee relationship and to prevent conflict. These documents provide a wealth of information for the franchisee, and when
properly utilized, should help provide a better answer to the “franchise or not to franchise” question (Justis, Chang and Haynes, 1991).

The Federal Trade Commission and Franchises

The Federal Trade Commission has established certain trade regulations regarding the franchisor-franchisee agreement. These provisions are set forth in the Federal Trade Regulation Rule entitled “Disclosures, Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures” (the “Rule”) which was declared on December 21, 1978 and became effective on October 21, 1979 (16 CFR SEC. 436).

In general, the Rule addresses the problems of nondisclosure and misrepresentation which arise when prospective franchisees purchase franchises without essential and reliable information about them. To alleviate these problems, the Rule requires franchisors and franchisor brokers to furnish prospective franchisees with information about the franchisor, the franchisor’s business, and the terms of the franchise agreement in a single document: “The Basic Disclosure Document.” Additional information must be supplied if any claims are made regarding the franchisor’s actual or potential earnings in the “Earnings Claim Document.” Copies of the proposed franchise agreement must also be provided. Disclosures must be made at prescribed times before a sale is consummated (16 CFR SEC. 436).

The Rule requires disclosure of important facts, but does not regulate the terms of the agreement between the franchisor and franchisee. It does not require filing with the Federal Trade Commission any documents regarding the sale (16 CFR SEC. 436).
Under section five of the Federal Trade Commission Act, it is an unfair or deceptive practice for any franchisor or franchise broker:

1. To fail to furnish prospective franchisees with the Basic Disclosure Document in the manner and within the time frames established in the Rule;

2. To make any representations about the actual or potential sales, income, or profits of existing or prospective franchises, except in the manner and within the time frames established by the Rule, including dissemination of the Earnings Claim Document;

3. To make any claim or representation (such as in advertising or oral statements by sales persons) which is inconsistent with the information required to be disclosed by the Rule;

4. To fail to furnish prospective franchisees, within the time frames established by the Rule, with copies of the franchisor's standard forms of franchise agreements and copies of the final agreements to be signed by the parties; and

5. To fail to return to prospective franchisees any funds or deposits (such as down payments) identified as refundable in the Basic Disclosure Document.

Violators are subject to civil penalty actions brought by the Commission of up to $10,000 per violation. In addition, the Commission may bring action in federal or state court on behalf of the franchisees (16 CFR SEC. 436).

The Commission also believes that the courts should and will hold that any person injured by a violation of the Rule has a private right of action against the violator under the *Federal Trade Commission Act*. This right is
necessary to protect the members of the franchisee class for which the Rule
was intended to protect (16 CFR SEC. 436).

**Franchise Disclosure Laws and the States**

California was the first state to enact a law regulating the sale of
franchises. *The California Franchise Investment Law* was enacted in 1970 and
became effective January 1, 1971. Several states have enacted similar laws,
using the California law as a model. These laws give state administrators
broad powers to require disclosure of information. Administrators also have
the authority to determine whether a franchisor has demonstrated that
adequate financial arrangements have been made to fulfill his or her
obligations to the franchisee. If the state administrator determines that the
franchisor has insufficient capital sources to meet these obligations, he or she
can require the franchisor to place funds paid to the franchisor by the
franchisee in escrow until such obligations have been performed. The
administrators have the power to stop the sale of a franchise if the franchisor
has failed to comply with the requirements of the disclosure law or if the sale
of the franchise would operate as a fraud of prospective franchisees (Fels,
1976).

Since 1971, 15 states (California, Hawaii, Illinois, Indiana, Maryland,
Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South
Dakota, Virginia, Washington and Wisconsin) have enacted laws regulating
the offer and sale of franchises. With the exception of Michigan and Oregon,
all of these states require the franchisor to register with the appropriate state
administrator prior to the offer and sale of the franchises. The registration
process involves administrative review of the required disclosure
documents. If the administrator is satisfied that adequate and clear disclosure of the required information has been provided, the franchisor may secure registration in that state to offer and sell franchises. The disclosures required under the state laws are similar to those called for by the Rule. While the various states have adopted a disclosure format referred to as a Uniform Franchise Offering Circular, each state may require modification of material disclosed or additional information. The registration is valid for a one year period and must be renewed by an updating of the Offering Circular if offers and sales of franchises will continue to be made in the state (Axelrad and Rudnick, 1987).

**More About the Basic Disclosure Document and the Uniform Franchise Offering Circular**

Under the Federal Trade Commission Rule, franchisors are required to furnish prospective franchisees with the Basic Disclosure Document. This must be done at the first “personal meeting” or the “time for making of disclosures,” whichever occurs first.

The time for making disclosures is defined as ten business days prior to the earlier of (i) the execution by a prospective franchisee of any franchise agreement or any other agreement imposing a binding legal obligation on such prospective franchisees or (ii) the payment by a prospective franchisee, about which the franchisor, franchise broker, or any agent, representative, or employee thereof knows or should know, of any consideration in connection with the sale or proposed sale of a franchise (Jefferies, 1983).

In addition to the Basic Disclosure Document, other papers must be furnished by the franchisor to the prospective franchisee. A copy of the
franchisor's standard franchise agreement, and related documents such as leases and purchase orders, must be supplied by the franchisor at the time the Basic Disclosure Document is furnished. The prospective franchisee must then receive a copy of the complete franchise agreement and any other related agreements that the parties intend to execute five business days prior to the day the agreements are to be executed (Jefferies, 1983).

The Federal Trade Commission requires national compliance with the disclosure laws. Federal Trade Commission Rules do not prohibit states from imposing different or more stringent requirements upon franchisors in those states (Jefferies, 1983).

Several states use a disclosure format known as the Uniform Franchise Offering Circular (UFOC) to assure compliance with their state registration and disclosure requirements. The Federal Trade Commission may allow the UFOC to be used in lieu of the disclosures of the Federal Trade Commission Rules (Jefferies, 1983).

**Uniform Franchise Offering Circular**

Several states permit use of a disclosure format known as the Uniform Franchise Offering Circular (UFOC) to accompany their own state registration or disclosure requirements.

The UFOC format was adopted by the Midwest Securities Commissioners Association on September 2, 1975. The Commission has determined that, in the aggregate, the disclosures required by the UFOC format provide protection to the prospective franchisees which is equal to or greater than that provided by the Rule. Therefore, the Commission permits the use of UFOC in lieu of the disclosure requirements.
There are certain changes and limitations for which the original guidelines should be consulted. Either the Rule or the UFOC disclosure format must be used in its entirety. Franchisors or franchise brokers may not pick and choose questions from each format. The FTC disclosure format is accepted in all fifty states, whereas UFOC format is not accepted in all states. Also, FTC requires disclosure of important facts, and it does not require registration, approval or the filing of any documents with the Federal Trade Commission in connection with the sale of franchises (Khan, 1992).

Contents of the Disclosure Document

The Basic Disclosure Document of the FTC consists of 20 categories of information, whereas the UFOC disclosure format contains 23 categories of information. Khan (1992), describes the categories of information required by the FTC given below, highlighting the differences when compared to the UFOC format:

1. **Identifying information about the franchisor.** This includes the:
   
   (a) official name and address and principal place of business of the franchisor and of the parent firm or holding company of the franchisor (if any);
   
   (b) name under which the franchisor is doing or intends to do business; and
   
   (c) trademarks, trade names, service marks, advertising or other commercial symbols (the marks) which identify the goods, commodities, or services to be offered, sold, or distributed by the
prospective franchises, or under which the prospective franchisee will be operating.

The UFOC requires the disclosure of whether the franchisor is a corporation, a partnership, or some other type of business entity.

2. **Business Experience of Franchisor's Directors and Key Executive Officers.** Disclosures should include the name and relevant business experience of the franchisor's current directors. In addition, disclosures should list those executive officers who will have significant management responsibilities with respect to the marketing and servicing of franchises, franchise training, and franchise servicing. Information for each listed person should include that person's current position, coupled with facts about his or her business experience during the preceding five fiscal years. It should also include the names of past employers and positions or titles held. The UFOC also requires a disclosure of the names and business history of any franchise brokers or sub-franchisors who are affiliated with the franchisor and who will have management responsibility relating to the franchise.

