DOCUMENT RESUME

ED 238 808 SO 015 370

AUTHOR	Maxey, Phyllis F.
TITLE	Competition in the Franchise Business. Instructor's Guide [and] Student Materials. Business Issues in the Classroom. Revised.
INSTITUTION	Constitutional Rights Foundation, Los Angeles, Calif.
PUB DATE	83
NOTE	20p.; For related documents, see SO 015 366-381.
AVAILABLE FROM	Constitutional Rights Foundation, 1510 Cotner Ave., Los Angeles, CA 90025 ($4.95).
PUB TYPE	Guides - Classroom Use - Materials (For Learner) (051) -- Guides - Classroom Use - Guides (For Teachers) (052)
EDRS PRICE	MF01 Plus Postage. PC Not Available from EDRS.
DESCRIPTORS	*Business; *Business Administration; Business Communication; Case Studies; *Competition; *Economics Education; Instructional Materials; Learning Activities; Mergers; *Organizational Effectiveness; Secondary Education; Units of Study
IDENTIFIERS	*Franchising

ABSTRACT

One of a series of units designed to acquaint secondary students with business issues, this packet examines the franchise as a type of business organization. Teacher and student materials are provided in separate sections. The teacher's guide provides an overview, objectives, four detailed lesson plans, answer keys, background information, and recommendations for using a business person as a classroom resource. The student section contains six activities focusing on organizing a franchise and its accompanying problems. A reading explains the franchise relationship and offers a sample franchise agreement. Using a chart, students analyze the advantages and disadvantages of this type of business organization. Five fictional case studies and one legal case illustrate a variety of problems inherent in franchising. The unit concludes with a vocabulary worksheet which reviews key terms and concepts. (LP)

COMPETITION IN THE FRANCHISE BUSINESS

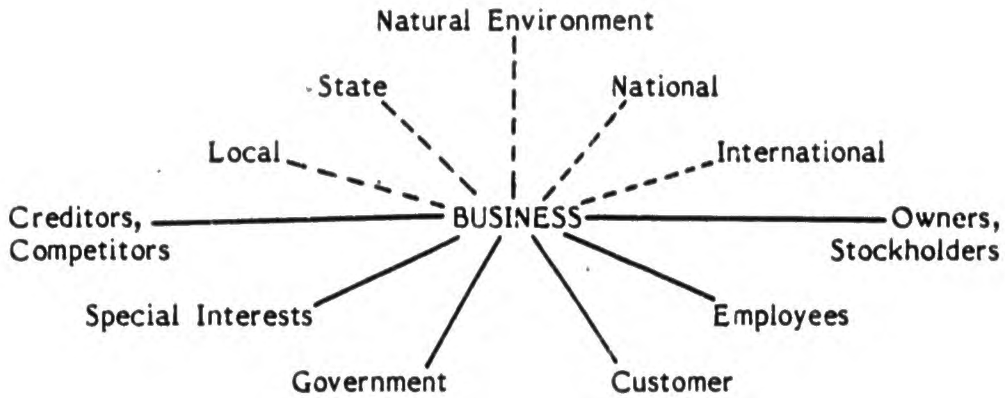
Instructor's Guide

Author: Phyllis F. Maxey
Business Issues in the Classroom
Constitutional Rights Foundation
Los Angeles, California
Revised, 1983

COMPETITION IN THE FRANCHISE BUSINESS

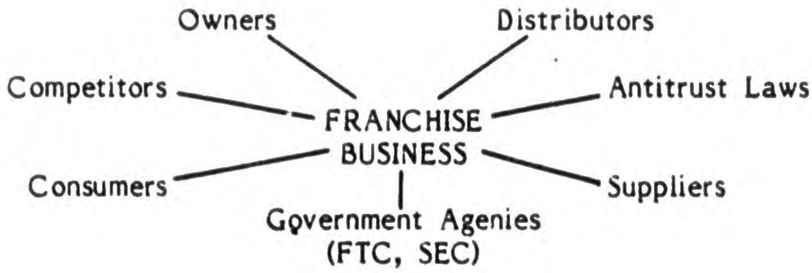
OVERVIEW

Business Issues in the Classroom (BIC) introduces students to exciting, difficult, and complex decisions that face the business community today. Case studies and activities help students understand the setting in which American companies must function. This business environment includes many groups with conflicting interests: stockholders, consumers, employees, special interest groups, business competitors and creditors, and government. These groups affect business and, in turn, are affected by business decisions. Each BIC lesson plan focuses on a specific issue which highlights a particular relationship in the business decision-making environment.



