

Franchising in the Philippines: To Regulate or Not To Regulate?

Claro F. Certeza*

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* '83 LL.B, Ateneo de Manila University School of Law. He is the Senior Partner in the Subido Pagente Certeza Mendoza & Binay Law Offices and teaches Property, Provisional Remedies, and Law on Franchising at the Ateneo de Manila University School of Law. He also served as a member of the Board of Directors of the Philippine Franchise Association (PFA) and continues to be a Member of its Legal Committee. He prepared the Fair Franchising Standards adopted by the PFA to govern the conduct of its members. He also teaches Labor Law at the Lyceum of the Philippines University College of Law. This Article was prepared under a professorial grant by the Nippon Foundation.

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I. INTRODUCTION

Franchising is not something new in the Philippines. When foreign fast food chains began appearing in the 1980s, Filipinos began their fascination with franchising. Soon, home grown entrepreneurs adopted franchising as a method for expanding business. Some even outperformed their foreign counterparts.

Franchising is defined simply as a contractual relationship where the owner of a trademark and proven business system, called the franchisor, grants to another, called the franchisee, the limited right to use the same in consideration of an agreed upon fee.

As competition grew, the need to rapidly expand and penetrate the market became the principal concern of every entrepreneur. Thus, franchising became the desired vehicle for expansion mainly because it does not strain one's financial resources since the franchisee invests in the construction and operation of the outlet. Furthermore, it provides highly motivated managers to operate the business at no cost to the franchisor because the franchisee manages the business to protect and maximize his investment.

With franchising, franchisors have been known to establish 60 branches within the span of one year. It is indeed a powerful economic growth engine.

Surprisingly, while franchising presents a viable solution to our country's economic problems, no franchise-specific regulation has been enacted to promote it. There exists no legal definition of "franchising" in our jurisdiction. Even as other states like Australia, China, Indonesia, Japan, Malaysia, South Korea, Taiwan, and Vietnam have adopted franchise-specific regulations, the Philippines continues to rely on the provisions of general laws to govern the subject.

This Article provides a basic understanding of franchising and an analysis of the need for specific legislation to govern the same. It begins with a discussion of what business format franchising is and the advantages it offers to the franchisor, the franchisee, and the state, and proceeds to discuss the common abuses of franchisors which could diminish the value of franchising as a tool for economic development. It then looks at the provisions of the general law, specifically, the provisions of the Intellectual Property Code¹ and the Civil Code² provisions on Obligations and Contracts,³ to ascertain whether they are sufficient to preserve, if not promote, the merits of franchising as a tool for economic growth. A brief discussion of the types of franchise-specific regulations adopted by other states is also made to show how they regulate franchising within their respective jurisdictions. Along the same vein, the provisions of the Model Franchise Law formulated by the International Institute for the Unification of Private Law (UNIDROIT) is presented as basic material for formulating a franchise-specific regulation. The Article ends with a recommendation that a franchise-specification is indeed necessary and proposes what the contents of the proposed legislation ought to be.

II. HISTORY OF FRANCHISING

The word “franchise” was derived from the Anglo-French word meaning “liberty.” In Middle French, it is “*franchit*,” to free. In Old French, it is “*franc*,” signifying free. The French term “*francis*” means granting rights or power to a peasant or serf. The English term “enfranchise” is defined as empowering those who have no rights. The term “Royal Tithes” is the predecessor of royalties, and originated as the practice of certain English men (referred to as “freemen”) receiving a percentage of the land fees paid by serfs to nobility.⁴

During the Middle Ages, local governments granted high church officials and other parsonages a license to maintain civil order and to assess taxes. Medieval courts or lords granted others the right to operate ferries, hold markets, and perform professional business activities. The licensee paid a

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1. An Act Prescribing the Intellectual Property Code and Establishing the Intellectual Property Office, Providing for its Powers and Functions, and for Other Purposes [INTELLECTUAL PROPERTY CODE OF THE PHILIPPINES], Republic Act No. 8293 (1998).
 2. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386 (1950).
 3. CIVIL CODE, arts. 1156-1422.
 4. ROBERT L. PURVIN, JR., THE FRANCHISE FRAUD 40 (1994).

royalty to the powers that be in exchange for, among other things, protection. This was equivalent to a monopoly on commercial ventures. The practice was perpetuated throughout the Middle Ages, and eventually became part of European common law.⁵ During the Colonial Period, European monarchs bestowed franchises on daring entrepreneurs who agreed to establish colonies and gain the protection of the Crown in exchange for taxes and royalties.⁶

In 19th century England and Germany, pub proprietors with financial difficulties became exclusive distributors of beer purchased from specific brewers. The breweries did not exercise any day-to-day control over the pubs.⁷

The first franchise in Australia under royal privilege was granted by Governor Macquarie in 1809. The franchisee was granted the right to import 45,000 gallons of rum over three years in exchange for building the Sydney Hospital (the so-called “Rum Hospital”).⁸

In the United States (U.S.) during the mid-1800s, trademark/product franchising developed when the Singer Sewing Machine Company formed a franchise in 1851. Due to the lack of necessary capital and the incipient stage of the sewing industry, Singer had difficulty in marketing sewing machines, and turned to franchising. Singer commissioned agents to sell and repair its line of machines,⁹ as well as educate people on the use of this new technology.

At the close of the 19th Century, soft drink manufacturers turned to franchising because it was too expensive to ship their bottled drinks over long distances. The bottlers identified the drink product with the manufacturer’s trademark and distributed these products within their regional areas.¹⁰

5. Franchise Classroom, History of Franchising, *available at* http://www.bus.lsu.edu/ei/FranchiseClass/pages/ForBook/ChapterOne/ChapterOne_Page3.html (last accessed Sep. 9, 2009).

6. PURVIN, JR., *supra* note 4, at 43.

7. Franchise Classroom, *supra* note 5.

8. The Hawkesbury Historical Society, Sydney’s First Permanent Hospital Known as “The Rum Hospital,” *available at* http://www.hawkesburyhistory.org.au/articles/rum_hospital.html (last accessed Sep. 9, 2009).

9. PURVIN, JR., *supra* note 4, at 37.

10. ONTARIO BAR ASSOCIATION, FRANCHISING 101 I (2003).

Business format franchising began in the U.S. in the late 1940s and early 1950s when, for the first time, franchising was applied as a distinct way of starting a new business as opposed to merely a method of distributing and existing product. From only a few franchisors in 1946, there were over 700 by 1960. During that period many businesses which have since become household names were established, such as McDonald's, Holiday Inn, and Budget Rent-a-Car.¹¹

The growth of franchising over the past 30 years has been nothing but phenomenal. Arthur Andersen surveyed the franchise associations of 39 countries around the world and found that growth potential for franchising worldwide was exponential.¹²

The experience of the U.S. with business format franchising is illustrative of its potential as an economic growth engine. Between the period of 1980-1986, sales of products and franchises grew by \$198 billion that by the end of the last year, the U.S. Department of Commerce calculated that retail sales from franchised establishments comprised 34% of all retail sales in the country.¹³ Over the next three years, the franchising industry added over 400,000 new jobs to the U.S. economy; franchising also accounted for 40 times as many new jobs given that Fortune 500 companies added only 10,000.¹⁴ In 1988, with more than 416,000 franchise businesses and roughly seven million employees, estimated sales reached \$543 billion.¹⁵

The impressive data on business format franchising underscores the need to study the subject matter closely in terms of understanding how and why it works. From this understanding, appropriate measures in the public and private sector may then be implemented, so that the benefits witnessed in the history of business format franchising can be replicated in our country.

III. PHILIPPINE FRANCHISING — THE EARLY YEARS

Franchising entered the Philippine business landscape in the early 1980s with the arrival of foreign brands, such as McDonald's. At about the same time,

11. CONRAD LASHLEY & ALISON J. MORRISON, *FRANCHISING HOSPITALITY SERVICES* 23 (2000).

12. FranchiseConsulting.net, *Franchise Statistics*, available at <http://www.franchiseconsulting.net/stats.html> (last accessed Sep. 9, 2009).

13. Mario L. Herman, *A Brief History of Franchising*, available at <http://www.franchise-law.com/PracticeAreas/Brief-History-of-Franchising.asp> (last accessed Sep. 9, 2009).

14. *Id.*

15. *Id.*

local brands like Jollibee adopted franchising as a mode of business expansion. As the Philippine business landscape became dotted with franchised branches of these fast food chains, franchising became the buzzword for entrepreneurs.

Data from the Philippine Franchise Association, a non-stock non-profit corporation formed to organize the growing number of franchise industry players, show that, in 2005, franchising contributed 5.2% or \$5.6 billion to the Philippines' GDP. The sector also generated an estimated 700,000 jobs and more than 100,000 franchise outlets nationwide. From 50 franchise concepts existing in the early 1990s, there are around 1,000 franchises operating today, and the number continues to grow.¹⁶ In fact, franchising as a mode for business expansion is also being used by non-food concepts like salons, laundry shops, auto shops, video rental outlets, ink re-filling stations, shoe repair shops, barbershops, schools, etc. Indeed, its presence in the Philippine business landscape is pervasive, and it contributes significantly to economic growth.

IV. KINDS OF FRANCHISING

Franchising may be divided into two broad categories, commonly known as product franchising and business format franchising.

A. Product Franchising

In a product franchise, the franchisor licenses the franchisee to sell the franchisor's trademarked goods within an exclusive geographic distribution area large enough to assure profitability. The franchisee is usually prohibited from selling outside that area. Franchisees thus have a strong incentive to deal only (or at least primarily) in the franchisor's goods. The franchisor offers only limited assistance and imposes only minor control on the franchisee's business operation, each franchisee being free to adopt its own business style and distribution technique. As a result, the public perceives the franchisee as independent owners/operators, whose only link to the franchisor is the brand name of the goods being distributed.

The main differences between a product franchise and a more traditional distribution arrangement are the greater identification of the franchisee with the trademark, the greater level of support services provided to the franchisee, and the greater concentration of effort on selling the franchisor's products. Automobiles, soft drinks, gasoline, consumer appliances, and other

16. Data of the Philippine Franchise Association made available through Ms. Joanna Tomagan (on file with author).

goods which require a large degree of pre-sale or post-sale service are especially well-suited for distribution by product franchising.¹⁷

B. The Business Format Franchising

In a business format franchise, the franchisor licenses the independent franchisee to sell goods or services identified with the franchisor's trademark. In addition, the franchisee is licensed to use the comprehensive business format, operating system, and marketing plan and strategy which are owned by the franchisor. The franchisor usually provides the franchisee with comprehensive support, including site analysis and selection, leasing and construction services, financing services, fixturing, and stocking the outlet, training, opening assistance and other initial services, quality control and operating standards, volume purchasing and advertising, advice and guidance, and other continuing support in all aspects of operating the business.