3. **Business Experience of the Franchisor.** This item requires disclosure of the business experience of the franchisor and the franchisor's parent firm (if any), including the length of time that each:
   
   (a) has conducted a business of the type to be operated by the franchisee;

   (b) has offered or sold a franchise for such business;
(c) has conducted a business or offered or sold a franchise in other lines of business, together with a description of such other lines of business.

4. **Litigation History.** The disclosure document requires disclosure of past franchisor litigation, including criminal, civil or administrative proceedings. Franchisors must reveal the:

(a) identity of the court or agency involved in the litigation;
(b) date of conviction, judgment, decision order or ruling;
(c) amount of award or judgment; and
(d) terms of any settlement order or ruling.

Both the FTC Rule and the UFOC require litigation history disclosure. The UFOC requires disclosure for related subfranchisors and franchise brokers as well. The FTC Rule requires a disclosure of litigation history in the United States for the past ten fiscal years.

5. **Bankruptcy History.** Disclosure documents must set forth the franchisor's bankruptcy history during the previous seven fiscal years; while the UFOC requires disclosure of a franchisor's bankruptcy history for the past fifteen fiscal years. The franchisor must disclose, with respect to each bankruptcy proceeding requiring disclosure:

(a) the name of the person(s) or business entity who has filed in bankruptcy, been adjudged bankrupt, or has been reorganized due to insolvency (if other than the franchisor, the identity of such persons should be disclosed, e.g., the chief executive officer);
(b) the court in which the proceeding was held, including the case or docket number, and the nature of the proceeding such as bankruptcy, reorganization, and the like;
(c) the date of adjudication of bankruptcy or confirmation of a plan for reorganization and the date of discharge; and
(d) any other material facts.

6. **Description of Franchise.** The disclosure document must provide a factual description of the franchise being offered for sale. Included within this disclosure must be a:
   (a) general description of the business to be conducted by the franchisee;
   (b) detailed discussion of the "business format" and/or "product line" which the franchisee is purchasing, including goods and/or services to be sold by the franchisee; and
   (c) description of the markets in which the goods and/or services are to be sold by the franchisee (e.g. whether the goods will be marketed to a specific segment of the community such as students, elderly, upper income consumers, and others).

7. **Initial Funds Required to be Paid by a Franchisee.** The franchisor must disclose the nature, amount, payee, and due date of all monies which the franchisee must pay in order to obtain or commence the franchise operation. In those circumstances where such payment is made either to: (i) the franchisor, (ii) an affiliate of the franchisor, or when (iii) the franchisor or affiliate collects the payment on behalf of a third party, such payment procedures must be documented. Such
payments include, but are not limited to, the initial franchise fees, deposits, down payments, prepaid rent, and equipment and inventory purchases. If exact amounts for any one or more categories vary, then a reasonable range of anticipated payments for each of such categories may be substituted.

The disclosure statement must also indicate, for each payment, whether all (or any part thereof) is refundable, and, if so, under what conditions. Although the Rule neither requires nor prohibits refund promises, the Rule requires that refunds must be made when promised. Failure to do so constitutes a violation of the Rule. In addition, franchisors must disclose any non-recurring commitments of funds by franchisees to the franchisor or affiliated persons for securing the franchise.

The Rule recommends that franchisors disclose the nature and approximate amount of other payments that a franchisee would need to make to obtain or commence business. Moreover, the UFOC also requires disclosure of suggested working capital requirements. The UFOC also requires the franchisor to disclose whether identical franchise fees or initial payments are charged for each franchise. In cases where fees are not identical, a statement of the formula or method for determining the amount of the fee must be disclosed. The UFOC also requires the franchisor to disclose how it will use payments it receives.

8. **Recurring Funds Required to be Paid by a Franchisee.** The franchisor must disclose the nature, amount and payee of all payments which a
franchisee must make on a recurring basis while carrying on the franchise business. The franchisor must also note recurring funds required in those circumstances when payments are made to (i) the franchisor, (ii) an affiliate of the franchisor, or when (iii) the franchisor or its affiliate collects the payment on behalf of a third party. Such payments include, but are not limited to, royalty, lease, advertising, training, sign rental fees, and equipment purchases.

Two categories of recurring payments should be listed: those payable on a regular periodic basis, such as royalties, advertising, and inventory purchases (in those circumstances where there are minimum purchase requirements); and those infrequent, anticipated expenses of a major nature, such as the replacement cost of expensive equipment.

The amount of recurring payments should be expressed as an estimated dollar amount. If the amount of payments are dependent on a variable, such as sales volume, then these amounts may be expressed as a percentage of such variable. Where no accurate dollar amount is available, an estimated payment range may be used.

Infrequent anticipated major expenses may be expressed in their present or estimated future cost. The UFOC format requires additional disclosure of whether any recurring or isolated fees are refundable.

9. Affiliated Persons with Whom the Franchisee is Required or Advised To Do Business with by the Franchisor. This disclosure requires a list of persons who are either involved with the franchisor or any of its affiliates, and with whom the franchisee is required or advised to do
business. The franchisor must list those suppliers whom it requires or advises the franchisee to use, regardless of whether the supplier is the sole approved supplier or one of several approved suppliers, whenever such supplier is the franchisor or an affiliate of the franchisor. The supplier must be listed even if its use is recommended rather than required. A brief description of the goods or services supplied by any listed supplier also must be disclosed.

10. **Obligation to Purchase.** This disclosure requires a description of specified items, related to the establishment or operation of the franchise business, which the franchisor requires the franchisee to purchase, lease, or rent. Such items include real estate, services, supplies, products, inventories, signs, fixtures, equipment, and the like. If any listed items must conform to certain franchisor-imposed specifications, such as brand names or product standards, the existence of such specifications must be disclosed. If such specifications make the item substantially more expensive or difficult to obtain, then such fact should be mentioned. The franchisor should indicate the manner in which the franchisor issues and changes specifications, and the business justification for such specification(s). The UFOC format also requires disclosure of the amount of the purchases the franchisor requires the franchisee to make.

The list of required purchases and required suppliers may be contained in a document separate from the Basic Disclosure Document, if this separate document is delivered to the prospective franchisee
along with the Basic Disclosure Document, and if the Basic Disclosure Document notes the existence of such document.

11. Revenue Received by the Franchisor in Consideration of Purchases by a Franchisee. This disclosure involves a description of consideration paid (such as royalties, commissions, and the like) by third parties to the franchisor or any of its affiliates as a result of a franchisee’s purchase from such third parties. Disclosure is limited to such situations in which (a) the supplier (or group of suppliers) is a required or advised source of franchisee purchases and (b) the rebate is received by the franchisor as a result of such purchases by the franchisee. The term “rebate” refers to any revenue or other monetary or non-monetary consideration, including (but not limited to) cash payments in the form of “kickbacks” or commissions. Franchisors must also disclose both the basis for calculating rebates and the amount received by them or their affiliates.

12. Financing Arrangements. This disclosure must include a description of any franchisor assistance in financing the purchase of a franchise. The UFOC format requires more detailed disclosure than the FTC Rule. The UFOC format also requires examples of the legal documents in which the financing arrangements are set forth.

   Disclosure description should include the material terms of financing arrangements offered to the franchisee where such financing is to be made directly by the franchisor or any affiliated person or, indirectly, through third parties who lend money to franchisees as a result of an arrangement with or through the intercession of the
franchisor. Material terms would include items such as the name and address of the lender, the amount to be financed, the terms and annual interest rates, repayment rights, and provisions in the event of default. The franchisor must disclose any rebate such as a finder’s fee received by it, or an affiliate, from a third person arising out of or in consideration of a franchisee’s financing arrangement.

Neither open account financing, payable within 90 days, nor franchise fees, payable without interest over a period of time, need be disclosed.