THE BUSINESS DECISION-MAKING ENVIRONMENT

This unit introduces students to the franchise type of business organization. Many of us are quite familiar with this business because as consumers we buy food, gas, clothes, records, a night's lodgings, and hundreds of other products and services from these businesses. Franchising offers students a look at a business relationship in which a successful national company lends its name and expertise to many small businesses who serve as retail outlets for local markets. The lesson exposes students to some of the problems that have arisen in this type of business relationship. The Securities Exchange Commission (SEC) and the Federal Trade Commission (FTC) have become involved in some of these disputes and helped establish and enforce fair business practices.



THE FRANCHISE ENVIRONMENT

Activities in this unit include readings on the franchise relationship, an activity focusing on a contract between franchisor and franchisee, five fictional case studies and one legal case that illustrates problems in franchising. A vocabulary worksheet helps students review the terms used in the lesson.

OBJECTIVES

Students will be able to:

1. define a franchise.
2. list advantages and disadvantages of the franchise type of business.
3. give examples of unfair business practices on the part of franchisors and franchisees.

TIME FRAME

4 or more class periods

CLASSROOM APPLICATIONS

Day 1 <u>Discussion</u>: Have the students read the introduction to the unit, p. 1, and then turn to the activity on p. 2. This activity can help you determine the extent of students' knowledge of franchising. They are probably employees or customers of franchise establishments, but have little knowledge of why such a business organization developed.

Day 2 Reading and Small Group Work: Either individually or as a class, read "The Franchise Relationship" on p. 3. Then divide the class into small groups and have them examine the franchise agreement on p. 4. After each group has discussed the agreement and answered the questions, bring them back as a full class and examine the contract together.

The contract presented on p. 4 lists many favorable aspects of the arrangement for the franchisor. One of the questions raised is, "What should the franchisor do for the franchisee?" The franchisee might try to get the following provisions written into the contract for his or her protection:

1. The franchisor must aid the franchisee in the promotion and advertising of franchisee's business.
2. The franchisor must not invade the assigned business territory by operating a company-controlled competitive business.
3. The franchisor must assist the franchisee to relocate his business when changing conditions cause significant sales losses.
4. The franchisor must provide managerial assistance including manuals and record books.
5. Specific reasons for terminating the lease should be listed in the contract.

Day 3 Small Group Discussion: Refer students to the cases on p. 5-6 which illustrate problems between the franchisor and franchisee. Divide the class into small groups and have them decide if the business practices are fair or unfair. Ask them to identify the interests of franchisor, franchisee, and consumers.

Suggested answers to these questions are given below. Ask each group to give their opinions on the five disputes.

CASE 1 -- McMustard's

The franchisor can suggest prices based on market research. As long as there is no coercion, it is okay for the company to encourage Jack to lower his prices. Jack's prices may be out of line and cause his business to fail.

CASE 2 -- Blue Jeans

If the company can prove that their demands for cleanliness and speedy service are not unreasonable, then the company has the power to terminate the license.

CASE 3 -- Melinda Smith

The franchise contract should state what the procedure should be if deficiencies are discovered by an audit. It is unlikely that she would lose her license because of a $2,000 error.

CASE 4 -- Little Lucy's

This action by the franchisor may be prohibited by the franchise agreement -- allowing an exclusive area to the franchisee, free of company stores' competition.

CASE 5 -- Yummy Candy

It is perfectly legal to require her to use a specified product because of the need for the franchisor to maintain quality control. In the case of an emergency, she could use a substitute instead of the usual products.