In a business format franchise there is an almost complete merging of the business identity of franchisee and franchisor, so that the public perceives each franchised outlet as part of a larger chain of identical outlets, all offering the same high quality goods and services. To assure that this public image is maintained, the franchisor imposes extensive continuing controls on the franchisee's business operation. Thus, business format franchising is characterized by an intimate ongoing business relationship between franchisor and franchisee.¹⁸

Typically, an entrepreneur comes up with a business idea that is aimed to address a specific need of the market. At the same time, he also adopts a unique brand name that he uses to identify the business. Over time, the entrepreneur gains valuable know-how and insights on the business in the critical areas of site selection, store design and construction, operating efficiencies, marketing strategies, inventory management, accounting standards, supply chain management, and human resources development, among others. Additionally, the brand name acquires goodwill as it becomes identified by the public with high quality products and/or service resulting from the know-how acquired by the entrepreneur over the years.

Undeniably, the business know-how (also called the "business format" in franchising parlance) and the trademark or brand name are valuable assets of the business. To a certain degree, they are intellectual property rights which only the owner of the business can exploit.

17. ONTARIO BAR ASSOCIATION, *supra* note 10, at 1-2.

18. *Id.* at 2.

For a neophyte businessman, having access to a proven business format and the goodwill associated with an established trademark can literally spell the difference between success and failure. Without such access, the neophyte businessman has no other recourse but to go through the process of trial and error to ascertain the best way to operate his business. This is not only time consuming but costly as well. There is also a distinct possibility that the neophyte businessman may not survive his costly mistakes. Moreover, a person starting a business from scratch will have to spend substantial expense, effort, and time to build the necessary goodwill to attract customers.

Franchising allows a person to gain access to such proven business format. In a franchise relationship, the owner of the business format and brand name grants to the franchisee the non-exclusive right to use the same, usually in consideration of the payment of a fixed one-time fee, the franchise fee, and a continuing monthly royalty fee.

Aside from the payment of franchise fees and royalties, the franchisor is able to expand his market presence rapidly without being limited by his financial capability, since the franchisee funds the investment in the franchised outlet. The franchisor benefits from the rapid penetration of the market through franchising which, in this day and age, is crucial to the continued success of any business.

Franchising therefore provides a win-win situation. The franchisor is able to rapidly expand his presence in the market, while the franchisee gains a proven business system and established business identity crucial to the success of his business.

This Article will be confined to business format franchising since this is the type that is most pervasive in the Philippines.

V. ADVANTAGES OF FRANCHISING

Franchising has several advantages. For the franchisor, this means access to a medium for fast growth at a minimum level of investment and recruitment of motivated operators. For the franchisee, this means acquiring the rights to own and operate an established business format while getting support usually found in large corporations. Franchisees also enjoy a reduced level of risk compared to other small business start-ups.¹⁹

Business format franchising addresses the important issues that are now confronting both established businesses as well as start-up businesses.

19. LASHLEY & MORRISON, *supra* note 11, at 5.

An established business seeks to continuously grow to achieve the critical mass to enable it to be always competitive. With more branches, an established business commands a better price for its supplies as its requirements are bigger — the benefit of economies of scale. Moreover, the burden of administrative costs (operations management and support, marketing, human resource development, accounting, etc.) is shared across numerous outlets, resulting in a more efficient manner of operation.

The need for growth, however, is usually hampered by limitations on financial and human resources. The rate of expansion of any business is dictated by the availability of financial capital. As financial resources are always limited, it naturally follows that the capacity to expand is likewise limited. But even if a business should have unlimited capital, which is very unlikely, there is still the matter of having qualified and competent managers to operate the business. The reality is, as the business expands, so too should its human resource. If and when the right people are hired, there is the constant need to motivate them so that they become highly productive.

Business format franchising enables the established business operator to transcend these growth inhibitors. For one, in a business format franchise set-up, the established operator does not have to spend his own money to create new branches for the business — it is the franchisee who will do this. And because the franchisee, given his investment, has a personal stake on the business, he is compelled to manage it very well.

A start-up entrepreneur always looks to improving his chances for business success. If possible, he will only invest his money on a sure thing. The business reality is, there is no such thing as a sure thing. Thus, business format franchising allows the start-up entrepreneur to reduce his risk of failure. He is given a proven business model identified with a well-known trademark that enjoys a substantial following. In this sense, business format franchising provides value to both the established entrepreneur and the one who is just about to start a business.

VI. FRANCHISING: AGENT FOR ECONOMIC ACTIVITY AND GROWTH

Business format franchising can be an agent for economic activity and growth for the Philippines. Firstly, by allowing entrepreneurs access to a proven business format and a strong brand, more business opportunities are made available to Filipinos, thus reducing the need to migrate to other countries to achieve financial stability. Secondly, as more independent businesses are opened under a business format arrangement, jobs are created to address the issue of unemployment. Lastly, business format franchising allows Filipino entrepreneurs to access a level of support (research and development, managerial assistance, marketing support, etc.) typically found

only in large chain organizations, thereby making them highly competitive — a prerequisite for success in an era of globalization.

VII. FRANCHISING: EMPOWERMENT OF A STRONG MIDDLE CLASS

Another strength of franchising is its power to provide ordinary people with the ability to do business in a big way with less capital. As earlier shown, in a typical franchise relationship, the franchisee is provided, as part of the franchise package, access to valuable business know-how and the right to be identified with a strong brand. The know-how includes support in the following areas: site selection, store design and construction, marketing strategies, inventory management, supply chain management, and human resources development.

A. Site Selection

Evaluating where to operate is a very complicated matter. As the saying goes, there are three very important matters that impact the success of a business — location, location, and location. The franchisor assists the franchisee in the evaluation of the site taking into consideration factors such as demographics, traffic count, accessibility, etc.

B. Store Design and Construction

Those knowledgeable about business know that store design and construction affects the marketability and profitability of the business. For instance, the layout design of a kitchen can improve work efficiency that will allow one to operate with less people and at the same time increase productivity due to a lesser turnaround time. A standard design layout is usually provided by the franchisor to the franchisee.

C. Marketing Strategies

How many start-up businesses have failed mainly because of the fact that no thought was devoted on how the businesses will be marketed? The most important ingredient for one's marketing success is knowing who the primary customer is.²⁰ Franchisors normally undertake extensive marketing studies to understand the needs of its customers to guide them in the formulation of their marketing plans.

D. Inventory Management

20. Rod Christian, Target Market Analysis: Consumer Focus, *available at* <http://www.mc.maricopa.edu/~rchristian/targetmarket.html> (last accessed Sep. 9, 2009).

Having a high amount of inventory for an extended period of time is usually not good for a business because there are inventory storage, obsolescence, and spoilage costs. However, possessing inadequate inventory is not good either, because the business runs the risk of losing out on potential sales and market share. Inventory management forecasts and strategies, such as a just-in-time inventory system, can help minimize inventory costs because goods are created or received only when needed.²¹ Franchisors provide their franchisees a uniform inventory system to efficiently manage the latter's inventory costs.

E. Supply Chain Management

To function more effectively and efficiently, organizations outsource ownership and management of raw materials and distribution channels to cost-effective entities.²² The overall purpose of supply chain management is "to improve trust and collaboration among supply chain partners, thus improving inventory visibility and velocity."²³ Companies with best-in-class supply chain management practices achieve 10-30% higher on-time delivery performance than average performers, while spending 30-50% less in total supply chain management costs. The savings potential is substantial: it can range from three percent to seven percent of revenue, not to mention the competitive advantage gained.²⁴ Franchisors usually take charge of the supply chain management to ensure that the franchised stores are efficiently and timely supplied with the materials needed to meet customer demand.

F. Human Resources Development

The most valuable resource of business organizations is its people. Without competent, trained, and dedicated people, it would be very difficult to succeed. Not only must there be a match between people and the job, employees must also be properly trained and motivated. Moreover, there

21. ACE ERP, Inventory Management (with Multi-Locations and Transient Management), available at <http://www.web4bharat.com/erp/inventory.php> (last accessed Sep. 16, 2009).

22. Arun Gupta, Effective Supply Chain Management for Improved Productivity, available at <http://www.articlesbase.com/software-articles/effective-supply-chain-management-for-improved-productivity-706129.html> (last accessed Sep. 16, 2009).

23. *Id.*

24. Rick Ludolph, Creating Value Through Supply Chain Management, available at http://www.techexchange.com/thelibrary/creating_value.html (last accessed Sep. 9, 2009).

should be constant feedback given to the employee on how he is doing so that appropriate interventions are made to improve performance. All these require systems and processes which are developed at great effort and expense — something a single unit operator simply cannot afford. As part of the business format franchise package, these systems and processes are developed by the franchisor and made available to franchisees.

It is evident that the foregoing capabilities or expertise are simply beyond the reach of ordinary businessmen. They primarily require the hiring of consultants or professionals competent in the field, which entails expenditure of substantial amounts of cash — an expense only large companies can afford. The huge disparity in access to these vital resources is one reason why big companies dominate our business landscape. This is also one reason why many start-up businesses fail. The failure is not so much because of a lack of effort on the part of the ordinary businessman but because of a lack of critical know-how and support.

Business format franchising provides the necessary business know-how which empowers ordinary entrepreneurs to do business in a big way and in a manner that is at par with large companies or multinationals. It also enables the small entrepreneur to operate as part of a chain of stores and enjoy the operating efficiencies that goes with it. In fine, franchising is a powerful tool for the empowerment of ordinary people by giving them the chance to achieve financial success in a business landscape dominated by large players. This leads to the creation of a strong middle class — a prerequisite to the establishment of a strong and stable nation.

VIII. THE UGLY SIDE: FRANCHISING AS A TOOL FOR ABUSE

Franchising, in a way, requires the franchisee to be dependent upon the franchisor with respect to the operating details of the franchised business and the promotion of the brand. As shown earlier, the franchisor provides the business format and the strong brand identification necessary for the franchisee to enjoy the benefits of operating under a franchise system. This dependence gives the franchisor the opportunity to abuse the relationship in many ways.

The author has observed that some abuses are commonly perpetrated by franchisors in practice, as will be discussed below.