13. **Restriction of Sales.** The disclosure requires a description of whether the franchisee is:

(a) limited in the type of products or services it may sell;
(b) limited in the customers to whom it may sell;
(c) limited in the geographic area in which it may sell; or
(d) granted territorial protection by the franchisor.

Any of the foregoing limitations or grants may result from specific terms of the franchise agreement or by written or verbal understanding.

The disclosure must describe the specific limitation(s) involved and the franchisor’s reason(s) for imposing such limitation(s). The description of any geographic limitation should include the typical boundaries of such area. If the franchisee is limited to selling goods or services from a particular location, this fact must also be disclosed. The UFOC format requires a statement as to whether sales goals must be achieved to maintain territorial limitations.
14. **Personal Participation Required of the Franchisee in the Operation of the Franchise.** A statement must be included in the document noting the extent to which the franchisor requires the franchisee (or, if the franchisee is a corporation, any person affiliated with the franchisee) to participate personally in the direct operation of the franchise. A brief description of the types of activities which constitute such participation should be included. In the case of a corporation, the statement must indicate whether any specific director or employee thereof must participate personally in the direct operation of the franchise business.

15. **Termination, Cancellation, and Renewal of the Franchise.** With respect to the franchise agreement and any related agreements, this requires a statement disclosing the:

(a) term (if any) of such agreement, and whether such term is or may be affected by any agreement (including leases or subleases);
(b) conditions under which the franchisee may renew or extend;
(c) conditions under which the franchisor may refuse to renew or extend;
(d) conditions under which the franchisee may terminate;
(e) conditions under which the franchisor may terminate;
(f) obligations of the franchisee after termination of the franchise by the franchisor; and the obligations of the franchisee after termination of the franchise by the franchisee and after the expiration of the franchise;
franchisee’s interest upon termination of the franchise, or upon refusal to renew or extend the franchise, whether by the franchisor or by the franchisee;

(h) conditions under which the franchisor may repurchase, whether by right of first refusal or at the option of the franchisor;

(i) conditions under which the franchisee may sell or assign all or any interest in the ownership of the franchise, or of the assets of the franchise business;

(j) conditions under which the franchisor may sell or assign, in whole, or in part, its interest under such agreements;

(k) conditions under which the franchisor may modify the franchise agreement.

(l) the conditions under which the franchisee may modify the franchise agreement.

(m) rights of the franchisee’s heir(s) or personal representative(s) upon the death or incapacity of the franchisee; and

(n) the provisions of any covenant not to compete.

16. Statistical Information Concerning the Number of Franchises and Company-Owned Outlets. This disclosure requires statements as to the total number of operating franchises and company-owned outlets of the franchisor, as well as the number of franchises which the franchisor has terminated, failed to renew, or acquired during the preceding fiscal year. It also requires disclosure of the number of franchises voluntarily terminated or not renewed by the franchisee.
The franchisor may comply by (a) listing the ten franchised outlets nearest the prospective franchisee’s intended location (or all franchise units if fewer than ten); (b) listing all franchisees; or (c) listing all franchisees located in the state where the prospective franchisee will locate its business or where the prospective franchisee lives.

General reasons for franchisee termination such as “failure to comply with quality control standards” or “failure to make sufficient sales” should be provided wherever applicable.

The franchisor is not required to disclose either the name or any other identifying information about a terminated franchisee. The UFOC format requires disclosure of franchises that have been sold but are not yet in operation and an estimate of the number of franchises to be sold during the coming year. While the FTC Rule requires data for the preceding fiscal year, the UFOC format requires data for the preceding three fiscal years.

17. Site Selection. The disclosure required by this section concerns the selection or approval of a site for the proposed franchise outlet and the time frames for such activity, based on the franchisor’s experience in the preceding fiscal year.

18. Training Programs. If the franchisor offers an initial training program or informs the prospective franchisee that it intends to provide such person with initial training, a statement must be included disclosing the:
(a) type and nature of the initial training;
(b) minimum amount, if any, of training that will be provided; and
(c) cost, if any, to be borne by the franchisee for such training.

The type and nature of the training must include a description of the general contents of the initial training program and all elements of such training.

The required disclosure is limited to training the franchisor offers at the beginning of the franchise relationship — that is, from the period after the execution of the franchise agreement through shortly after the actual commencement of the franchise business. The franchisor, at its option, may describe any additional training available to franchisees during the term of the franchise relationship. The UFOC requires detailed disclosure of training aspects, such as the duration, content, cost of training programs, and training experience of the instructors.

19. Public Figure Involvement in the Franchise. If the name of a public figure is used in connection with a recommendation to purchase a franchise, or as a part of the name of the franchise operation, or if the public figure is stated to be involved with managing the franchise, a statement must be included disclosing the:

(a) nature and extent of the public figure's involvement and obligations to the franchisor, including but not limited to the promotional assistance the public figure will provide to the franchisor and to the franchisee;

(b) total investment of the public figure in the franchise operation; and
(c) amount of any fee or fees the franchisee will be obligated to pay for such involvement or assessment provided by the public figure.

The term "public figure" refers to a person whose identity would be known to a substantial portion of the public nationally or within the geographic area in which the franchise is sold, such as a person who has achieved prominence in sports, entertainment, or public affairs. The term does not include non-living or fictionalized characters.

20. **Financial Information Concerning the Franchisor.** Required disclosure includes a balance sheet (statement of financial position) for the franchisor's most recent fiscal year, and an income statement (statement of results of operations) for the most recent three fiscal years. Financial statements prepared and filed with the Securities and Exchange Commission in accordance with SEC Regulation S-X and SEC's Accounting Series Releases may be used. Although audited financial statements are required under certain conditions, unaudited financial statements may be used. Updated information should be provided to prospective franchisees when significant changes occur in the information contained in the financial statements.

As evident, there are similarities in the disclosure document requirement by the FTC Rule and the UFOC. The UFOC format requires detailed disclosure about patents and copyrights that are part of the franchise system. A sample copy of the franchising agreement is required to be attached to the offering circular under the UFOC guidelines, whereas the FTC Rule requires that proposed agreements
accompany the offering circular. All contractual agreements under both formats are required to be delivered to the prospective franchisee at least five business days prior to execution. Under the UFOC guidelines, the last page of each offering circular is a detachable acknowledgement of receipt. The prospective franchisee returns it to the franchisor after signing, as an acknowledgement of the date of receipt of the offering circular.

All of the foregoing information required by the FTC Rule shall be contained in a single disclosure statement or prospectus, which shall not contain any materials or information other than that required. This does not preclude franchisors or franchise brokers from giving other non-deceptive information orally, visually, or in separate literature so long as such information does not contradict the information in the disclosure statement required by the FTC Rule. This disclosure statement shall carry a cover sheet conspicuously showing the name of the franchisor, the date of issuance of the disclosure statement and the notice.

All information contained in the disclosure statement shall be current as of the close of the franchisor's most recent fiscal year. After the close of each fiscal year, the franchisor is given a period not to exceed 90 days to prepare a revised disclosure statement.

A table of contents must be included in the disclosure statement.

The disclosure statement must include a comment which positively or negatively responds to each disclosure item required to be in the disclosure statement.
The disclosure document must be given to a prospective franchisee at the earlier of (1) the prospective franchisee's first personal meeting with the franchisor, or (2) ten business days prior to the execution of a contract or payment of money relating to the franchise relationship. In addition to the document, the franchisee must receive a copy of all agreements which he or she will be asked to sign.

Earnings Claims

The Rule prohibits earnings representation about the actual or potential sales revenue or profits of existing or prospective franchisees unless:

1. Reasonable proof exists to support the accuracy of the claim;
2. The franchisor has in its possession, at the time the claim is made, information sufficient to substantiate the accuracy of the claim;
3. The claim is geographically relevant to the prospective franchisee's proposed location; and
4. An earnings claim disclosure document is given to the prospective franchisee at the same time the other disclosures were given. The earnings claim document must contain six items:
   (a) A cover sheet as specified by the Rule.
   (b) The earnings claim.
   (c) A statement of the basis and assumptions upon which the earnings claim is made.
   (d) Information concerning the number and percentage of outlets that have earned at least the amount set forth in the claim, or a statement of lack of experience, as well as the beginning and ending dates of the time period covered by the claim.
(e) A mandatory caution statement, whose text is set forth in the Rule, concerning the likelihood of duplicating the earnings claim.

