

## **A LOOK AT FRANCHISING IN THE PHILIPPINES, WITH A GLIMPSE OF OTHER JURISDICTIONS**

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Many have confused and have used interchangeably franchising with licensing. The mix-up is quite understandable given that franchising is a special type of licensing, both involving generally, the use of intellectual property. For our purposes however, it would be best to first distinguish one from the other if only to put in context the succeeding discussion, which focuses mainly on franchising and its regulation. By definition, licensing is an arrangement between an intellectual property rights owner (licensor) and another who is authorized to use such rights (licensee) in exchange for an agreed payment. While the same definition applies as well to franchising, the franchise relationship is more controlled and restrictive since the person authorized to use the intellectual property (franchisee) can only do so in accordance with the methods and procedures prescribed by the intellectual property rights owner (franchisor). Because of the control largely exerted by the franchisor upon its franchisee, the franchise relationship has more often been subject to abuses by the franchisor. Many jurisdictions have in fact acknowledged these abuses and have enacted franchise-specific laws to afford more protection to the franchisee. With this brief introduction, I move on to discuss specifically franchising and whether or not the same must be subject to state regulatory measures.

### *Franchise Regulation in the Philippines*

A recent trip to the Department of Trade and Industry confirmed my suspicions: the Philippine franchise sector has run amuck for the past 40 years and was placed only on a loose leash in 1995 with the establishment of the Philippine Franchise Association (PFA), a voluntary self-regulating governing body for franchising in the Philippines. In 2005, PFA enacted its Fair Franchising Standards (FFS) establishing uniform standards of conduct to govern franchise relationships between PFA members who are franchisors and their franchisees. Chief among the objectives of the FFS is to promote the growth of the Philippine franchise sector as a self-regulating system. As a legal practitioner in my chosen field, self-regulation can rarely be a good thing, especially where intellectual properties are concerned. However, despite the absence of a firm statutory framework, the Philippine franchise sector has grown in the past decade and in fact, continues to grow, accounting for an estimated fifteen percent (15%) of the country's annual retail sales or roughly US\$5 billion. A recent joint study conducted by the PFA and the University of Asia and the Pacific likewise confirmed that in 2007, the Philippines ranked first in the Southeast Asian Region in terms of total number of franchise concepts and



total number of outlets established notwithstanding its comparatively low Gross Domestic Product per capita. With these figures, the almost moot and academic debate of whether franchising should be classified as a state-regulated business activity is again brought forward. While this paper is inclined to answer in the negative for the reasons to be discussed below, in the end, a regulatory framework might still be needed if only to assuage the undeniable reluctance of foreign industry players to invest in a jurisdiction where there is no adequate legal protection. However, given the nature of the franchisor-franchisee relationship, a rigid legal framework would appear to be inappropriate where a general legislative policy on franchising would suffice.

### *Surveying the Franchising Legal Landscape*

The enactment of franchise-specific laws has in the past years, gained the affirmative nod of most countries within the region. Except for the Philippines, Singapore and New Zealand, other jurisdictions have enacted their own laws to govern the franchise relationship giving particular importance to disclosure and relationship provisions. In each of these laws, *franchising* has been generally defined as a contract where a franchisee is granted the right to offer, sell or distribute products or services under a marketing plan or system that comes with a trademark, name, or logo owned by a franchisor, who in turn acquires the right to collect such fees as may be agreed upon under a franchise agreement. Essentially, the franchise relationship boils down to two elements, which I choose to state in terms of rights conferred: (1) the right of the franchisee to use the franchisor's intellectual properties, which may be in the form of trade marks, patents, trade secrets or other confidential information; and (2) the right of the franchisor to prescribe specific methods and procedures for the use of his intellectual property and to collect fees in consideration for such use.

Given the rights involved, franchise laws must necessarily address situations where violations of these rights will presumably recur the most. Given further the nature of a franchise relationship involving as it does the right to use intangible assets and the purchase of a system of conducting business, information necessary for a reasonably prudent decision by the franchisee may not be as easily determinable as the franchisee might think. A franchisee would therefore have to be protected against unscrupulous franchisors who, after only putting up one or two outlets, would instantly call themselves "franchisors" and sell their business concepts to unsuspecting potential franchisees who may rush at a business opportunity without conducting proper due diligence. To remedy this situation, jurisdictions with franchise-specific laws require a franchisor to provide a disclosure document detailing what the franchisee should know. In Australia, franchisors are mandated to furnish its potential franchisees a copy of the Australian Franchise Code of Conduct, which must be given along with a disclosure document, fourteen (14) days prior to the signing of any franchise agreement. A franchisor is also required to disclose not only to potential franchisees, but also to existing franchisees who may request for continuing annual disclosures. The franchisor's obligations also extend to securing a written confirmation from his potential franchisee that the latter has read and understood both the disclosure document and the Code and has had a reasonable opportunity to understand the same. Japan has likewise imposed very stringent disclosure requirements, mandating the "head office" to disclose information even on such matters relating to the details, procedures, frequency and the cost of guidance to the "member" about the business activity. Indonesia requires the franchisor to furnish its potential franchisee a profit and loss statement for the past two years, its franchise experience and details of past and current franchisees. Similar disclosure documents