A. Bogus Franchise Packages

Activities of bogus franchisors have become widespread in the recent years. These are entities that normally copy an existing successful business concept, put their registered business name on it then sell the entire business package

as a franchise, even without a proven record. They charge very low franchise fees, sometimes accepting down payments from just anybody. In the end, the unsuspecting franchisee is left on his own.

This abusive practice has reached alarming proportions. Ricardo Cuna, President of the Association of Filipino Franchisers, Inc., warned the public against franchisors who “just get your hard-earned money, then they leave you on your own, *bahala ka na*. They do not have any support in terms of marketing, logistics, personnel training, systems, experience, and infrastructure. They give franchising a bad name.”²⁵

Certainly, one only has to look at the ad sections of newspapers to see one or two advertisements offering a franchise. A typical advertisement requires the payment of a low investment, usually ₱10,000–50,000, and a promise of a quick return of one’s money. Unknown to the unwary investor, however, is that after paying the initial fee, he will never see his franchisor again — there is zero support in terms of seeing the business through. The foregoing anomaly is true not only in our jurisdiction but also in the U.S., where business format franchising started. Prior to the regulation of franchising in the U.S., some of the franchises offered in the 1950s, 1960s, and 1970s were for companies that had never opened a single unit before selling franchises. Some had management that had not experienced going into the business but had experience in other fields such as bankruptcies, litigations, and problems with regulators. Some companies were so fiscally fragile that they required the revenues from franchise sales to meet the payroll or to fund the franchise advertisements that the prospects responded to. There were also stories of franchisors whose furnishings were being repossessed in one room while the prospective franchisee was in the other.²⁶

Given the low investment cost required by bogus franchises, they mostly attract retirees and overseas contract workers. Not having the wherewithal nor the sophistication of established entrepreneurs, these people cannot even undertake the most basic due diligence to evaluate the franchise opportunity. Hence, they are easy targets for pseudo-franchisors who prey on their sincere desire to establish a profitable business.

B. Tie-in Provisions

25. Franchise Group Warns Against Franchise Scams, *available at* <http://www.plantersbank.com.ph/wp-content/uploads/2007/11/smeecom-no6.pdf> (last accessed Sep. 16, 2009).

26. Michael H. Seid, Scam Alert, *available at* <http://www.entrepreneur.com/franchises/franchisezone/howto/article48750.html> (last accessed Sep. 9, 2009).

Tying or a tie-in agreement is common in many transactions. On one hand, the seller vends a product (tying good); on the other hand, a buyer purchases the tying good along with a different product (tied good) as a condition of the transaction.²⁷ The tie-in agreement may be expressed in a contract or implied in the transaction as a “consequence of the manufacturer’s product design or sales decision.”²⁸

Franchisors defend tie-in agreements because it prevents the franchisee from lowering costs by purchasing cheaper inputs from another supplier.²⁹ Using cheaper inputs might lower quality standards to the detriment of the overall brand rather than just the franchisee’s store.³⁰

Initially, tie-in arrangements were considered *per se* illegal. In one U.S. case, it was ruled that tying agreements serve hardly any purpose beyond the suppression of competition.³¹

In the guise of protecting standards, some franchisors use tie-in arrangements as a means of generating income at the expense of their franchisees. A franchisee of a bakeshop interviewed by the author revealed that he was required by his franchisor to purchase all his equipment from the latter. He paid the price for brand new equipment but what he got was a reconditioned one. Another franchisee of a beauty salon was required to purchase all his supplies from his franchisor. To his dismay, he found out that his franchisor’s selling price was even higher than the retail price of the same product in supermarkets and department stores.

Indeed, tie-in arrangements also provide certain beneficial effects. There are efficiency and revenue maximizing reasons for tie-in arrangements that are non-monopolistic in nature. For instance, the combined requirements of a chain of franchise stores enable a franchisee to command lower prices for supplies as a direct consequence of group purchasing. Similarly, from an advertising perspective, being a part of a store chain also allows the franchisee to have access to expensive advertising programs since the cost is shared by other franchisees in the system. Thus, in a 1977 case,³² the U.S. Supreme Court distinguished vertical restraints intended to hinder competition from those that may have redeeming virtues in promoting inter-brand

27. Paul Gift, *The Tie-In Decision*, available at <http://gbr.pepperdine.edu/082/tying.html> (last accessed Sep. 9, 2009).

28. *Id.*

29. *Id.*

30. *Id.*

31. *Standard Oil Company v. United States*, 377 U.S. 293, 305 (1949).

32. *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

competition, by permitting a manufacturer to compete more efficiently, or by assuring the safety and quality of products to consumers.³³ Since franchise agreements generally have such redeeming virtues, the decision was considered a victory for franchise proponents and entrepreneurs. Hence, tie-in provisions are allowed in the U.S. when there is a reasonable basis for it, such as, for instance, to ensure product quality and uniformity within the franchised chain of outlets.

C. False Earnings Claims

Franchise offerings that entice the public to invest in franchise concepts based on earnings and claims that are too good to be true are prevalent. Typical franchise advertisements contain a statement of the required investment and the claim that the same can be recovered in six to 12 months. While some of these claims may prove to be correct, there is no law requiring their substantiation, such that unscrupulous franchisors who overstate their earning claims with impunity just to entice would-be franchisees to invest in the franchised business incur no liability.

A common ploy of pseudo-franchisors is selective releasing of financial data — presenting the highest sales figures of its best performing store and omitting the sales figures of those performing poorly. This misleads a prospective franchisee in calculating the potential sales of the business. Moreover, there is no effort to differentiate sales from profits. Some franchisors provide figures for the gross revenues of their franchisees. These figures, however, do not say anything about the franchisees' actual costs or profits. High overhead, rent, and other expenses must be taken into account because high gross sales revenue on paper may hide losses.³⁴ Hence, the unwary investor is sometimes enthralled by very high gross sales figures without realizing that the more important data on net profit was withheld by the franchisor. In the U.S., the franchise industry is regulated by rules of disclosure and compliance requirements that were first enacted on the national level in 1979. Essentially, much of the motivation for those first stages of disclosure requirements was a desire on the part of Congress to curb abuses that were then considered to be rampant throughout the franchise industry. At that time, the most consistent area of abuse was that of franchise companies giving excessive and overly optimistic claims of potential earnings

33. *Id.* at 65.

34. See generally FEDERAL TRADE COMMISSION & NORTH AMERICAN SECURITIES ASSOCIATION, CONSUMER GUIDE TO BUYING A FRANCHISE (1994).

and profits that could be realized by potential franchisees if they bought that particular franchise opportunity.³⁵

Arguably, the disclosure of earnings claims are important for the proper evaluation of a franchise offering provided they are accurate and have reasonable basis. In the U.S., according to the Federal Trade Commission (FTC),³⁶

an earnings claim must have a reasonable basis to support the accuracy of the claim, the documents to substantiate the claim must be in the franchisor's possession, and the claim must be geographically relevant to the prospective location. The Rule requires, in "immediate conjunction with any earnings claim, the disclosure of the number and percentage of the outlets which the franchisor or broker knows to have made at least the same results as those presented in the claim." Franchisee and company-owned outlets must be reported separately. Finally, all earnings claims must include the following warning in any projection or forecast: these figures are only estimates; there is no assurance you will do as well. If you rely upon our figures, you must accept the risk of not doing as well.³⁷

Sadly, in our jurisdiction, the absence of any regulation requiring the disclosure of accurate earnings claims has allowed pseudo-franchisors to advertise misleading financial figures that lure investors to part with their hard-earned capital only to find out later that the business concept is not as profitable as the franchisor claimed it to be. If left unabated, this practice will definitely destroy the image of franchising in general.

D. Onerous Franchise Provisions

Another common source for potential abuse is the franchise agreement or its precursor, normally called the reservation agreement.

Reservation agreements are resorted to by some franchisors to immediately bind a potential franchisee. In the guise of testing the seriousness of the potential franchisee to acquire the franchise, the latter is made to pay a reservation fee or the entire franchise fee.

In one case, an overseas contract worker was enticed to acquire a franchise for a snack cart in a franchise expo. He was advised that if he signs

35. Carl Jeffers, Earnings Claims — Have We Come Full Circle?, *available at* <http://www.centercourt.com/usa/jeffers1.html> (last accessed Sep. 9, 2009).

36. Code of Federal Regulations, 16 C.F.R. § 436.1 (2009).

37. FisherZucker Law Firm, Earnings Claims, *available at* http://www.franchise-law-firm.com/franchise_sales_reference/franchise_earnings_claims.htm (last accessed Sep. 9, 2009).

the reservation agreement during the expo, the franchise fee of ₱300,000 shall be discounted by 50%. Desirous of taking advantage of the huge discount, he relented and paid ₱100,000 and promised to pay the balance several weeks thereafter. In the heat of the transaction, so to speak, he was not told by the franchisee that aside from the franchise fee, he must also spend for the fabrication of the cart, the rental deposit for the cart space, and the initial inventory for supplies. Consequently, he decided not to proceed. When he tried to refund his money, the franchisor showed him a proviso in the reservation agreement indicating that any fee paid is non-refundable.

Some franchise agreements have very short contract terms, such that the franchisee is not given sufficient time to recover his investment and earn a decent profit. Others stipulate the payment of advertising fee but do not establish guidelines on how it will be used. One franchise manager admitted that they use the advertising fee collected from its franchisees to pay for ad placements promoting the sale of the franchise concept. This is clearly erroneous because the purpose of the advertising fee is the promotion of the franchised business, i.e. to sell the product or service offered by the brand and not the sale of the franchise.

Given the fact that the franchise agreement is presented to the prospective franchisee on a take-it or leave-it basis, abusive franchise provisions, for so long as they are not contrary to law, good customs, or public policy, are most definitely a reality. One who succumbs to signing a franchise agreement containing these obnoxious clauses is left without any legal relief.

*Valles v. Villa*³⁸ is instructive. The Supreme Court warned the litigants:

The law furnishes no protection to the inferior simply because he is inferior any more than it protects the strong because he is strong. The law furnishes protection to both alike to one no more or less than the other. It makes no distinction between the wise and the foolish, the great and the small, the strong and the weak. The foolish may lose all they have to the wise; but that does not mean that the law will give it back to them again. Courts cannot follow one every step of his life and extricate him from bad bargains, protect him from unwise investments, relieve him from one-sided contracts, or annul the effects of foolish acts.³⁹

Considering such doctrine, if a franchisee should agree to a two-year franchise term only to find out that the same is insufficient for him to recoup his investment and make a decent profit, it would be difficult for him to go

38. *Valles v. Villa*, 35 Phil. 769 (1916).