(f) A statement that information sufficient to substantiate the accuracy of the claim is available for inspection by the franchisee.

Prospective franchisees must be notified of any material changes in the information contained in the earnings claim prior to becoming a franchisee (Khan, 1992).

Violation of the Franchise Rule

It is an unfair or deceptive act or practice within the meaning of the FTC Act for any franchisor or franchise broker to:

1. fail to furnish prospective franchisees, within the time frames established by the Rule, a disclosure document containing information on the 20 different subjects relating to the franchisor, the franchise business, and the terms of the franchise agreement;

2. make any representations about the actual or potential sales, income or profits of existing or prospective franchises except in the manner set forth in the Rule;

3. make any claim or representation (such as in advertising or oral statements by salespersons) which is inconsistent with the information required to be disclosed by the Rule;

4. fail to furnish prospective franchisees, within the time frames established by the Rule, copies of the franchisor's standard forms of franchise agreements and copies of the final agreements to be signed by the parties; and
5. fail to return to prospective franchisees any funds or deposits (such as downpayments) identified as refundable in the disclosure document. Violators are subject to civil penalty actions brought by the Commission of up to $10,000 per violation (Khan, 1992).

Franchising and the Law

General Guidelines

Individuals may decide to enter the hotel business by obtaining a franchise from an established company willing to use this means of expanding the market for its product or service. A franchise gives a participating franchisee the right to use the trademark of a specific product or service in return for an investment. Such an arrangement gives the participant an advantage over a non-franchised competitor, since the franchisee has the advantage of a known product, plus the advisory services of his or her franchisor (Sherry, 1984).

With a franchise, the participating franchisee remains an independent owner or operator of his or her own business. He or she is primarily responsible to both state and local authorities for complying with all building, health, and sanitary codes. The franchisee is also responsible to his or her patrons for all personal injuries and property damage or losses arising out of negligence or intentional misconduct of its employees, and to federal and state regulatory agencies that enforce antitrust activities (Sherry, 1984).

Essentially, buck-passing stops at the franchisee's front door. A franchisee may not shift his or her responsibilities without the consent of the franchisor, who is under no obligation to take on franchisee burdens. Rather,
most franchise agreements strongly favor the franchisor, making the franchisee responsible for any losses suffered by the franchisor due to his or her own failure to carry out the pertinent legal responsibilities (Sherry, 1984).

Court judgments notwithstanding, the franchising prospect should read the franchising agreement carefully to see whether it contains tying arrangements, and to decide whether he or she would be placed in a less competitive position because of them (Sherry, 1984).

Typical Legal Problems

Franchising relationships are not always harmonious. Porter and Renforth (1978), identified the ten most common legal problems encountered by franchisees. These are listed in Table A-1 on the following page. The most frequently occurring problem concerned the sharing of advertising costs by franchisees, particularly when they believed they had not received their fair share of advertising expenditures. This usually occurred when local franchisees felt their areas had been neglected, or had not received sufficient attention. The research found that franchisees often wish to write into the contract the specific dollar amount of advertising to be utilized in their local areas.

Other frequent difficulties discovered in the study involved franchisee dissatisfaction concerning the evaluation of the minimum performance requirements established by franchisors. Many times franchisees saw these requirements as problem areas created by the franchisor, or they felt that the franchisor did not require all franchisees to adhere to the same standards. Franchisees sometimes disagreed with the site inspection evaluations of the
franchisor, and requested further elaboration by the franchisor on those evaluations (Justis and Judd, 1989).

**TABLE A-1**

**TEN MOST COMMON LEGAL PROBLEMS OF FRANCHISEES**

<table>
<thead>
<tr>
<th>Frequent Problems</th>
<th>Rank*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sharing Advertising Costs</td>
<td>1</td>
</tr>
<tr>
<td>Inspection/Evaluation by Franchisor</td>
<td>2</td>
</tr>
<tr>
<td>Minimum Performance Requirements</td>
<td>3</td>
</tr>
</tbody>
</table>

**Occasional Problems**

<table>
<thead>
<tr>
<th>Frequent Problems</th>
<th>Rank*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty Payments</td>
<td>4</td>
</tr>
<tr>
<td>Fees for Support Services</td>
<td>5</td>
</tr>
<tr>
<td>Territorial Limits</td>
<td>6</td>
</tr>
</tbody>
</table>

**Rare Problems**

<table>
<thead>
<tr>
<th>Frequent Problems</th>
<th>Rank*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Penalties for Violation of Contract</td>
<td>7</td>
</tr>
<tr>
<td>Restrictions on Products or Prices</td>
<td>8</td>
</tr>
<tr>
<td>Employee Conduct/Training</td>
<td>9</td>
</tr>
<tr>
<td>Limits on Competitive Businesses</td>
<td>10</td>
</tr>
</tbody>
</table>

*The ranks were determined by summing the weights assigned (on a point scale of 1 to 5) to each factor by the survey respondents.
Justis and Judd (1989), also cited problems arising over royalty and fee payments. Their study concluded that payments must be clearly understood and outlined in the contract. They urged that special attention should be paid to the definition of gross revenues upon which almost all royalty and fee payments are based. Also, they urged franchisees to check to see if fees are to be charged for support services.

The study also revealed that territorial limits are an occasional source of problems between franchisors and franchisees. These kinds of difficulties are often precluded by an understanding of the definite boundaries and the conditions of first refusal for additional franchises in the territory.

Other problems that have been reported, but have occurred only rarely, included penalties for violation of contract, restrictions on products or prices, employee conduct/training requirements and limits on competitive businesses. One such problem occurred when a franchisee of a large, nationally known fast-food franchise began to offer Jell-O as a regular menu item. He was quickly told by the franchisor that this was inappropriate, because it was not in the the franchising agreement, and was requested to stop serving Jell-O at the restaurant (Justis and Judd, 1989).

A Canadian study, Knight (1984), investigated the similarities and differences between franchisees and independent entrepreneurs with respect to management skills, personal characteristics, financing requirements and the availability of support services. Of particular interest to Knight was the determination of problem areas of the franchise relationship (as perceived by the franchisee). Many of the problem areas or critical issues that were identified were covered in most general franchise contracts. Knight found the
most common legal problems to be lack of support services, fee disputes, advertising policies and purchasing requirements.

Justis and Judd (1989), concluded in their study that most franchisees will never have legal difficulties with their franchisors. They observed that some major differences exist between franchisees who often have legal troubles and those who rarely have such problems. They also concluded that most franchisees who avoid, or experience few, legal difficulties are usually successful, profitable franchisees, willing to follow the format of the franchisors. Franchisees with legal problems are often less successful.

Some identifying characteristics of franchisees with and without legal problems have been identified by Porter and Renforth (1978). They concluded that franchisees who were able to avoid legal problems usually had previous business experience, understood their rights in the franchising agreement, conducted independent market research, and were able to negotiate the terms of their franchising agreements. These are some of the areas identified in Table A-2 on the following page.

As previously noted franchisees with legal problems are often involved in their first business undertaking; do not receive professional legal advice; typically accept franchisors’ projections without independent research, and have problems in other areas of the business.