Day 4 Discussion: As a group, read the legal case, Susser v. Carvell Corp. on p. 7-8. The students' materials only give the charges brought by the dealers against Carvel. Discuss the students' reaction to the charges before explaining the Supreme Court's decision, provided in the Background Information on p. 7 of this guide.

Be sure that students understand some of the legal terms introduced in this case to describe certain business practices. The Vocabulary Worksheet on p. 9 can be used to assess students' understanding of this unit.

Day 5 Follow-up Activities: If time permits there are several ways to extend this unit. Students might conduct an interview study of owners or managers of franchises in their communities. They might use as a basis for the interview the chart on p. 2 of the student materials which asks about the advantages and disadvantages of franchising. Remind them that in addition to fast food restaurants, there are many other businesses that are franchised. They might try to discover some of these lesser known businesses.

This lesson can be extended by using it as an introduction to the more complex business environment. The Hamburger War and The Business Environment are two BIC units that examine business decision making and unfair business practices for both the sole proprietorship and the corporation. You also might invite a business person or lawyer to join your class to discuss franchising and fair business practices.

USING A RESOURCE PERSON IN THE CLASSROOM

The Business Issues in the Classroom program (BIC) has a talented group of business professionals who are prepared to teach one day of this lesson. At least two weeks before you want a resource person, call the Constitutional Rights Foundation at (213) 473-5091 and ask the BIC placement coordinator to arrange a classroom visit.

The business resource person could participate in the following ways:

Days 3, 4: as a discussion leader for the fictional or legal case studies.

Follow-Up: as a resource to explain recent developments in franchising.

Answers to VOCABULARY WORKSHEET, p. 9

1. trademark	2. exclusive dealing	3. price fixing
4. tying arrangement	5. franchisor	6. franchisee

All of the elements could play an important role in the franchise business. The market area can become too crowded with similar establishments. Competitors may offer a better product or a lower price which will affect the franchisee's sales. Owners have certain rights set out in the contract and the franchisee must fulfill those legal obligations. The owners or parent company can also be a source of expertise for the franchisee. Employees must be supervised so that quality of service or product is maintained. Suppliers must receive payment for goods on time. The franchisee may want to use other suppliers who offer better delivery terms or cheaper supplies. Laws such as antitrust laws are important because they establish legal business practices for the franchisor and the franchisee.

BACKGROUND INFORMATION

Problems in the Franchise Business

There have been difficulties in the franchise business and several government regulatory agencies have been involved in franchise disputes. The Federal Trade Commission and the Securities Exchange Commission (SEC) have been active in franchise disputes. Antitrust laws prohibit price fixing. In the famous Brown Shoe Case, FTC v. Brown Shoe Company, 384 U. S. 316 (1966), it was held that Brown Shoe had violated the Federal Trade Commission Act. It had required franchised stores to buy only Brown Shoes and not any competitive lines. The FTC charged that this was an "unfair trade practice." The concern of the antitrust law is to encourage purchasers' freedom to buy on the open market, to encourage competition. The Supreme Court agreed with the FTC that it was an unfair method of competition.

SUSSER v. CARVEL

The significance of this case lies in three main issues:

Price fixing: an agreement made between two or more persons for the unlawful purpose of raising, lowering, fixing, or stabilizing the price of the market.

Tying arrangement: an agreement in which the franchisor (Carvel) will sell one product only if the purchaser (the franchisee) agrees to buy other products from the franchisor.

Exclusive dealing arrangement: an arrangement in which the franchisee is restricted to buying supplies and products from the franchisor. The franchisee can not go anywhere else to buy supplies.

Price Fixing

After reviewing the case, the Court found that Carvel Corporation was not taking part in illegal price fixing. The Court had to look at two different contract agreements. The one before 1955 set certain prices that had to be charged by the dealers for the ice cream products. This the Court found to be price fixing. The agreement after 1955 merely recommended prices for the products based on the marketing research done by Carvel. However, the agreement clearly set out that each dealer had the right to set his or her own prices, and the Court did not find this to be unlawful.