39. *Id.* at 787-88.

to court to compel the franchisor to give him a longer term. The Court will not extricate him from a bad bargain.

IX. DEALING WITH FRANCHISE ABUSES

To curb abusive practices in franchising, states have introduced various legislations to regulate the sale of franchises and the relationship between franchisor and franchisee. Such regulations are either disclosure regulations or relationship regulations. In some instances, they are a combination of both.

A. Disclosure Regulations

In some jurisdictions, specific franchise regulatory measures have been adopted that will enable a prospective franchisee to have access to certain information about the franchisor to allow the former to make an informed decision about the franchise offering. These regulations are commonly referred to as disclosure regulations.

A key to understanding franchise (disclosure) regulations is recognizing that the law does not try to eliminate risk for investors. In keeping with capitalist economic ideals, the law does not seek to prevent businesspersons from making poor business decisions; rather, it seeks to ensure that businesspersons are able to make informed decisions regarding franchise opportunities. If, after learning all the facts about a franchise opportunity, an investor still wants to undertake the risks inherent in opening a franchise, he or she is free to do so.⁴⁰

The UNIDROIT convened a Committee of Government Experts to draft a Model Franchise Disclosure Law (Model Law) to present the same at the disposal of the international committee. The Model Law was intended to serve as an instrument for legislators in drafting laws specifically aimed at franchising. Further, it was envisioned as a blueprint that may be consulted as they deem it appropriate.

The Model Law is a disclosure law. A disclosure law may be considered as a means to create a secure legal environment between all the parties in a franchise arrangement. To that end, the Model Law ensures that the prospective franchisees who intend to invest in franchising receive material information about franchise offerings, thus permitting them to make an informed investment decision. In addition, the Model Law brings security to franchisors in their relationships with franchisees, administrative authorities,

40. Texas Franchise and Dealership Laws, *available at* <http://www.weblocator.com/attorney/tx/law/b26.html#txb260100> (last accessed Sep. 9, 2009).

and courts.⁴¹ It further requires the franchisor to disclose to the prospective franchisee, information prior to the execution of the franchise agreement.⁴²

The data required by disclosure regulations are substantial — and for good reason. It seeks to compel the franchisor to be transparent in dealing with prospective franchisees. To this end, the franchisor must provide the prospective franchisee, before the execution of the franchise agreement or before receiving any consideration for the sale of the franchise, comprehensive information relating to franchisor's qualifications and details about the franchised business so that the prospective franchisee can make an informed decision whether to acquire the franchise or not.

The nature of the information required to be disclosed can be broadly classified into four categories, namely:

- (a) information relating to the personality and business experience of the franchisor;
- (b) information relating to the business format and the marks;
- (c) information relating to the terms and conditions of the franchise; and,
- (d) information relating to the financial requirements and business performance of the franchised concept.

Insofar as the personality and business experience of the franchisor is concerned, the Model Law requires the prior disclosure of the juridical personality of the franchisor and its legal address, as well as the experience of the senior executives who are running the franchised business including data relating to any past or pending litigation involving said executives. These are vital information as far as the prospective franchisee is concerned. It provides him with an idea of who he is dealing with and their competence to operate the franchised business. This effectively bars fly-by-night operators from conveniently omitting their dark secrets concerning past failed ventures or complaints lodged by former franchisees as one of the critical factors affecting the franchised business is the knowledge and wealth of experience of the franchisor.

With regard to information concerning the business format and the marks, the Model Law obliges the franchisor to describe the business being franchised so that the prospective franchisee can understand how the business model works. The franchisor must also provide details concerning its

41. Model Franchise Disclosure Law, UNIDROIT Proceedings and Papers 2002 (Sep. 25, 2002).

42. *Id.* at 5-8. See Appendix A.

trademark, its registration or pending application number, when the registration will expire, and any pending litigation concerning the trademark. Again, these facts are critical because the value of any franchise offering lies in the fact that the franchise business has a proven track record and a powerful brand that attracts recognition by the public. Without a law requiring disclosure of these data, past experiences show that some unscrupulous franchisors have sold franchises whose trademarks were not registered or were currently being contested. In the Philippine jurisdiction, an unregistered trademark does not enjoy any exclusivity whatsoever, and in fact, its use may be proscribed by one who has registered the trademark. Further, the fact that the use of a trademark is being contested by another significantly weakens the power of the mark as a means of drawing patronage. Undeniably, this information is crucial for one who is evaluating the merits of any franchise offering.

The terms and conditions of the franchise are of immense concern to the prospective franchisee. Unfortunately, because franchisors employ very good sales tactics, prospective franchisees have been pressured to sign the franchise agreement without even understanding its terms and conditions. For instance, during exhibits or trade shows, franchisor's sales agents have been known to tell interested would-be franchisees that if they immediately signed up, they would be given as much as 50% discount in the franchise. In this situation, greed overcomes prudence and the prospective franchisee ends up signing a franchise agreement without even understanding its basic terms and conditions.

The Model Law effectively prevents the use of high pressure sales tactics. It requires the disclosure of the terms and conditions of the franchise agreement 14 days before the execution of the franchise agreement or receipt of payment of any fees in connection with the award of the franchise, whichever comes first. The two-week period between the disclosure of the terms of the franchise and the execution of the franchise agreement or the receipt of payment of any fees enables the would-be franchisee to reflect upon the said terms and consult advisors of his choice before making the important commitment to be bound under the agreement.

The last category relates to the financial requirements and business performance of the franchised concept. A typical franchise inquiry involves simply a query on the needed investment and the Return on Investment (ROI). For one who is not well-versed in the intricacies of accounting, blind reliance on the ROI provided by franchisors can be very misleading. ROI is a performance measure for evaluating the efficiency of an investment. It is a popular ratio because of its versatility and simplicity. If an investment does

not have a positive ROI, or other opportunities exist with higher ROI, then the investment should not be undertaken.⁴³

Franchisors normally equate ROI with payback but this is not entirely correct. First, ROI can be presented in such a way that capital expenses are not amortized as cost so that a better rate would result. Thus, in the normal course of things, the cost of purchasing equipment used for the business is reflected as capital expense. But since these deteriorate because of use over a period of time, the cost of repair or replacement must be considered as an additional expense by the franchisee before computing payback. Second, typical ROI computations do not reflect operating capital requirements, i.e. the cost required to pay for salaries and wages, licenses and taxes, inventory cost, etc. Finally, one must remember that ROI computations are based on assumptions. The franchisor looks at the financial performance of his other stores and assumes that the same will happen with respect to a new store to be opened by the franchisee. Store performance, however, varies depending upon such factors as site location, economic or market conditions, and other matters affecting the store's sales and cost.

The disclosure requirement on earnings claims prevents the franchisor from manipulating financial data to misrepresent the earning capacity of the franchise offering. By requiring the clear substantiation of any claim, the would-be franchisee is placed in a position to ascertain whether to rely on the same, to ask for further data, or to altogether disregard the claim.

From a practical standpoint, disclosure regulations would appear to be an effective means for curbing abuses of pseudo-franchisors. In requiring the disclosure of material information relating to the franchise offering before the execution of the franchise agreement or before the payment of any fees, the regulation prevents would-be franchisees from being pressured into entering a franchise relationship without having the opportunity to know more about the business he is investing on. The accuracy of the information is guaranteed by the fact that any misrepresentation in the disclosure document serves as a ground for the franchisee to terminate the franchise agreement and to demand compensation for damages.⁴⁴

43. Return on Investment (ROI) for the Ambulatory Electronic Medical Record, available at http://www.himss.org/content/files/ambulatorydocs/200702_ReturnOnInvestment.pdf (last accessed Sep. 16, 2009). To calculate ROI, the benefit (return) of an investment (gain from investment minus cost of investment) is divided by the cost of the investment; the result is expressed as a percentage or a ratio.

Id.

44. See Model Franchise Disclosure Law, *supra* note 41, at 40-42.

Disclosure regulations do not benefit would-be franchisees only. A legitimate franchisor is similarly protected in the sense that the accuracy of information he furnishes would-be franchisees is preserved in the disclosure statement. The franchisor cannot be held liable for data other than those indicated in the statement. In a way, the franchisor's responsibility for any material information relayed is confined within the four corners of the disclosure document.

B. Relationship Regulations

Relationship regulations are more intrusive as compared to Disclosure Regulations. They are laws which regulate specific terms of the franchise relationship, such as prohibiting franchisors from preventing its franchisees from forming associations with other franchisees, establishing minimum standards before allowing the franchisor to require the franchisee to pay to a marketing fund, and fixing the minimum term for the franchise agreement, among others. Relationship regulations go beyond providing the prospective franchisee with material information concerning the franchise offering to enable him to make an informed decision. These types of regulations attempt to do more — it steps into the relationship between the franchisor and the franchisee and attempts to establish acceptable norms of conduct between the two.

Australia is one state that has adopted Relationship Regulations. Under its Trade Practices (Industry Codes-Franchising) Regulations 1998,⁴⁵ a franchisor must not induce a franchisee not to form an association or not to associate with other franchisees for a lawful purpose. The same law also stipulates that if a franchise agreement provides that a franchisee must pay money to a marketing or other cooperative fund, the franchisor must have the funds audited and make such audit available to franchisees.⁴⁶

In Malaysia, the Franchise Act⁴⁷ regulates the relationship between franchisors and franchisees by, among others, stipulating that the franchise term shall be no less than five years.

To discourage pseudo-franchisors, the Indonesian Franchise Laws⁴⁸ require that a franchisor must own and manage at least one outlet of the concept being franchised.

45. Franchising Code of Conduct, 1998, c. 15 (Austl.).

46. *Id.* c. 17.

47. Franchise Act, 1998, art. 25 (Malay.).

In Korea, the Act on Fairness in Franchise Transactions⁴⁹ mandates the return of the franchise fees paid by the franchisee if false or exaggerated information is provided or if the franchisor unilaterally suspends the franchise agreement.

C. Disclosure Regulations versus Relationship Regulations

Between the two types of franchise regulations, which one is better?