Often the success of franchisees who can avoid legal problems results from a positive attitude (Justis and Judd, 1989). The prior experience of these franchisees enables them to conduct negotiations with diplomacy and professionalism. They often utilize private attorneys, market research firms, and independent advertising agencies.
<table>
<thead>
<tr>
<th>Franchisees With Problems</th>
<th>Franchisees Without Problems</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(1)</strong> Are involved in their first business undertaking.</td>
<td><strong>(1)</strong> Have previous business experience.</td>
</tr>
<tr>
<td><strong>(2)</strong> Do not have the agreement reviewed by their own lawyers.</td>
<td><strong>(2)</strong> Obtain legal counsel to review the franchising agreement.</td>
</tr>
<tr>
<td><strong>(3)</strong> Accept standard contracts without modification to accommodate individual or local conditions.</td>
<td><strong>(3)</strong> Request modification of standard agreement formats.</td>
</tr>
<tr>
<td><strong>(4)</strong> Generally have problems in other operational areas of the business.</td>
<td><strong>(4)</strong> Have generally successful, profitable businesses.</td>
</tr>
<tr>
<td><strong>(5)</strong> Accept franchisors' estimates without verification.</td>
<td><strong>(5)</strong> Conduct independent market surveys</td>
</tr>
<tr>
<td><strong>(6)</strong> View business as a zero-sum game.</td>
<td><strong>(6)</strong> Expect to resolve occasional, routine legal disagreements in the normal course of business.</td>
</tr>
</tbody>
</table>
Successful franchisees have a cooperative "win-win" relationship with the franchisor. They anticipate difficulties, but expect to resolve occasional disagreements that arise during normal business activities.

To minimize potential problems, Justis and Judd advised franchisees to negotiate the original franchising agreement to accommodate local or special conditions. They also advised franchisees to work to maintain a strong, productive relationship with the franchisor.

**More Friction Points**

Sometimes franchisors get carried away. They try to sell more franchises than the system can handle, to the extent of admitting unqualified franchisees. An overly-ambitious franchisor may not have the time to devote to each franchisee's problems or to maintain quality. If one franchisee is negligent, the entire system can be affected.

Once a franchise agreement is signed, a long-term relationship is begun, and if problem franchisees are allowed into the system, a long-term problem results.

The primary function of the franchisor is to maintain the quality of franchise products and services. Cooperation from both franchisees and franchisors is essential for quality maintenance (Khan, 1992).

Other problems are related to inadequate communication between the franchisor and franchisees. Many friction points can be traced to one's "personal" interpretation of the disclosure statement. Many franchisees feel strongly that the termination and other regulating clauses in the agreement favor franchisors to the disadvantage of franchisees (Khan, 1992).
Allocation and use of expenses as expressed in the disclosure statement may represent a sore point in the franchise relationship. Many franchisees feel they are paying for more benefits than they are receiving. Franchisees may not approve of the advertising and promotion activities of the franchisor. At times the advertising may not have any impact on the area where the franchise is located. In some cases, franchisees do not need any advertising, but they still pay a percentage of their gross sale for such advertising. All of these aspects have an impact on the franchise relationship (Khan, 1992).

The following chapter, Methodology, reveals empirical evidence used in addressing the problem statement and encompasses legal hotpoints and areas of concern by franchisees voiced in their answers to pertinent survey questions regarding their personal franchise relationships.
CHAPTER III: METHODOLOGY

Sampling and Survey Procedures

The data for this study were collected with survey questionnaires and telephone interviews.

Initially, a control group of 122 hotel franchisees was randomly selected. This control group encompassed franchisee participants from four middle to upper-middle class hotel chains.

Questionnaires were mailed exclusively to franchised properties in Southern California and Las Vegas. Fifty usable responses were returned. This represented a 41 percent response rate. Also, four legal counsels representing the aforementioned hotel chains were contacted and interviewed by telephone.

The survey process consisted of two phases. In the first phase, hotel franchisee participants were sent survey questionnaires. The first mailing was sent April 28, 1992. As an inducement to respond, one dollar was sent along with a cover letter and questionnaire to each of the franchisee participants (See page 72 for a copy of the cover letter). A follow-up mailing was sent out on May 19, with no inducements (See page 73 for a copy of the follow-up letter).

The survey instrument used a structured format that consisted of 23 questions. The first 22 questions used a close-ended format. The final question in the survey required an open-ended response (See page 74 for a copy of the
questionnaire). The survey questionnaires were developed by a board of experts from the University of Nevada, Las Vegas.

The survey’s initial question asked participants to identify whether they had read the disclosure statement before signing the franchise contract. The second question asked participants who had read the franchisor’s disclosure statement before signing the contract, to reveal the level of its clarity. Questions 3 through 22 gave participants twenty typical disclosure statement items on which to elaborate, and asked participants to assess their perceived clarity of each item. Finally, question 23 used a 1978 Porter and Renforth study format, to determine the most common legal problems encountered by franchisees. Participants were provided with a list of frequently occurring franchise legal points of conflict and were asked to identify the number of problems they had encountered during the past one, three, and five years with each one.

The second phase of the study consisted of telephone interviews conducted with four legal representatives of hotel chains who had dealt with franchise legal issues. These legal representatives were asked both open- and closed-ended questions. A semi-structured interview format was used. Participants were asked to reveal the most common friction points they had encountered in hotel franchising relationships. Participants were also asked to agree or disagree on the researcher’s stated hypothesis.

Survey questions were pre-tested by Hotel Administration graduate students at the University of Nevada, Las Vegas for clarity and validity during a five-day period from April 13 to April 17, 1992. The students found the survey questions to be both clear and concise. There were no changes made on the survey questions after the pre-test.
Survey questions were formulated and validated through a board of experts. This board was made up of four graduate faculty representatives from the University of Nevada, Las Vegas.

**Data Analysis**

Because of the small sample size (122), the researcher chose to use descriptive statistics, specifically the mean, mode, range, and standard deviation to evaluate the data generated from the survey. The use of descriptive statistics helped the researcher identify the participants’ overall level of understanding of the disclosure statement, and how it related to the number of problems encountered by participating franchisees.

For evaluation purposes, the mean was used as the primary measure of a franchisee's level of understanding of each issue in the disclosure statement. (The author determined that the mean of the sample population was limited as it related to the total population mean.) The individual mean score was used to determine perceived clarity and frequency of disagreement.

The survey used a 5-point Likert scale with 1 = Very Clear, to 5 = Not Clear. The Likert scale was used to rate the participants’ perceived clarity toward each item on the disclosure statement. The scale was also used to determine the frequency of disagreement between franchisee participants with a very clear understanding of the disclosure statement and those with a somewhat unclear understanding. Finally, descriptive statistics were used to determine the frequency of problems encountered by franchisee participants who read their disclosure statement versus those who did not.
In a separate survey, conducted with hotel legal counsel, content analysis was used to determine the most common sources of conflict encountered in a hotel franchise relationship. Legal counsel were asked to agree or disagree as to whether a franchisee's thorough understanding of the disclosure statement would reduce typical points of conflict.
CHAPTER IV: DESCRIPTIVE ANALYSIS OF THE FINDINGS

Results of the Survey

The initial survey was sent to 122 hotel franchisees on Tuesday, April 28, 1992. There were 39 survey responses returned from the first mailing. A follow-up mailing to non-respondents was sent on Tuesday, May 19, 1992. The cut-off date for receipt of the survey responses was set as Tuesday, June 9, 1992. There were 11 survey responses returned from the follow-up mailing. In total, 50 survey responses were returned. The following results represent all pertinent statistical data collected during the aforementioned time period:

1. Did you read your disclosure statement before signing your contract?
   - Yes (39)
   - No (11)

   Of the 50 respondents to the survey, 78 percent stated they had read their disclosure statement, while 22 percent had not.

   Questions 2 through 22 asked the respondents to rate the following statements: 1 = Very Clear to 5 = Unclear.

2. Did you find your disclosure statement to be clear?
   - Mean 2.54
   - Mode 2
   - Range 4
   - Standard deviation 1.0220
The respondents who read the disclosure statement before signing the contract found their document to be somewhat clear. The standard deviation of 1.0220 reveals a high variability among the responses.

3. How clearly did your franchisor disclose information regarding the company name and address, the name under which it is doing business, and the trade names, trade marks or service marks used in connection with the franchise?