are likewise required of franchisors from China, South Korea, Malaysia, Vietnam and Taiwan giving the franchisor varying periods of time to furnish such documents prior to the execution of any franchise agreement.

Arguably, a franchisee would be at a more disadvantageous position given the inherent imbalance characteristic of a franchise relationship. A franchisee would usually be at the mercy of its franchisor who in practice, dictates the conditions for securing its franchise. In the event that disputes may arise and unless mediation is prescribed under the franchise agreement, jurisdictions without statutory franchise regulation would traditionally direct such disputes to regular courts under an action for damages or enforcement of a private contract. Given again the nature of a franchise relationship, built primarily on a collaborative and interdependent system, resort to adversarial remedies may prove to be fatally damaging and quite expensive, especially for the franchisee. Franchise-specific laws have thus addressed this concern by writing into every franchise agreement mediation as a preferred and sometimes, exclusive method of dispute resolution.

Cooling-off periods are also imposed state authorities as an additional layer of protection for franchisees who may have executed franchise agreements under high-pressure sales and negotiations. Other control mechanisms in place among jurisdictions with franchise-specific laws include registration of the franchise agreement with a government authority such as the Minister of Industry and Trade in Indonesia, and the Registrar of Franchise in Malaysia. Statutory minimum requirements are also provided for with respect to the assignment, termination or renewal of a franchise agreement. Needless to say, the foregoing legal provisions strike at maintaining a balance of interests between the franchisor and the franchisee while simultaneously slightly tilting the scales in favor of the franchisee whom experience has demonstrated to be more vulnerable to abuse.

### *The Problem with State Regulation*

While I pose no serious objection to the enactment of laws to govern specifically the franchise relationship, I do have qualms about placing a highly fluid and dynamic legal relationship within the confines of a detailed set of inflexible rules that are often enforced to the letter. Having in place a franchise-specific law leaves little room for accommodation of inevitable changing situations in a business relationship. This in fact has been a growing problem in most jurisdictions where the enactment of franchise laws has resulted to even more uncertainty especially with respect to the interpretation and application of these laws.<sup>1</sup> The difficulty may be rooted in the fact that a franchise relationship is more characteristic of an economic rather than a legal relationship, which our laissez-faire intuitions would advise to place as little state intervention as possible. Allowing the state to regulate franchising also raises the possibility of an institution imposing its theoretical notions on how best to regulate a system it may know little or nothing about. Giving the state authority to regulate franchising may also promote and breed institutional red tape and corruption both of which will discourage local and foreign enterprises from venturing into franchising, consequently stunting development of the franchise sector and hindering its potential contributions to the economy.

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<sup>1</sup> Zeidman, Philip K. *Franchising in Asia: A Crash Course*. Franchise Times, January 2008.



Despite its downside, institutionalized regulation may still comfortably find its place within the franchise sector. Regulation may not necessarily have to emanate exclusively from state authorities as in fact private sector regulation may supplement state policies on franchising. State regulations need not also directly address franchise-specific issues in order to protect franchisors and franchisees who may already be adequately protected by contract and intellectual property laws. Ultimately, regulation must be of such form as to provide adequate legal protection without sacrificing economic freedom.

### *The Philippine Franchise Industry*

There are no franchise laws in the Philippines. This is not to say however that the franchise sector has progressed without legal safeguards in place. Generic laws continue to apply to a franchise which at bottom, is a private contract governed primarily by such principles as freedom and mutuality of contract, and enforcement in case of breach. Intellectual property rights have likewise been accorded stronger protection under local intellectual property laws, which have incorporated principles of reciprocity and the recognition of well-known marks, paving the way for international brands to confidently establish and locate their enterprises within Philippine shores. These laws of general application have managed to place a working legal framework that has created a healthy and safe legal environment for would-be franchisors and franchisees, without stifling the franchise industry by imposing more onerous legal obligations.