A Study Group organized by the governing council of the UNIDROIT concluded that the experience of states with relationship laws had been negative, whereas experience with disclosure legislation had on the whole been positive.⁵⁰

More in point is the study of an Iowa statute enacted in 1992⁵¹ regulating the franchise relationship. The statute, in part, limits the right of the franchisor to terminate the franchise agreement, requires that franchisors allow the franchisee a right to cure defects, and explicitly restricts waiver and enforcement of contractual choice of law and choice of forum clauses.⁵² The result of the study shows that the enactment of this law “led to a reduction in both the number of franchised units and the total number of chain outlets. That is, the observed increase in the number of franchisor operated establishments was not sufficient to offset the decrease in the number of franchised outlets caused by the franchise regulation.”⁵³

Relationship laws are, by their nature, very intrusive. They impinge on the right of the parties to freely stipulate the terms and conditions of their franchise agreement. In a franchise relationship, the franchisor entrusts to the franchisee the use of franchisor’s trademark and business format on the condition that franchisee will strictly abide by franchisor’s standards to promote uniformity and maintain quality of the products or services offered by the franchised business. It is therefore critical for the franchisor to be able to terminate the franchise at will should the franchisee deviate from

48. Decree of the Minister of Industry and Trade Concerning the Provisions on and the Procedure for the Implementation of Franchised Business Registration, 1997, art. 4. (Indon.).

49. Act on Fairness in Franchise Transactions, 2002, art. 10 (S. Korea).

50. Model Franchise Disclosure Law, *supra* at note 41, at 16.

51. 1992 Iowa Acts, ch. 1134, § 1.

52. *Id.*

53. Jonathan Klick, et al., The Effect of Contract Regulation: The Case of Franchising 6, available at http://www.law.gmu.edu/assets/files/publications/working_papers/07-03.pdf (last accessed Sep. 9, 2009).

established standards as this deviation will prejudice the entire franchise chain of stores. Thus, any restriction on the right to terminate will be unacceptable.

Relationship regulations operate on a “one size fits all” basis. It fails to consider that not all franchises are alike. For instance, a regulation arbitrarily requiring the term of the franchise must not be less than five years ignores the fact that some franchised businesses have shorter payback periods than others. By prescribing a longer franchise term, the franchisor’s right to prescribe the proper period for the exploitation of his intellectual property rights is interfered with.

Be that as it may, not all relationship regulations are bad. However, before any proposed relationship regulation is adopted, care must be taken to ascertain whether they take into account the realities of a business format franchise relationship. Moreover, any intended legislation must balance the right of the franchisor to exploit his intellectual property and the right of the franchisee to earn from his investment.

X. THE CURRENT PHILIPPINE FRANCHISING REGULATORY SCENARIO

A. Lack of a Legal Definition

In Philippine jurisprudence, there is no legal definition of the term “franchise” or what constitutes “franchising” within the context of business format franchising. Even without such definition, however, the fact remains that franchising has become an integral part of the Philippine business landscape. This is evident from the data earlier shown indicating the substantial sales generated from franchising and the number of business concepts being franchised in the Philippines.

The Philippine Franchise Association, a voluntary self-regulating governing body for franchising in the Philippines,⁵⁴ requires its members to comply with certain requirements in connection with the sale of their franchise to ensure “evenhandedness” in the conduct thereof.

The Fair Franchising Standards defines franchising as “[a] business relationship wherein, for a consideration, the franchisor grants to the franchisee a licensed right, subject to agreed upon requirements and restrictions, to conduct business utilizing the business format and trade/

54. See Philippine Franchise Association, *available at* <http://www.philippinefranchiseassociation.com> (last accessed Sep. 9, 2009).

service marks of the franchisor.”⁵⁵ However, this definition is binding only upon members of the association.

In the U.S., an exhaustive legal definition⁵⁶ of franchising is provided in their Code of Federal Regulations describing technically the terms franchise, franchisor, franchisee, their rights and obligations, as well as those franchises exempted or entities excluded from the purview of the statute.

In China, Article 2 of the Measures for the Regulation of Commercial Franchises⁵⁷ defines franchising as:

an arrangement whereby the franchisor, through an agreement with the franchisee, grants the franchisee the right to use business operating resources including trademarks, tradenames, business models, etc., which the franchisor has the right to grant others to use; and the franchisee shall operate under the uniform franchise system and pay franchise fees to the franchisor in accordance with the agreement.⁵⁸

The Franchising Code of Conduct⁵⁹ in Australia defines franchising as an agreement:

- (a) that takes the form, in whole or in part, of any of the following:
 - (i) a written agreement
 - (ii) an oral agreement
 - (iii) an implied agreement; and
- (b) in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and
- (c) under which the operation of the business will be substantially or materially associated with a trademark, advertising, or commercial symbol:

55. PHILIPPINE FRANCHISE ASSOCIATION, FAIR FRANCHISING STANDARDS, FRANCHISE 2007 CONFERENCE HANDBOOK 27 (2007).

56. 16 C.F.R. § 436.2.

57. Measures for the Regulation of Commercial Franchises (promulgated by Min. of Commerce, Dec. 31, 2004, effective Feb. 1, 2005), art. 2, *translated in* CCH Business Franchise Guide, ¶ 7065 (2009) (P.R.C.).

58. *Id.*

59. Franchising Code of Conduct, c. 4 (Austl.).

- (i) owned, used or licensed by the franchisor or an associate of the franchisor; or
- (ii) specified by the franchisor or an associate of the franchisor; and
- (d) under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:
 - (i) an initial capital investment fee; or
 - (ii) a payment for goods or services; or
 - (iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or
 - (iv) a training fee or training school fee.⁶⁰

The absence of a legal definition of what a “franchise” is or what constitutes “franchising” in Philippine jurisprudence is of great significance vis-à-vis the promotion of franchising as a method of business expansion and in the protection of the rights of franchisors and franchisees.

The Civil Code provides that “[t]he contracting parties may establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order, or public policy.”⁶¹ Since there is no law to define “franchising” or the term “franchise,” the parties are left to themselves to establish the parameters of their relationship.

The franchise advantage can only be realized, however, if the franchisor brings into the relationship a proven business format and an established brand and the franchisee agrees to conform to the said format. If these obligations are not provided for in the franchise agreement — as the parties are free to stipulate the parameters of their relationship, there being no law defining what the relationship should be — then said advantage can be lost. The parties may wittingly or unwittingly enter into a franchise relationship without correctly establishing their proper rights and obligations and the franchising advantage may not materialize at all.

A legal definition as exhaustive as that provided in the U.S. Code of Federal Regulations or in the franchise laws of China and Australia definitely clarifies the roles of the parties to a franchise arrangement. They require the franchisor to possess a business format and a registered trademark while the franchisee is required to abide by said format.

60. *Id.*

61. CIVIL CODE, art. 1306.

The importance of law as a source of obligation is highlighted by the legal principle that existing law enters into and forms part of a valid contract without need for the parties expressly making reference thereto.⁶² A contract is understood to incorporate therein the provision or provisions of law specifying the obligations of the parties under the contract.⁶³ Accordingly, a legal definition of the term “franchise” or what constitutes “franchising” indicating the necessary ingredients for successful franchising ensures that said ingredients enter into and form part of the contract whether the same is actually provided for or not by the parties.

B. Intellectual Property Code

While there is no specific legislation relating to franchising, the Intellectual Property Code is applied, albeit indirectly, to franchise relationships.

Chapter IX of the Intellectual Property Code, which deals with Voluntary Licensing of Patents, provides that “[t]o encourage the transfer and dissemination of technology, prevent or control practices and conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition and trade, all technology transfer arrangements shall comply with the provisions of this Chapter.”⁶⁴

The same statute defines technology transfer arrangements as:

contracts or agreements involving the transfer of systematic knowledge for the manufacture of a product, the application of a process, or rendering of a service including management contracts; and the transfer, assignment, or licensing of all forms of intellectual property rights, including licensing of computer software except computer software developed for mass market.⁶⁵

In the same vein, the term “Intellectual Property Rights” is defined as “consisting of Copyright and Related Rights, Trademarks and Service Marks, Geographic Indications, Industrial Designs, Patents, Layout-Designs (Topographies) of Integrated Circuits, and Protection of Undisclosed Information.”⁶⁶

62. *Lakas ng Manggagawang Makabayan (LMM) v. Abiera*, 36 SCRA 437, 442 (1970); *Boman Environmental Development Corporation v. Court of Appeals*, 167 SCRA 540, 547-48 (1988).

63. *Commissioner of Internal Revenue v. United States Lines Company*, 5 SCRA 175, 181 (1962).

64. INTELLECTUAL PROPERTY CODE OF THE PHILIPPINES, § 85.

65. *Id.* § 4.2.

66. *Id.* § 4.1.

Guided by the foregoing definition of technology transfer arrangements as involving the transfer of systematic knowledge and the assignment of all forms of intellectual property rights which includes trademarks and service marks, some quarters conclude that franchise agreements is or at least is a species of technology transfer arrangements. Thus, while a search of the entire length and breadth of the Intellectual Property Code does not yield a single reference to business format franchising, it is asserted that certain provisions of the subject statute apply to franchise agreements to the extent that such agreements are considered technology transfer arrangements by legal definition.

Franchising is best thought of as a contractual arrangement usually in the service industry rather than in the manufacturing industry. It bundles together a wide variety of intellectual property rights. In contrast to licensing, which is thought of as a single right — as for example, a patent — franchising encompasses the right to copy a business. Copying a complete business clearly requires clearance to copy all of the aspects of that business as well as the intellectual property rights associated with the business. Thus, a franchising arrangement may include license components for trademarks (the name of the business), for copyright (the paperwork, business forms, publicity or marketing materials), and for know-how (detailed knowledge and experience of how to run such a business successfully). Additional components, though they tend to occur less frequently in franchising arrangements, can cover the use of the particular designs, or the use of patented methods or process.⁶⁷

In one sense, franchising arrangements can be thought of as a particular sub-category of technology transfer arrangements, albeit one where the technology content may be relatively small in proportion to the entire body of information as to how to run such a business.⁶⁸ Two questions, then, come to mind: (1) should the Intellectual Property Code, particularly its provisions relating to Voluntary Licensing of Patents, apply to business format franchising?; and (2) do said provisions promote franchising and provide substantial protection to the parties to a franchise arrangement?

C. Doubtful Application of the Intellectual Property Code to Franchise Relationships

67. Richard J. Gallafent, *Role of Licensing/Franchising of Intellectual Property Rights and Other Technology Transfer Arrangements in Business Partnerships and Strategic Alliances for Enhancing the Competitiveness of Products and Services of SMEs*, available at http://www.wipo.int/edocs/mdocs/sme/en/wipo_ip_mow_02/wipo_ip_mow_02_10.pdf (last accessed Sep. 9, 2009).