   Mean 1.92
   Mode 1
   Range 3
   Standard deviation 0.8998

   The respondents felt they had a clear understanding of the franchisor's disclosure information regarding company name and address, the name under which it is doing business, and the trade names, trade marks or service marks used in connection with the franchise. The standard deviation of 0.8998 represented only a modest variation factor among respondents.

4. In the disclosure statement, how clearly did the franchisor identify the past business experience of the parent company's directors and executive officers?

   Mean 3.18
   Mode 3
   Range 4
   Standard deviation 1.2539
The respondents believed their disclosure document was somewhat clear in identifying the past business experience of the parent company’s directors and executive officers. The standard deviation of 1.2539 reveals considerable variation among the response scores.

5. How clearly did the disclosure statement describe your franchisor’s past business experience?
   - Mean 2.74
   - Mode 2
   - Range 4
   - Standard deviation 1.1173

   The respondents believed their disclosure statement was somewhat clear in describing the franchisor’s past business experience. The standard deviation of 1.1173 shows a high variability factor among the responses.

6. Did the disclosure statement sufficiently cover the litigation history of your parent company?
   - Mean 3.10
   - Mode 2
   - Range 4
   - Standard deviation 1.2936

   The respondents felt the litigation history of the parent company was somewhat clearly discussed in the disclosure statement. The standard deviation of 1.2936 shows a high degree of variability among the replies.
7. Was the bankruptcy history of your parent company clearly discussed in the disclosure statement?
   Mean 3.24
   Mode 5
   Range 4
   Standard deviation 1.4025

   The respondents believed the bankruptcy history of the parent company was somewhat clearly discussed in the disclosure statement. The standard deviation of 1.4025 reveals considerable variation among the response scores.

8. How clearly did the disclosure statement describe your franchisor’s past business experience?
   Mean 2.53
   Mode 2
   Range 4
   Standard deviation 1.1563

   The respondents felt the disclosure statement was moderately clear in discussing the bankruptcy history of the parent company. The standard deviation of 1.1563 represents high variability among the survey replies.

9. How clearly did the franchisor disclose all initial fees you were to pay, including franchise fees, down payments, prepaid rent, equipment, and inventory charges?
   Mean 2.15
   Mode 2
   Range 4
Standard deviation 1.1130

The respondents believed the disclosure document portrayed a moderately clear picture regarding the initial fees to be paid. The standard deviation of 1.1130 represents a high degree of variability among the response scores.

10. Did the disclosure statement clearly cover the recurring funds required to be paid to your franchisor including royalties, leases, advertising, training, sign rental fees, and equipment or inventory purchases?

Mean 2.59
Mode 2
Range 4
Standard deviation 1.1634

The respondents felt the disclosure statement was somewhat clear in covering the recurring funds required to be paid to the franchisor. The standard deviation of 1.1634 reveals a high variability among the responses.

11. Did the disclosure statement clearly identify all affiliated people with whom you are required to do business?

Mean 2.97
Mode 3
Range 4
Standard deviation 1.2189

The respondents believed the disclosure statement was fairly clear in identifying affiliated people with whom they were required to do business. The standard deviation of 1.2189 reveals a high degree of variability among the replies.
12. Did the disclosure statement clearly describe specified items, such as real estate, services, supplies, products, inventories, signs, fixtures, or equipment that you were required to purchase, lease or rent?

   Mean 2.56
   Mode 2
   Range 4
   Standard deviation 1.0207

   The respondents felt the disclosure document was somewhat clear in describing specified items required to be purchased, leased, or rented from the parent company. The standard deviation of 1.0207 shows a high variation among the replies.

13. Did the disclosure statement clearly describe third-party payoffs to your franchisor through required or advised purchases from affiliated suppliers?

   Mean 3.34
   Mode 5
   Range 4
   Standard deviation 1.3809

   The respondents perceived the disclosure statement was moderately clear in describing third-party payoffs to the franchisor. The standard deviation of 1.3809 shows a considerable degree of variation among the response scores.

14. How clearly did the disclosure statement describe the material terms of financing, including such items as the name and address of the lender, the amount to be financed, the terms and annual percentage interest rates, repayment rights, and provisions in the event of default?
Mean 3.29
Mode 5
Range 4
Standard deviation 1.3628

The respondents felt the disclosure document was fairly clear in describing the material terms of financing and its related particulars. The standard deviation of 1.3628 shows a high variation among the response scores.

15. In the disclosure statement, how clearly were you informed of any sales restrictions placed upon the franchisee regarding limitation of goods which may be offered for sale, limitation of customers to whom you may sell, limitation on the geographic area in which you may sell and the granting of territorial protection to you?

Mean 3.24
Mode 2
Range 4
Standard deviation 1.3241

The respondents felt the disclosure statement was moderately clear in providing information regarding sales restrictions and territorial provisions. The standard deviation of 1.3241 reveals a high variation among the replies.

16. Did the disclosure statement clearly explain your duties and obligations to participate in the direct operation of the franchise?

Mean 2.51
Mode 2
Range 4
Standard deviation 1.0972

The respondents perceived the disclosure statement clearly explained the duties and obligations to participate in the direct operation of the franchise. The standard deviation of 1.0972 represents a high variation factor among the response scores.

17. How clearly were terms disclosed to you by your parent company regarding termination, cancellation and renewal of your franchise operation?
   Mean 2
   Mode 2
   Range 4
   Standard deviation 0.7947

   The respondents felt the disclosure statement clearly described the termination, cancellation and renewal policy of the franchise operation. The standard deviation of 0.7947 represented only a modest variation factor among respondents.

18. Did the disclosure statement clearly present a thorough list of current operating franchises and company-owned outlets of your franchisor, and the number of franchises that have been terminated, failed to renew, or were reacquired during the preceding fiscal year?
   Mean 3.21
   Mode 4
   Range 4
   Standard deviation 1.2978

   The respondents believed the disclosure statement was somewhat clear in presenting a thorough list of current operating
franchises and company-owned outlets of the franchisor, and in providing the number of franchises that have been terminated, failed to renew, or were reacquired during the preceding fiscal year. The standard deviation of 1.2978 reveals considerable variation among the response scores.

19. How clear was the disclosure statement regarding the selection and/or approval of a proposed franchise site and the time frames involved for such activities?

   Mean 3.33
   Mode 3
   Range 4
   Standard deviation 1.3443

   The respondents perceived the disclosure statement to be somewhat clear in providing information regarding the selection and/or approval of a proposed franchise site and the time frames involved for such activities. The standard deviation of 1.3443 shows a high degree of variability among the replies.

20. How clear was the disclosure statement concerning the type and nature of the initial training program, the minimum amount of training that would be provided, and the cost of the training to you?

   Mean 2.79
   Mode 2
   Range 4
   Standard deviation 1.1281

   The respondents felt the disclosure document was somewhat clear in describing the type and nature of the initial training program,
the minimum amount of training that would be provided, and the cost of the training to the franchisee. The standard deviation of 1.1281 reveals a high variation among the responses.

21. If a public figure was used in connection with your franchise program, how clearly were you informed as to the nature and extent of the public figure’s involvement, his or her other obligations to the parent company, the total investment of the public figure in the franchise operation, and the fees that you would be obligated to pay for the public figure’s involvement or assistance?

   Mean 3.45
   Mode 5
   Range 4
   Standard deviation 1.3780

   The respondents felt the disclosure document to be somewhat clear in discussing any public figure’s involvement with the franchise operation. The standard deviation of 1.3780 shows a high degree of variability among the response scores.

22. Did the disclosure statement clearly provide pertinent financial information, such as the franchisor’s balance sheet, income statement (statement of results of operation), and a statement of changes in financial position for the three most recent fiscal years?

   Mean 3.08
   Mode 3
   Range 4
   Standard deviation 1.3024
The respondents believed the disclosure statement to be fairly clear in providing pertinent financial information regarding the franchisor. The standard deviation of 1.3024 denotes a considerable variation in the response scores.