Tying Arrangement

The second charge against Carvel was that the franchise involved an unlawful tying arrangement. Two of the three Justices found that the arrangement was justified. Carvel had an interest in preserving its good will and reputation by requiring products important to the Carvel trademark be purchased by the franchisees.

Exclusive Dealing Arrangements

The final issue was whether the requirement that a dealer sell only Carvel and Carvel-approved products was an unlawful exclusive dealing arrangement. The Court found that Carvel was justified in its arrangements and that it did not unduly interfere with free competition in the marketplace. Carvel was operating in the public's interest. Customers could identify each store as part of a chain offering identical products at a uniform standard of quality. The Court also noted that it is in the best interest of the public that trademarked products, such as Carvel ice cream, be under the control of the franchisor to insure quality control.

COMPETITION IN THE FRANCHISE BUSINESS

Student Materials

Author: Phyllis F. Maxey
Business Issues in the Classroom
Constitutional Rights Foundation
Los Angeles, California
Revised, 1983

COMPETITION IN THE FRANCHISE BUSINESS

One way for a business to expand rapidly is through franchising. A nationally recognized company such as ARCO, McDonald's or Del Taco sells its products with the aid of independent business people who pay those companies for the use of their names. You may be be familiar with franchises as an employee or as a consumer. In this unit we will study this type of business organization.

Often the relationship between the parent company and the dealer is a helpful one. The experienced company helps out the dealer who may be a person just starting out in business. The dealer knows that the product is of a certain quality and is in demand; this eliminates some of the risks of starting one's own business. But sometimes the relationship is stormy. Dealers may sue the parent company for unfair business practices. The company may refuse to renew its contract with a dealer because the dealer has failed to maintain quality controls.

Activities in this unit include:

1. ACTIVITY: Competition in the Franchise Business
2. READING: The Franchise Relationship
3. ACTIVITY: Problems in Franchising
4. CASE STUDY: Susser v. Carvel Corporation
5. LEGAL CASE STUDY
6. VOCABULARY WORKSHEET

COMPETITION IN THE FRANCHISE BUSINESS

McDonald's Burger King Insta-Tune
Chevron Kentucky Fried Chicken Pizza Hut
Baskin-Robbins Denny's Holiday Inn

All of these businesses have something in common. They are examples of franchises. A franchise is a type of business. A franchise also means a license granted by the owner of a trademark permitting a business person to sell a product or service under that trademark name. The business person pays a fee for the use of the name, signs a contract agreeing to operate under certain conditions, and gives the owner of the trademark a percentage of sales. The owner of the trademark is called the franchisor. The person licensed to operate a business is called the franchisee.

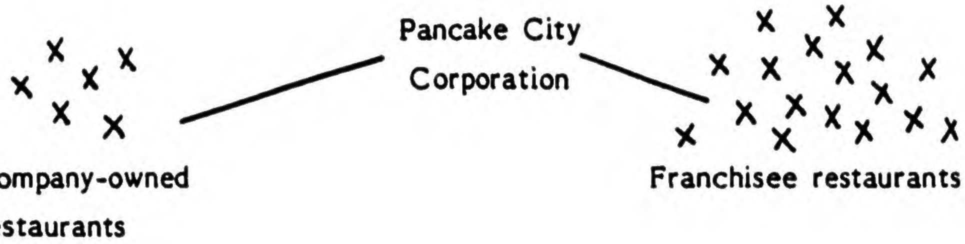
If you wanted to start your own business why would you pay a company with a national trademark, such as Standard Oil or McDonald's, to use its name and sell its products? Why would that Company want you to open an outlet?

List as many advantages and disadvantages of franchising as you can:

ADVANTAGES	FOR	DISADVANTAGES
	Franchisee	
	Franchisor	

THE FRANCHISE RELATIONSHIP

Franchising really caught on in the 1950s in America. It provided a form of business organization that gave security to a small business ownership and personalized the service to the customer while providing the quality and economy of national name brands. Many franchisors have some outlets that are owned by the franchisor (company stores) and other outlets that are owned by the franchisees.