68. *Id.*

The pertinent provisions of the Intellectual Property Code relating to technology transfer arrangements are found in Chapter IX, Part II which covers the Voluntary Licensing of Patents. Definitely, patents and franchising are poles apart. On one hand, a patent is a grant issued by the Philippine Government giving an inventor the right to exclude others from making, using or selling his invention within the Philippines in exchange for his patentable information or disclosure (*quid pro quo*). Under the current statute, the right allows the exclusion of others from importing the invention.⁶⁹ The right to a patent belongs to the inventor, his heirs, or assigns.⁷⁰

Franchising, on the other hand, basically involves the licensing of the business know-how and the trademark or service mark associated with the said know-how. In a typical franchise arrangement, there is no licensing of inventions or patents involved. Therefore, while franchising may be a form of technology transfer arrangement, it is not one that deals with inventions or patents which is what is contemplated in Chapter IX, Part II of the Intellectual Property Code.

As a general rule, the intent of the legislature to be ascertained and thereafter given effect is the intent expressed in the language of the statute.⁷¹ If a statute is clear, plain, and free from ambiguity, it must be given its literal meaning and applied without attempted interpretation.⁷²

As previously pointed out, the provisions of Chapter IX, Part II of the Intellectual Property Code are applicable to franchising because it covers technology transfer arrangements. Franchise agreements are a species of this type of arrangement. What this fails to consider is that Chapter IX, Part II of the Intellectual Property Code on Voluntary Licensing falls under Part II, The Law on Patents.

It is evident from the foregoing that the wording of the statute in question clearly establishes the intent of the Legislature to apply the provisions of Chapter IX to Voluntary Licensing of Patents only and not to franchise agreements. This conclusion is reinforced by the fact that an examination of the entire length and breadth of the law fails to disclose any reference at all to franchising or franchise agreements for that matter.

The elementary rule of statutory construction is that when the words and phrases of a statute are clear and unequivocal, their meaning must be

69. INTELLECTUAL PROPERTY CODE OF THE PHILIPPINES, § 71.1 (a).

70. *Id.* § 28.

71. *Regalado v. Yulo*, 61 Phil. 173, 179 (1935).

72. RUBEN E. AGPALO, STATUTORY CONSTRUCTION 206 (6th ed. 2009).

determined from the language employed and the statute must be taken to mean exactly what it says. Hence, what is not clearly provided in the law cannot be extended to those matters outside its scope.⁷³

Since the words and phrases of the Intellectual Property Code clearly and unequivocally state that the provisions of Chapter IX, Part II apply to voluntary licensing of patents only, it must be taken to mean exactly what it says. Hence, what is not clearly provided in the law, i.e. the applicability to franchise arrangements, cannot be extended as to those matters. Thus, the application of the provisions of Chapter IX, Part II of the Intellectual Property Code is a doubtful proposition.

D. The Intellectual Property Code is not Supportive of Franchising

Even if we concede that the provisions of Chapter IX, Part II of the Intellectual Property Code apply to a franchise relationship, these provisions show that they neither promote franchising as a legitimate means of expanding one's business nor provide adequate protection to would-be franchisees.

To encourage the transfer and dissemination of technology and to prevent or control practices and conditions that may, in particular cases, constitute an abuse of intellectual property rights having an adverse effect on competition and trade,⁷⁴ the Intellectual Property Code prohibits certain clauses from Technology Transfer Arrangements and impliedly from Franchise Agreements.⁷⁵

It is submitted that because of the obvious disconnect between voluntary licensing of patents and business format franchising, certain provisions declared prohibited under Section 87 of the Intellectual Property Code are in fact standard in franchise arrangements.

Section 87.1 prohibits the licensor from requiring the licensee to acquire raw materials from a specific source. In business format franchising, the franchisee is normally required to purchase from the franchisor the proprietary raw materials needed to produce the products of the franchised business. This is to ensure that the uniformity and the product quality standards of the franchisor are maintained at all times.⁷⁶

73. *Id.*

74. INTELLECTUAL PROPERTY CODE OF THE PHILIPPINES, § 85.

75. *Id.* § 87.

76. *Id.* § 87.1.

Section 87.2 states that the licensor cannot reserve the right to fix the sale or resale prices of the products manufactured on the basis of the license. In business format franchising, the franchisor normally prescribes the selling price for the products of the franchised business for the sake of uniformity, and this practice is accepted in the industry.⁷⁷

Section 87.4 states that the licensor cannot prohibit the use of competitive technology in a non-exclusive technology transfer arrangement. In franchising however, the franchisor prohibits the franchisee from adopting different standards and procedures or any other technology for that matter not otherwise set in the Operations Manual. This is necessary in franchising because any departure from operating standards will likely affect uniformity of the products and services. The operation of a franchise system arguably considers uniformity of products and services across all branches as its value offering to its clientele.⁷⁸

Section 87.11 disallows any stipulation which require the technology recipient not to contest the validity of any of the patents of the technology partner. However, in a franchise arrangement, the franchisor requires the franchisee not to contest the validity or ownership of franchisor's trademarks because the premise of the franchise relationship is that the franchisee recognizes that the franchisor owns the trademarks and desires to be associated with goodwill attached to it.⁷⁹

Sections 87.12 and 87.13 disallow any provision that would restrict the research and development activity of the licensee designed to absorb and adapt the transferred technology to local conditions or to initiate research and development programs in connection with new products, processes or equipment.⁸⁰ In franchising, the franchisor provides the operating systems and proven business format to save the franchisee from the perils of developing them himself. Again, this is a basic premise in franchising — the franchisor provides the know-how and the franchisee acknowledges the value of said know-how. Under these circumstances, it is normal for the franchisor to prohibit the franchisee from making any adaptations to the system or from developing new products not developed by the franchisor.

Section 87.14 proscribes any stipulation which would exempt the licensor for liability for non-fulfillment of his responsibilities under the technology transfer arrangement and/or liability arising from third party suits

77. *Id.* § 87.2.

78. *Id.* § 87.4.

79. *Id.* § 87.

80. INTELLECTUAL PROPERTY CODE OF THE PHILIPPINES, §§ 87.12 & 87.13.

brought about by the use of the licensed product or the licensed technology. In franchising, the franchisee operates as an independent contractor. The franchisee is not an employer or partner of the franchisor. A typical franchise agreement ordinarily stipulates that the franchisee shall indemnify the franchisor against any claims arising out of the operation of the franchised business.⁸¹

The Intellectual Property Code also provides that the presence of prohibited clauses renders the technology transfer arrangement, and for that matter the franchise agreements non-enforceable⁸² unless an exemption is obtained under Section 91.⁸³

From the foregoing, it is fairly obvious that the provisions of Chapter IX, Part II of the Intellectual Property Code, if applied to franchising, deter legitimate franchisors from expanding their business through franchising. It imposes an unreasonable burden upon the franchisor to obtain exemption for what are otherwise standard provisions in franchising arrangements lest their agreements with franchisees be declared unenforceable.

E. The Provisions of the Intellectual Property Code do not Provide Adequate Protection to Would-Be Franchisees

The next question to ask is: does the law provide adequate protection to would-be franchisees?

An analysis of the provisions of Chapter IX, Part II of the Intellectual Property Code reveals that the said provisions are in the nature of relationship regulations. These types of regulations attempt to control the stipulations of the parties in their agreements so that one or both is protected. Relationship regulations do not provide adequate protection to would-be franchisees because, firstly, it does not allow would-be franchisees from making an informed decision before entering into a franchise agreement. Be it noted that these regulations seek to control the terms and conditions of the franchise agreement only. Unlike disclosure regulations, they do not require the franchisor to make available to the franchisee material information that would help the latter evaluate the franchise offering before they enter into any franchise agreement.

Secondly, it provides a weak remedy for victims of pseudo-franchisors. While an agreement containing prohibited provisions are considered unenforceable, the reality is that by the time the would-be franchisee has

81. *Id.* § 87.14.

82. *Id.* § 92.

83. *Id.* § 91.

entered into a franchise agreement, he would have already paid the fees demanded by the franchisor and made substantial investment in the business. In other words, the would-be franchisee would have already lost his money, and the law merely provides him with the remedy of suing the franchisor for compensation. Clearly, the damage has already been done.

Lastly, the law does not clearly establish the rights of the franchisor and the franchisee if the franchise agreement is unenforceable for containing prohibited provisions. For instance, under the Civil Code,⁸⁴ unenforceable contracts are subject to ratification. If the franchisee already paid the franchise fee and operated the franchise business, may the unenforceable franchise agreement be considered ratified and therefore enforceable?

Verily, the Intellectual Property Code is inadequate for promoting business format franchising and protecting the parties thereto. It discourages legitimate franchisors from pursuing the expansion of their business through franchising by declaring standard business practices in franchising as prohibited. Worse, it does not prevent pseudo-franchisors from ensnaring would-be franchisees into entering into a franchise agreement by withholding vital information that will enable the latter to properly evaluate the franchise being offered.

F. Application of Civil Code Provisions to Franchising

The Civil Code provides that “obligations arise from law, contracts, quasi-contracts, acts or omissions punished by law, and quasi-delicts.”⁸⁵ Thus, the rights and obligations of the franchisor and the franchisee in a franchise agreement may only arise from any of the enumerated sources. The enumeration of the sources of obligation under the Civil Code is exclusive, which means that there can be no other sources of obligations other than those enumerated in the article.⁸⁶

Whether or not the Intellectual Property Code is considered applicable to franchising, the pertinent Civil Code provisions will still apply as to those matters not foreseen in the former. This is because obligations arising from law shall be regulated by the law which established such obligations, and the Civil Code provides that those obligations not foreseen shall be regulated by the provisions of the said law.⁸⁷

84. CIVIL CODE, art. 1403.

85. *Id.* art. 1157.

86. MELENCIO S. STA. MARIA, JR., OBLIGATIONS AND CONTRACTS 69 (2d ed. 2003) (citing *Sagrado Orden v. Nacoco*, 91 Phil. 503 (1952)).

87. CIVIL CODE, art. 1158.

A perusal of the provisions of the Civil Code reveals that there is no specific provision on franchising. Since the Intellectual Property Code does not cover all aspects of franchise relations, it can be safely assumed that the Civil Code provisions on Obligations and Contracts can be applied to franchise agreements, by default, in matters not foreseen by said law.

Under the Civil Code, for so long as the essential elements of consent, object, and cause, are present, there is a contract.⁸⁸ Once a contract is perfected, it is the law between the parties, and the parties are bound to comply with the terms thereof, in good faith.