The final question of the survey asked the 50 respondents to identify the number and types of legal problems that they had encountered in the past one to five years. Table A-3 on the following page identifies the ten most common areas of friction in a franchisor-franchisee relationship, and the number of problems, individual mean scores and standard deviations for frequency of disagreement encountered by the respondents during the past one, three and five years.
<table>
<thead>
<tr>
<th>ISSUE</th>
<th>No. of Problems</th>
<th>Mean Scores</th>
<th>Standard Deviation</th>
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<tr>
<td>Shared Advertising Costs</td>
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<tr>
<td>1 Year</td>
<td>17</td>
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<td>5 Years</td>
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<td>Royalty Fees</td>
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<td>.62</td>
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<td>5 Years</td>
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<td>1.00</td>
<td>3.2006</td>
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<td>Penalties for Violation of Contract</td>
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<tr>
<td>1 Year</td>
<td>6</td>
<td>.12</td>
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<td>3 Years</td>
<td>9</td>
<td>.20</td>
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<td>5 Years</td>
<td>9</td>
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<tr>
<td>Inspection/Evaluation by Franchisor</td>
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<tr>
<td>1 Year</td>
<td>27</td>
<td>.54</td>
<td>0.9941</td>
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<td>3 Years</td>
<td>55</td>
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<td>5 Years</td>
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### TABLE A-3 CONTINUED

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<td>1 Year</td>
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<td>.46</td>
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<td>3 Years</td>
<td>41</td>
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<td>5 Years</td>
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<td><strong>Restrictions on Products and Prices</strong></td>
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<td></td>
</tr>
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<td>1 Year</td>
<td>8</td>
<td>.16</td>
<td>0.5481</td>
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<td>3 Years</td>
<td>9</td>
<td>.20</td>
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<td>5 Years</td>
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<td><strong>Minimum Performance Requirements</strong></td>
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<tr>
<td>1 Year</td>
<td>8</td>
<td>.16</td>
<td>0.5841</td>
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<td>3 Years</td>
<td>16</td>
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<td>5 Years</td>
<td>16</td>
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<td><strong>Territorial Limits</strong></td>
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<td>1 Year</td>
<td>22</td>
<td>.44</td>
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<td>5 Years</td>
<td>40</td>
<td>.95</td>
<td>1.7384</td>
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<tr>
<td><strong>Employee Conduct/Training</strong></td>
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</tr>
<tr>
<td>1 Year</td>
<td>8</td>
<td>.16</td>
<td>0.6181</td>
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<tr>
<td>3 Years</td>
<td>20</td>
<td>.44</td>
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<tr>
<td>5 Years</td>
<td>28</td>
<td>.67</td>
<td>3.1052</td>
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### TABLE A-3 CONTINUED

<table>
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<tr>
<th>ISSUE</th>
<th>No. of Problems</th>
<th>Mean Scores</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limits on Competitive Businesses</td>
<td>1 Year</td>
<td>15</td>
<td>.30</td>
</tr>
<tr>
<td>3 Years</td>
<td>22</td>
<td>.49</td>
<td>1.1604</td>
</tr>
<tr>
<td>5 Years</td>
<td>26</td>
<td>.62</td>
<td>1.5765</td>
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</table>
 Legal Counsel Interviews

Four hotel legal professionals were interviewed by telephone during a five day period from June 5 to June 9, 1992. Professionals interviewed were chosen from a control group of four middle to upper-middle class hotel chains. Legal counsel were selected from the same companies surveyed.

These individuals were asked two main categories of questions. First, they were asked to identify their legal departments' conception of the five most common areas of friction in a franchise relationship. Second, they were asked to equate whether a franchisee's thorough understanding of the disclosure statement would reduce points of conflict in a franchise relationship.

A consensus of legal counsel surveyed agreed inspection evaluations by the franchisor, fees for support services, royalty payments, territorial limits, and shared advertising costs were the most common areas of friction in a franchise relationship. However, respondents disagreed as to "the most" common point of friction. One respondent felt that inspection/evaluations by the franchisor was his chain's most common friction area, whereas the three other respondents agreed that territorial limits were their organizations' biggest source of conflict.

A second area of questioning in regards to a franchisee's level of understanding of the disclosure statement revealed mixed results. One respondent stated that a thorough understanding of the disclosure statement had no bearing on reducing areas of conflict for his chain. He stressed that his organization's franchisees typically invest from one to two million dollars for
a hotel franchise, and therefore, were more sophisticated than typical franchisees. He indicated that all of his chain's franchisees do their homework before investing and "do have a thorough understanding of the franchise disclosure statement." On the other side of the coin, three respondents agreed that a franchisee's thorough understanding of the disclosure statement would help reduce typical points of conflict.

One respondent pointed out the economy "drives everything." When the economy is good, their chain receives few complaints from franchisees. When the economy is bad, their chain receives many complaints.

Analysis of the Results

Research, using descriptive statistical techniques as a unit of measurement, revealed a strong relationship between a franchisee respondent's level of understanding of the disclosure statement and the number of respondent conflicts encountered in a five-year period. Franchisee respondents with a very clear understanding of the disclosure statement were found to have encountered far fewer average problems per respondent (.20) over a five-year period than did those who had a somewhat unclear understanding of the disclosure statement (.96).

Moreover, the individual mean scores for clarity presented in the survey results section of this study identified 85 percent of the disclosure document survey items as being somewhat clearly understood by franchisee participants. The results also showed that 95 percent of the disclosure statement survey items had standard deviations that exceeded one on a five point scale. This revealed a high degree of variability among a majority of
survey response scores. The findings also suggested there was no strong relationship between the number of problems encountered by franchisee respondents who read their disclosure statement before signing the contract (6.64) and those who did not (5.09) during the past five years.

Other findings showed that such disclosure statement survey items as "public figure involvement" and "third-party payoffs to the franchisor through required or advised purchases" received the lowest clarity ratings (3.45 and 3.34). These survey item responses also showed a high degree of variability.

Finally, the findings revealed that the most prevalent areas of disagreement in a hotel franchise relationship were: inspection evaluation by the franchisor, fees for support services, royalty payments, territorial limits and shared advertising costs. The complete five-year respondent survey rankings are reported in Table A-4 on the following page.
TABLE A-4

SURVEY RESPONDENTS MOST COMMON LEGAL PROBLEMS
FOR THE PAST 5 YEARS

<table>
<thead>
<tr>
<th>AREA</th>
<th>RANK*</th>
<th>PROBLEMS*</th>
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</thead>
<tbody>
<tr>
<td>Inspection/Evaluation by Franchisor</td>
<td>1</td>
<td>68</td>
</tr>
<tr>
<td>Fees for Support Services</td>
<td>2</td>
<td>42</td>
</tr>
<tr>
<td>Royalty Payments</td>
<td>2</td>
<td>42</td>
</tr>
<tr>
<td>Territorial Limits</td>
<td>4</td>
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<tr>
<td>Shared Advertising Costs</td>
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<td>Employee Conduct/Training</td>
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<td>Limits on Competitive Businesses</td>
<td>7</td>
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<tr>
<td>Minimum Performance Requirements</td>
<td>8</td>
<td>16</td>
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<tr>
<td>Penalties for Violation of Contract</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Restrictions on Products or Prices</td>
<td>9</td>
<td>9</td>
</tr>
</tbody>
</table>

* The rankings and number of problems were based on this study's survey results.
CHAPTER V: CONCLUSIONS AND RECOMMENDATIONS
 FOR FURTHER RESEARCH

This study suggests most respondents to the hotel franchisee survey have a somewhat clear understanding of the disclosure statement, with 85 percent of the disclosure document items surveyed being identified "as somewhat clearly understood" by franchisee participants. However, a segment of respondents (17.9 percent) felt disclosure statements were somewhat unclear. These respondents were found to have encountered approximately five times as many problems as those with a very clear understanding of the disclosure statement.

The study also revealed that 75 percent of the hotel legal counsel interviewed agreed with the hypothesis that typical friction points in a hotel franchise relationship could be reduced by a franchisee's thorough understanding of the franchisor's disclosure statement.

The aforementioned results seem to validate an acceptance of this study's hypothesis, however these results should be looked at cautiously until a larger, more complete research sampling has been completed.