<u>The Psychology of Franchising</u>

Robert Emmons and Leonard Korot, consultants to many franchise companies, have suggested that there is a "psychology" of franchising, similar to growing up in a family.

The "parent" is the franchisor who provides advice, guidance, and support for the beginner in business. The "child" is the franchisee who depends on the wisdom of the "parent." He or she may be unskilled in operating a business and making the right decisions.

As the franchisee grows more confident, he or she may want more independence from the franchisor. The franchisee doesn't want to simply follow orders, but to run a business using his or her own ideas. Emmons and Korot suggest that a successful franchisor must learn to cooperate with this desire for independence. The parent company has much to learn from the individual franchisees. They often are the first to recognize changes in customers' tastes. The franchisor, however, has an interest in maintaining uniform quality so that the customer can expect the same product no matter what store he or she visits. Franchising involves cooperation by both parties.

By the 1960s, some of the abuses of the franchise relationship were beginning to receive attention. Companies came into existence just long enough to sell large numbers of franchises to hundreds of individuals, and then would be out of business. The life savings of a franchisee could be lost in this process. Franchisees began complaining about excessive prices for supplies, harassment by the franchisor, and termination of licenses without just cause.

Let's say the franchisor lays down the following conditions in order for you to get a license to operate a PANCAKE CITY restaurant:

THE FRANCHISE AGREEMENT

1. You must pay an initial fee of $50,000 for using PANCAKE CITY'S trademark, secrets, and methods of operation.
2. You must locate in a particular site chosen by PANCAKE CITY CORPORATION.
3. You must purchase the pancake batter formulas from PANCAKE CITY or its designated suppliers.
4. You must go through six weeks of intensive training at the corporate headquarters and two PANCAKE CITY stores to learn how to manage a store.
5. Your restaurant building must look like all other PANCAKE CITY restaurants.
6. You must submit to monthly inspections by representatives of the PANCAKE CITY CORPORATION.
7. You must pay an advertising fee equal to 1% of gross sales.
8. You must pay 5% of your gross sales to PANCAKE CITY CORPORATION.
9. You may not open a new business similar to PANCAKE CITY for three years after the termination of this contract.
10. The term of this contract is 25 years.

Do you think this is a fair contract? Can you add anything to your list of advantages and disadvantages of franchising? Are the rights of both franchisor and franchisee protected by this contract?

PROBLEMS IN FRANCHISING

Read each of the following accounts of conflicts between a franchisor and franchisee. Is there anything unfair or illegal in the actions of the business people?

CASE 1

McMustard's has 1,200 franchise restaurants all over the U. S. Every few months, the company sends a list of suggested prices and printed signs with a picture of the food and the new, suggested price next to it.

The local McMustard Restaurant owned by Jack Fraser always charges much more than the company's recommended prices. Jack is located near the expensive Marina and has to pay high rent. He says that he raises his prices to cover costs.

CASE 2

Karl Lund had worked as a salesman for 10 years and wanted his own business. He heard from a friend that Blue Jeans Franchise was licensing outlets in his part of the city. He could get a franchise for $30,000 and in return get national advertising, a top-selling brand, and helpful advice on how to set up his store.

Karl did just that, and in one year had a booming business selling jeans to high school and college students. Then he started having trouble with the Blue Jeans Company. They accused him in several inspection reports of having a dirty store and slow service. Now they were demanding that he either clean up his store and improve service or Blue Jeans would terminate his license to operate one of their franchises.

CASE 3

Melinda Smith bought her franchise in a Mexican fast-food chain in 1965. Today, she owns three stores and makes a total of 4 million dollars in sales. The stores must be audited each year according to the contract. An audit is an examination of all financial records by an accountant.

Last week, Melinda received a phone call from the auditors saying that she had failed to report $45,000 in sales last year. She called the franchisor and promised to pay them their proper share: 5% of $45,000, or $2,250. They said, "We have lost confidence in you and you have definitely violated the agreement. You will have to give up your license."