Consent is the concurrence of the wills of the offeror and the acceptor as to the thing and the cause which constitute a contract. An offer is a manifestation of a willingness to enter into a bargain so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it.⁸⁹

All things which are not outside the commerce of men may be the object of contracts.⁹⁰

As to the cause of contracts, in onerous contracts, the cause is understood to be, for each contracting party, the prestation or promise of a thing or service by the other.⁹¹ In reciprocal contracts, the obligation or promise of each party is the consideration for that of the other.⁹²

Undoubtedly, in franchise agreements, there exists a valid object and cause. The object of every franchise agreement is the business concept being franchised. It may be the operation of a service or retail establishment like a restaurant, a beauty salon, or a laundry station. For as long as the business is not prohibited by law, it can be the proper object of contracts like franchise agreements.

The cause of franchise agreements as to the franchisor is the promise of the franchisee to pay the required fees, specifically, the stipulated royalty and franchise fees. As to the franchisee, it is the right to use franchisors' know-how and trademarks.

Taking into account current realities in franchise transactions, the existence of a valid object and consideration is hardly an issue. If at all, any

88. *Id.* art. 1318.

89. STA. MARIA, JR., *supra* note 86, at 323.

90. CIVIL CODE, art. 1347.

91. *Id.* art. 1350.

92. *Penaco v. Ruaya*, 110 SCRA 46, 50 (1981).

dispute between the franchisor and the franchisee will probably center on whether or not the franchisee validly gave consent to the franchise agreement.

The law simply provides that where consent of the contracting party is obtained through fraud, the contract is voidable.⁹³ There is fraud in the procurement of consent when through insidious words or machinations of one of the contracting parties, the other is induced to enter into a contract, which, without them, he would not have agreed to.⁹⁴ However, the law also provides that the usual exaggerations in trade, when the other party had an opportunity to know the facts, are not in themselves fraudulent.⁹⁵ Further, the Civil Code provides that a mere expression of an opinion does not signify fraud, unless made by an expert and the other party has relied on the former's special knowledge.⁹⁶ Evidently, as far as the Civil Code is concerned, any intervention made after the contract has been concluded provides the party whose consent was obtained through fraud the right to have the contract declared void.

The inadequacy of the foregoing statutory provisions is best illustrated by the following example:

Mrs. X, a retiree, desires to invest her retirement pay on a business. To enhance her chances for success, she decides to obtain a franchise for a beauty salon. She proceeds to visit a particular branch of the franchised salon and observes that it enjoys a high degree of patronage. She is therefore convinced that it is a good investment. Mrs. X talks to the franchisor of the salon, Mr. Y. She is advised that franchisor will provide training for her staff and a Manual of Operations, that there are roughly 300 franchised outlets operating, and that the typical ROI is three years. Mrs. X is elated and she proceeds to pay the franchise fee of ₱350,000, enters into a Franchise Agreement and the Contract of Lease for the location of the salon, and spends another ₱800,000 to construct and equip the same.

After opening, it turns out that the staff trained by the franchisor is inadequately equipped to provide quality services to the customers. The Manual of Operations proves to be useless since the training of the staff do not jibe with the procedures in the manual. The result is that the franchised business fails to achieve the desired sales volume necessary to make it viable. After meeting other franchisees, Mrs. X discovered that they also have the

93. CIVIL CODE, art. 1330.

94. *Id.* art. 1338.

95. *Id.* art. 1340.

96. *Id.* art. 1341.

same problems. That of the 300 franchisees, 100 have already closed shop due to non-profitability, and that in fact, some of the franchisees have sued the franchisor for breach of contract.

If Mrs. X were to seek relief under the Civil Code, she has the burden of proving that she was induced by the statements of the franchisor, Mr. Y, to enter into the franchise agreement. This can be a very tricky matter because the law itself says that usual exaggerations in trade, when the other party had an opportunity to know the facts, are not in themselves fraudulent. The franchisor in our example can easily put to doubt any imputation of fraud by saying that Mrs. X had opportunity to verify the accuracy of franchisor's statements. But even if Mrs. X is able to prove fraud, the damage has already been done. She has already concluded a franchise agreement, made substantial payments to the franchisor, and likewise invested heavily into the business. She has to litigate to obtain relief which will surely involve substantial time and expense — something she cannot afford.

Taken within the foregoing context, it is clear that the provisions of the Civil Code are insufficient for the purpose of giving ample protection to would-be franchisees. There is nothing in the Civil Code that gives would-be franchisees access to relevant information regarding the franchise for them to make an informed decision prior to entering the franchise agreement. If at all, the Civil Code only provides relief after the fact, i.e. the right to declare the contract void for want of consent due to fraud. But to prove fraud and thus the lack of consent, the Civil Code places the burden upon the would-be franchisee to prove that any information disclosed is not the usual exaggeration in trade and which the would-be franchisee could not independently verify. This is untenable.

As regards protection from onerous or unfair provisions, the Code simply states that the contracting parties may establish such stipulations, clauses, terms and conditions as they may deem convenient, provided they are not contrary to law, morals, good customs, public order, or public policy.⁹⁷ Also, obligations arising from contracts have the force of law between the contracting parties and should be complied with in good faith.⁹⁸

It becomes abundantly clear that in the absence of any franchise-specific legislation, the source of rights and obligations in franchise relationships would be the franchise agreement entered into by the parties. Whatever the parties may agree upon is the law between them for so long as they are not contrary to law, morals, good customs, public order, or public policy.

97. *Id.* art. 1306.

98. *Id.* art. 1159.

The reality, however, is that prospective franchisees have little or no participation at all with respect to the drafting of franchise agreements. Ordinarily, the franchise agreement is prepared by the franchisor through the assistance of counsel and presented to the prospective franchisee on a “take-it or leave-it” basis. In this scenario, the tendency will be to stack the provisions heavily in favor of the franchisor.

Under the foregoing legal set-up, there is little chance that the franchisee will be able to protect himself from onerous provisions imposed by the franchisor. For so long as the stipulations in the franchise agreement are not contrary to law, morals, good customs, public order, or public policy, no matter how one-sided in favor of the franchisor, they are the law between the parties and must be complied with in good faith. Hence, if the franchise agreement should provide for a very short term of one year, this must be followed even if in doing so, the franchisee will not be able to recoup his investment. There is no law which provides otherwise. Prescribing a one year period is neither contrary to morals, good customs, public order or public policy. As far as the Civil Code is concerned, the franchisee in this case entered into a bad bargain and the courts will not extricate the franchisee from a bad bargain.⁹⁹

Clearly, existing Philippine laws are not only opposed to promoting legitimate franchising, it does not protect would-be franchisees from abuses by pseudo-franchisors as well.

XI. THE APPROPRIATE FRANCHISE REGULATION

Before any type of franchise-specific legislation is proposed, the specific role that it will have to play vis-à-vis the franchising industry must be considered.

Simon Lord and David Munn¹⁰⁰ extensively discussed this subject. According to them,

[a]nyone proposing a law to regulate franchising needs first thoroughly to understand the unique concept of full business format franchising. It is a method of doing business, not an industry. Governments around the world are increasingly recognising the importance of this method and the significant growth it brings to economies. We should therefore be careful to protect and enhance franchising, not stifle it.

I say that franchising is not an industry because, as a business model, it transcends particular industries — a lesson some recent advocates for

99. *Valles*, 35 Phil. at 788.

100. Simon Lord & David Munn, *Legislation: Help or Hindrance?*, available at <http://www.franchise.co.nz/article/view/195> (last accessed Sep. 9, 2009).

change are neglecting to understand. A problem in one industry which involves franchising is not necessarily a problem in another industry. It does not necessarily denote a problem with the franchising method itself. In many cases, then, the introduction of law to address such problems should be focused on that industry, rather than on the whole of franchising.

While franchising can achieve “big business” proportions by harnessing and nurturing the entrepreneurial heart of small independent business, it is a big mistake to presume to treat it in law as being of the same nature and power as big business corporate conglomerates. It may look like that, but as a marketing concept it is intended to. However, in the traditional economic and corporate sense, franchising often competes with the traditional big business world by releasing the energy of small business. Good franchising dramatically enhances competition and growth.

The all-important relationship structure of business format franchising, combined with the need for franchisors to manage a network of independent businesses, can make it vulnerable, though. To seek to neutralise the balance of power in business format franchising is to seriously risk damaging some of the very fundamentals that need to exist for the protection of a brand and franchise system. If law is required to address detrimental power imbalance factors in franchise contracts, then great care and definitional precision is required of the law-makers. We need to ensure that we do not introduce “broad brush” law that, far from promoting franchising and growth, actually makes it more difficult for business format franchising to flourish.¹⁰¹

Guided by the foregoing, any franchise-specific legislation, to be effective, must balance the need to protect the franchisee’s investment in the franchise concept with the need to allow the parties to stipulate such terms and conditions that will preserve uniformity and quality standards, the very fundamentals that need to exist for the protection of the brand and franchise system.

Definitely, disclosure regulation is proper under the circumstances to afford protection to the would-be franchisee during the pre-contractual negotiation stage when common abuses are committed by pseudo-franchisors. As such, it prevents any would-be franchisee from investing hard earned money into the franchise concept without first being given the chance to make an informed decision based on relevant data pertaining to the concept which franchisors are required to disclose. Undoubtedly, this is better than just providing post-contractual legal remedies which are only available after the franchisee has already executed the franchise agreement and parted with his investment.

101. *Id.*

The proposed disclosure regulation must require franchisors to divulge relevant matters with respect to the franchise business similar to those enumerated under the Model Law earlier discussed. The disclosure must be made several days prior to the execution of any franchise agreement or the payment of any fees — time sufficient enough for the would-be franchisee to evaluate the disclosed materials. In this manner, the law protects the franchisee's investment and at the same time leaves the parties free to stipulate the terms and conditions of the franchise agreement pursuant to the realities of business format franchising.

This is not to say, however, that there is no room for relationship regulations in the Philippine franchise setting. For sure, there will be some merit in adopting these types of regulations too. Nevertheless, any relationship regulation must take into account the fundamental requirements of business format franchising to ensure that any proposed regulation does not unduly prevent the parties from stipulating provisions that will preserve them.

Accordingly, a relationship regulation similar to a provision in the Franchise Law of Australia¹⁰² mandating that if a franchise agreement provides that a franchisee must pay money to a marketing or other cooperative fund, the franchisor must, within three months after the end of the last financial year, prepare an annual financial statement of the fund's receipts and expenses for the last financial year, is worthy of consideration. It does not ban the collection of contributions to a cooperative fund by franchisees — a regular feature of franchise agreements. In contributing to a common fund, franchisees are able to build up a huge advertising war chest to extensively promote the franchised brand. This is something a single-unit operator has no access to. At the same time, this regulation requires the franchisor to be transparent in handling any contribution to the marketing fund by obligating the franchisor to prepare an annual financial statement indicating the fund's receipts and disbursements. To this extent, the regulation protects the advertising fund from being misused or appropriated for purposes other than that for which they are intended.