Recommendations for Further Research

While this research was conducted with good intentions, some deficiencies in the methodology led to results which were statistically "soft." The conclusions drawn from these results, however, were informative.
However, to bring more validity to this study, future research should encompass the following ideas:

1. The sample size needs to be increased to allow the use of traditional inferential statistical analysis. The survey should also be redesigned to be more accommodating to standard, inferential statistics.

2. A future study on this subject could be undertaken during "prosperous" economic times. The study could compare the number of legal conflicts encountered in a hotel franchise relationship during a poor economic climate with the number of conflicts encountered during a robust economic period. The current study could be used as a basis for research conducted in "poor" economic conditions.

In conclusion, this study has offered some valuable insight into the franchise relationship for those people interested in purchasing a hotel franchise. The research has helped give prospective hotel franchisees a more thorough knowledge of the franchisor’s and franchisee’s business and contractual obligations, thereby paving the way to reduced legal problems. The information garnered from this research should be useful in establishing some guidelines for prospective franchisees to help them make more intelligent, informed franchise purchase decisions.
BIBLIOGRAPHY


APPENDICES
April 28, 1992

Dear Franchisee:

Will you kindly help us with this important University of Nevada, Las Vegas thesis study designed to identify typical points of conflict arising between hotel franchisors and franchisees concerning items discussed in the franchisor's disclosure statement? The questionnaire is being sent to a limited, select group of hotel franchisees throughout Southern California and Las Vegas; so your response is very important to us!

From the survey results, we hope to determine if a hotel franchisee's thorough understanding of a hotel franchisor's disclosure statement could reduce typical points of conflict. Results will be made available to all respondents upon written request.

The questionnaires are to be returned in the enclosed self-addressed envelope. All responses will be held strictly confidential.

Please fill out this form as completely as you can; it should take no more than 10 minutes to complete. It would also be greatly appreciated if you could return your responses within the next week or so.

We realize that your time is valuable, and that the dollar which is enclosed cannot possibly repay you for your kind efforts. But please accept it as an expression of my sincere thanks for your gracious time and assistance. If you have any questions please call me at (702) 792-9590.

Cordially,

Scott Witzman
Graduate Student, College of Hotel Administration

P.S. All requests for the results of this survey should be addressed to:
Scott Witzman, 4185 S. Paradise Road, Apt. #1055, Las Vegas, Nevada 89109
May 19, 1992

Dear Franchisee:

About three weeks ago I wrote to you seeking your response to a questionnaire involved with identifying typical points of conflict arising between hotel franchisors and franchisees. To this date I have not received your completed survey response, so vital to making my thesis study a valid one.

I am writing to you — once again — because of the special significance each questionnaire has to the usefulness of this study.

In the event that your questionnaire has been misplaced, I am enclosing a replacement copy.

Your cooperation is greatly appreciated.

Cordially,

Scott Witzman
Graduate Student, College of Hotel Administration
University of Nevada, Las Vegas
# Questionnaire

Do not write down your name. Please circle the most appropriate response to each question.

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Did you read your disclosure statement before signing your contract? (if No, skip to question 23)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Did you find your disclosure statement to be clear?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>3. How clearly did your franchisor disclose information regarding company name and address, the name under which it is doing business, the trade names, trade marks or service marks used in connection with the franchise?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>4. In the disclosure statement, how clearly did the franchisor identify the past business experience of your parent company’s directors and executive officers?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>5. How clearly did the disclosure statement describe your franchisor’s past business experience?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>6. Did the disclosure statement sufficiently cover the litigation history of your parent company?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>7. Was the bankruptcy history of your parent company clearly discussed in the disclosure statement?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>8. How clearly did the disclosure statement describe the franchise operation that you have purchased?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
<tr>
<td>9. How clearly did the franchisor disclose all initial fees you were to pay, including franchise fees, down payments, prepaid rent, equipment, and inventory charges?</td>
<td>1 2 3 4 5</td>
<td></td>
</tr>
</tbody>
</table>
10. Did the disclosure statement clearly cover the recurring funds required to be paid to your franchisor including royalties, leases, advertising, training, sign rental fees, and equipment or inventory purchases?

11. Did the disclosure statement clearly identify all affiliated people with whom you are required to do business?

12. Did the disclosure statement clearly describe specified items, such as real estate, services, supplies, products, inventories, signs, fixtures, or equipment that you were required to purchase, lease or rent?

13. Did the disclosure statement clearly describe third-party payoffs to your franchisor through required or advised purchases from affiliated suppliers?

14. How clearly did the disclosure statement describe the material terms of financing, including such items as the name and address of the lender, the amount to be financed, the terms and annual percentage interest rates, repayment rights, and provisions in the event of default?

15. In the disclosure statement, how clearly were you informed of any sales restrictions placed upon the franchisee regarding limitation of goods which may be offered for sale, limitation of customers to whom you may sell, limitation on the geographic area in which you may sell and the granting of territorial protection to you?

16. Did the disclosure statement clearly explain your duties and obligations to participate in the direct operation of the franchise?

<table>
<thead>
<tr>
<th></th>
<th>Very Clear</th>
<th>Clear</th>
<th>Somewhat Clear</th>
<th>Somewhat Unclear</th>
<th>Unclear</th>
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<tbody>
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</tbody>
</table>
17. How clearly were terms disclosed to you by your parent company regarding termination, cancellation and renewal of your franchise operation?

18. Did the disclosure statement clearly present a thorough list of current operating franchises and company owned outlets of your franchisor, and the number of franchises that have been terminated, failed to renew, or were reacquired during the preceding fiscal year?

19. How clear was the disclosure statement regarding the selection and/or approval of a proposed franchise site and the time frames involved for such activities?

20. How clear was the disclosure statement concerning the type and nature of the initial training program, the minimum amount of training that would be provided, and the cost of the training to you?

21. If a public figure was used in connection with your franchise program, how clearly were you informed as to the nature and extent of the public figure's involvement and obligations to the parent company, the total investment of the public figure in the franchise operation, and the fees that you would be obligated to pay for the public figure's involvement or assistance?

22. Did the disclosure statement clearly provide pertinent financial information, such as the franchisor's balance sheet, income statement (statement of results of operation), and a statement of changes in financial position for the three most recent fiscal years?
23. Indicate in the blank space the number of problems you have had in the last one to five years regarding the following franchise legal issues:

<table>
<thead>
<tr>
<th>LEGAL PROBLEM AREAS</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
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<tbody>
<tr>
<td>Shared advertising costs</td>
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<td>Royalty payments</td>
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<tr>
<td>Penalties for violation of contract</td>
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<tr>
<td>Inspection/evaluation by franchisor</td>
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<tr>
<td>Fees for support services</td>
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<td>Restrictions on products or prices</td>
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<td>Minimum performance requirements</td>
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<td>Territorial limits</td>
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<tr>
<td>Employee conduct/training</td>
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<tr>
<td>Limits on competitive businesses</td>
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</tbody>
</table>

Please place your completed questionnaire in the enclosed self-addressed envelope.
Thanks again for your help with this important study.
Franchise Legal Issues Mean Scores

[Bar chart showing mean scores for various franchise legal issues, including:
- Shared Advertising Costs
- Royalty Fees
- Penalties for Violation of Contract
- Inspection/Evaluation by Franchisor
- Fees for Support Services
- Restrictions on Products or Prices
- Minimum Performance Requirements
- Territorial Limits
- General Conduct/Training
- Employee Conduct/Training
- Limits of Competitive Business]
Most Common Legal Problems
(for the past 5 years)

- Royalty Payments: 13%
- Fees for Support Services: 13%
- Employee Conduct/Training: 9%
- Penalties for Violation of Contract: 3%
- Shared Costs Advertising: 3%
- Min. Performance Requirements: 5%
- Territorial Limits: 13%
- Inspection/Evaluation by Franchisor: 11%
- Restrictions on Products or Prices: 8%
- Limits on Competitive Businesses: 3%