CASE 4

Little Lucy's is a pancake franchise. One day, a huge conglomerate, Glom, bought the whole franchise company. The huge conglomerate had many financial resources and offices in ten different cities. Glom didn't need the financial resources and distribution network provided by the franchisees. Glom wanted to own the outlets themselves. They were only getting 5% royalty on the franchised Little Lucy stores. If Glom owned the stores and got rid of the franchisees, they would get 20%.

Glom chose the most profitable Little Lucy franchise locations and tried to buy out the franchisee. Those business people who wouldn't sell would soon find a brand new Little Lucy Pancake House opening in their market area. Glom could then get all of their customers and drive the franchisees out of business.

CASE 5

Yummy Candy Stores is a franchise business. Small shops are located in airports, shopping centers, and hotels and are owned and operated by many different men and women. Juanita had a Yummy Candy Store in the Hightop Hotel. During a trucking strike, she ran out of the usual chocolate syrup and bought a new brand. During the next inspection, Juanita told the company representative about the new syrup and recommended that others use it as the taste was so much better. The Yummy Candy Store told Juanita that she was deceiving the public by offering a different-tasting product than the one advertised. She had to either give it up or she would be dropped as a franchisee.

THE ICE CREAM BUSINESS:
SUSSER v. CARVEL CORPORATION*

****

This is an actual case of conflict between a franchisor and a group of franchisees. As you read the case, think about the answers to these questions:

1. Did the franchisor (Carvel Corp.) fix prices?

2. Was there an unlawful tying arrangement?

3. Was there an unlawful dealing arrangement?

****

Carvel Corporation is a New York dairy and soft ice cream corporation, a franchisor with approximately 400 franchised ice cream stores. Mr. Susser and other franchisees sued Carvel, charging that Carvel engaged in illegal price fixing and other unlawful arrangements with the dealers.

The court examined the franchise agreement which governed the general operations of the store, including: the types of products they could sell, the recipe for the ice cream, the advertising used, the color of the uniforms the workers had to wear, the appearance of the store itself, and even the hours the lights had to be kept on.

In terms of price fixing, the court had to look at two different agreements. The agreement before 1955 set certain prices that had to be charged by the dealers for ice cream products. The agreement after 1955 merely recommended prices for the products, based on marketing research done by Carvel. The second agreement clearly said that each dealer had the right to set his or her own prices, and Carvel never enforced or attempted to enforce the recommended prices.

*Susser v. Carvel Corp., 332 F 2d 505 (1964).

The second charge against Carvel was that the franchise involved an unlawful tying arrangement. A tying arrangement is an agreement under which the vendor (Carvel, in this case) will sell a product only if the purchaser agrees to buy another independent product as well. Carvel insisted dealers could only buy their secret formula ice cream if they also bought cones and toppings from them. The franchisees claimed that this unfairly limited their right to get their own suppliers simply to get the benefit of Carvel's name.

The final issue was whether the requirement that a dealer sell only Carvel or Carvel-approved products was an unlawful exclusive dealing arrangement. Such an arrangement is unlawful if it unduly interferes with competition in the marketplace.

VOCABULARY WORKSHEET

Place the correct word next to its definition

PRICE FIXING	TRADEMARK	FRANCHISOR
TYING ARRANGEMENT	FRANCHISEE	EXCLUSIVE DEALING

_____________ 1. a business's registered emblem or name used to identify its products or services

_____________ 2. an arrangement that requires the dealer to sell only the franchisor's products

_____________ 3. franchisor sets the prices which dealers must charge for its products

_____________ 4. an arrangement that requires dealers to buy several different products from the franchisor

_____________ 5. owner of the trademark

_____________ 6. business licensed to sell a product or service under the trademark name

In a franchisee's business, which of the following elements are important? Draw a line between the franchisee and each part of his or his or her environment that you think is important.

CUSTOMERS	COMPETITORS	SUPPLIERS
MARKET AREA	LAWS	EMPLOYEES

OWNERS OF TRADEMARK

****

FRANCHISEE

****

Explain how the items you chose affect the franchisee's business.

____

____

____

____