Franchising is an ongoing relationship. It is therefore important that there is a method of resolving disputes without destroying the relationship between the parties. Litigation tends to destroy relationships and is very expensive. It is of little consolation to advise a person that they have legal rights when they are washed up financially (if not emotionally) and cannot afford to pursue those rights. Mandatory alternative dispute resolution procedures such as mediation can, in many instances, preserve relationships

102. Franchising Code of Conduct, c. 17 (Austl.).

despite conflict. This too may be the proper subject of a relationship regulation.

Any effective relationship regulation should include mandatory provisions for franchise agreements that would have the effect of ensuring that the vital components for operating a successful franchise business — access to franchisor's know-how, use of the registered brand name, training in standards and procedures, and assistance in site selection, among others — are clearly stipulated as obligations of the franchisor. Similarly, regulations prohibiting certain provisions that are abusive or not conducive to promoting even-handedness between the franchisor and the franchisee will be acceptable. Thus, the proposed law may stipulate that tie-in provisions will be allowed in franchise agreements only if they are reasonably necessary to preserve product quality or uniformity.

The foregoing are some relationship regulations that may be considered as part of any franchise-specific legislation. Coupled with a comprehensive disclosure regulation similar to the Model Law earlier cited, they represent a proactive form of franchise-specific legislation that will promote business format franchising and at the same time provide effective protection to would-be franchisees.

XII. CONCLUSION

Irrefutably, the problem of our country is persistent poverty. Poor people grow out of poverty when their governments create an environment in which educated workers and capitalists have the physical and legal infrastructure that makes it easy to start businesses, raise capital, and become entrepreneurs.¹⁰³

The strength of business format franchising as a method of development for small economies is firmly established. Franchising brings to a local economy a wealth of expertise and system of doing business that may not be available otherwise. The economic impact of franchising are output and job creation, increase in tax base, economic modernization, balance of payment adjustments, small and medium enterprises and entrepreneurship development, and the acquisition of dynamic capabilities and skills.¹⁰⁴

The key, therefore, to fighting poverty, is to encourage franchising both in the retail and service industry. To do this, the government should provide

103. THOMAS L. FRIEDMAN, *THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY* 402 (2005).

104. ILAN ALON, *SERVICE FRANCHISING: GLOBAL PERSPECTIVE* 31 (2006).

the legal infrastructure to make it easy to enter into a franchise arrangement. This, however, does not mean zero regulation. Regulation is needed because as shown earlier, the very nature of franchise relationships require close collaboration between the franchisor and the franchisee for the endeavor to be successful. As more and more Filipinos work overseas, greater capital is made available for investment; hence, the opportunity to create real wealth for the ordinary Filipino. This opportunity, however, comes with great risk. Without any franchise-specific regulation, pseudo-franchisors can prey on the unsuspecting public and offer worthless franchise concepts and burden them with onerous franchise terms, with the end in view of milking them of their investment. This is not only bad for the investors — the country also loses the opportunity to capitalize on the benefits of franchising. Mainly, the ability to spur economic growth that numerous countries have already experienced is lost.

The author submits that the time is ripe for a franchise-specific legislation in the Philippines. To repeat, this regulation must be mainly a disclosure regulation with some well-studied relationship regulations. The primordial aim of the regulation is to promote — not stifle — franchising.

APPENDIX A

MODEL FRANCHISE DISCLOSURE LAW

I. In the disclosure document the franchisor shall provide the following information:

- (a) The legal name, legal form and legal address of the franchisor and the address of the principal place of business of the franchisor;
- (b) The trademark, trade name, business name or similar name, under which the franchisor carries on or intends to carry on business in the State in which the prospective franchisee will operate the franchise business;
- (c) The address of the franchisor's principal place of business in the State where the prospective franchisee is located;
- (d) A description of the franchise to be operated by the prospective franchisee;
- (e) A description of the business experience of the franchisor and its affiliates granting franchises under substantially the same trade name, including:
 - The length of time during which each has run a business of the type to be operated by the prospective franchisee; and
 - The length of time during which each has granted franchises for the same type of business as that to be operated by the prospective franchisee;
- (f) The names, business addresses, positions held, and business experience of any person who has senior management responsibilities for the franchisor's business operations in relation to the franchise;
- (g) Any criminal convictions or any finding of liability in a civil action or arbitration involving franchises or other businesses relating to fraud, misrepresentation, or similar acts or practices of:
 - (i) The franchisor; and
 - (ii) Any affiliate of the franchisor who is engaged in franchising for the previous five years, and whether any such action is pending against the franchisor or its subsidiary, and the court or other citation of any of the above;
- (h) Any bankruptcy, insolvency or comparable proceeding involving the franchisor and its affiliate(s) for the previous five years and the court citation thereof;

- (i) The total number of franchisees and company-owned outlets of the franchisor and of affiliates of the franchisor granting franchises under substantially the same trade name;
- (j) The names, business addresses and business phone numbers of the franchisees, and of the franchisees of any affiliates of the franchisor which are granting franchises under substantially the same trade name whose outlets are located nearest to the proposed outlet of the prospective franchisee, but in any event of not more than [X] franchisees, in the State of the franchisee and/or contiguous States, or, if there are no contiguous States, the State of the franchisor;
- (k) Information about the franchisees of the franchisor and about franchisees of affiliates of the franchisor that grant franchises under substantially the same trade name that have ceased to be franchisees during the three fiscal years before the one during which the franchise agreement is entered into, with an indication of the reasons for which the franchisees have ceased to be franchisees of the franchisor;
- (l) The following information regarding the franchisor's intellectual property to be licensed to the franchisee, in particular trademarks, patents, copyright and software:
 - (i) The registration and/or the application for registration, if any;
 - (ii) The name of the owner of the intellectual property rights and/or the name of the applicant, if any;
 - (iii) The date on which the registration of the intellectual property rights licensed expires; and
 - (iv) Litigation or other legal proceedings, if any, which could have a material effect on the franchisee's legal right, exclusive or nonexclusive, to use the intellectual property under the franchise agreement in the State in which the franchised business is to be operated;
- (m) Information on the categories of goods and/or services that the franchisee is required to purchase or lease, indicating
 - (i) Whether any of these have to be purchased or leased from the franchisor, affiliates of the franchisor or from a supplier designated by the franchisor;
 - (ii) Whether the franchisee has the right to recommend other suppliers for approval by the franchisor; and
 - (iii) Whether any revenue or other benefit that may be directly or indirectly received by the franchisor or any of the affiliates of the franchisor from any supplier of goods and/or services to the franchisee, such as rebates, bonuses, or incentives with regard to those goods and/or services, shall be passed on to

the prospective franchisee or, if not, whether a price mark-up will be made by the franchisor or the supplier recommended by the franchisor;

- (n) Financial matters, including:
 - (i)
 - (a) An estimate of the prospective franchisee's total initial investment;
 - (b) Financing offered or arranged by the franchisor, if any;
 - (c) The financial statements of the franchisor and when available audited or otherwise independently verified financial statements, including balance sheets and statements of profit and loss, for the previous three years. Franchisors, the creation of which goes back less than three years, are under an obligation to disclose the same documents prepared since they began their activity;
 - (ii) (a) If information is provided to the prospective franchisee by or on behalf of the franchisor concerning the historical or projected financial performance of outlets owned by the franchisor, its affiliates or franchisees, the information must:
 - (aa) Have a reasonable basis at the time it is made;
 - (bb) Include the material assumptions underlying its preparation and presentation;
 - (cc) State whether it is based on actual results of existing outlets;
 - (dd) State whether it is based on franchisor-owned and/or franchisee-owned outlets; and
 - (ee) Indicate the percentage of those outlets that meet or exceed each range or result.
 - (b) If the financial information referred to in the preceding subparagraph is provided, the franchisor must state that the levels of performance of the prospective franchisee's outlet may differ from those contained in the information provided by the franchisor.
- (o) A description of:
 - (i) The state of the general market of the products or services that are the subject of the contract;
 - (ii) The state of the local market of the products or services that are the subject of the contract;

- (iii) The prospects for development of the market; and`
 - (p) Anything else necessary to prevent any statement in the document from being misleading to a reasonable prospective franchisee.
- II. The following information shall also be included in the disclosure document. However, where the information is contained in the franchise agreement, the franchisor may in the disclosure document merely make reference to the relevant section of the franchise agreement. Where the following items of information are not included in the proposed franchise agreement, that fact shall be stated in the disclosure document:
- (a) The term and conditions of renewal of the franchise, if any;
 - (b) A description of the initial and on-going training programmes;
 - (c) The extent of exclusive rights to be granted, if any, including exclusive rights relating to territory and/or to customers and also information on any reservation by the franchisor of the right (i) to use, or to license the use of, the trademarks covered by the franchise agreement; (ii) to sell or distribute the goods and/or services authorised for sale by the franchisee directly or indirectly through the same or any other channel of distribution, whether under the trademarks covered by the agreement or any other trademark;
 - (d) The conditions under which the franchise agreement may be terminated by the franchisor and the effects of such termination;
 - (e) The conditions under which the franchise agreement may be terminated by the franchisee and the effects of such termination;
 - (f) The limitations imposed on the franchisee, if any, in relation to territory and/or to customers;
 - (g) In-term and post-term non-compete covenants;
 - (h) The initial franchise fee, whether any portion of the fee is refundable, and the terms and conditions under which a refund will be granted;
 - (i) Other fees and payments, including any gross-up of royalties imposed by the franchisor in order to offset withholding tax;
 - (j) Restrictions or conditions imposed on the franchisee in relation to the goods and/or services that the franchisee may sell;
 - (k) The conditions for the assignment or other transfer of the franchise; and
 - (l) Any forum selection or choice of law provisions, and any selected dispute resolution processes.
- III. Where the franchise is a master franchise, the sub-franchisor must, in addition to the items specified in paragraphs (1) and (2), disclose to the

prospective sub-franchisee the information on the franchisor that it has received under paragraphs (1) (a), (e), (h), and (c) and (f) of this article, as well as inform the prospective subfranchisee of the situation of the sub-franchise agreements in case of termination of the master franchise agreement and of the content of the master franchise agreement.