Perhaps the most challenging issue not specifically covered by generic laws that may potentially escalate into a systemic problem would be the propensity of some franchisors to exploit the franchise relationship to the franchisor's advantage and to the prejudice of the franchisee. This may happen when the franchisor imposes restrictive business practices such as requiring the franchisee to source its supplies and materials exclusively from the franchisor or a person designated by the franchisor and secretly selling the same at a premium. Another unaddressed issue is the proliferation of "pseudo investments" where franchisors offer "empty" franchises to uninformed potential franchisees. While these issues may be addressed by straightforward legislation, private sector regulation may still be the more suitable option given the unquestionable expertise of industry insiders. As mentioned earlier, the PFA has already addressed these issues and several other franchise-related concerns in its FFS. To ensure best practices in the industry, the FFS requires a franchisor to submit to the PFA, as a pre-condition to accreditation, a Franchise Offering Circular (FOC) containing such matters as the history of the franchise system being offered, including a summary of past and present litigation involving the franchise system, a description of the business concept, a full disclosure of the financial requirements of the franchise business and even a list of its key officials with a brief description of their qualifications and background. Franchisors are also required to be registered owners or duly authorized users of the trademarks/service marks of the business to be franchised. Franchisors are further required to maintain such registration and to diligently protect their right to the said mark. The FFS likewise mandates non-judicial remedies to settle disputes arising from the franchise agreement, requiring the franchisor to provide for such mechanisms in its franchise agreement.

Unfortunately, membership in the PFA is not mandatory for all franchisors, which limits the scope of application of the FFS. Moreover, enforcement of the FFS may fall short of traditional statutory enforcement methods given that the PFA has no police



power outside its ranks. The most PFA can do is to expel a member-franchisor who fails to comply with the FFS. Expulsion in itself however, is not a very effective deterrent as the erring franchisor can still continue operating its franchise albeit outside the PFA.

Despite being confined to a system of generic legislation and self-regulation, one can only surmise at how the Philippine franchise industry has continued to mature and contribute substantially to the generation of national revenues and local work opportunities. Part of the reason perhaps can be attributed to governmental support, but not in terms of franchise legislation but through other legislations that give fiscal incentives to local entrepreneurs who, in turn, are motivated to adopt franchising as a method of doing business. The other part of the reason may perhaps be attributed to the lack of state intervention, which from an economic standpoint undoubtedly does more good to the franchise industry. Even the legislature acknowledged the benefit of minimal state intervention to economic development when it adopted as a guiding principle in the Magna Carta for Small Enterprises the "*principles of minimum regulation to ensure stability of rules and to encourage entrepreneurial spirit among the citizenry.*" The same law also recognized the role of the private sector in recommending simplified procedures and localized incentives to small enterprises.

With both governmental and private sector support, local franchises are more emboldened to penetrate even international markets. The growing Filipino communities in the US, Canada, UK and the Middle East, also provide immediate patronage for local franchises locating in these jurisdictions. These franchises include retail store giant Bench, which has international presence in China, Saudi Arabia, United States, United Arab Emirates, Canada and Palau. In the food category, Jollibee, a fastfood restaurant chain founded by Ernst & Young World Entrepreneur Awardee, Tony Tan Caktiong, has likewise expanded internationally to the United States, Brunei, Hong Kong, Vietnam and Saipan. Max's Restaurant, a chicken and Filipino foods restaurant, also has stores established in Sacramento, Vallejo, West Covina in the United States and Oahu, Hawaii. These franchises lay testament to the ever-expanding Philippine franchise industry, which, despite the absence of firm legal framework to govern franchising, is slowly breaking down international barriers by bringing homegrown franchise concepts to international territories.

### *Successful Philippine Franchises<sup>2</sup>*

At this point, allow me to share with you a few local franchise gems that attest to the phenomenal growth of the Philippine franchise industry notwithstanding the absence of franchise-specific statutes. These stories demonstrate that not only can the local franchise industry thrive without franchise laws but it can also very well prosper even beyond national boundaries.

I begin the storytelling with fastfood chain mogul Tony Tan Caktiong's JOLLIBEE, which at present, commands 65% of the chicken-and-burger market in the country and has presently grown into a US\$1 billion food empire accounting for 20% of the total market revenues of the local franchise industry. Jollibee has also established outlets in 6 other countries bringing the total number of outlets to twenty three with the most recent restaurant opening in Las Vegas, Nevada last May 2, 2007.

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<sup>2</sup> As retold in "*A Guide to Franchising in the Philippines*" published by the Philippine Franchise Association in 2007.



But like all success stories, Jollibee's climb to the top of the retail food industry was a long and arduous one. With an initial capital of only US\$47,000.00 and the entry of international fastfood giant McDonald's in the Philippines in 1981, many thought that Jollibee would succumb to fierce pressure and competition by trading its restaurants for a McDonald's franchise. Determined to weather this challenge, Jollibee went on a head-on collision with its international rival despite all the odds pegged against it and, just as fate would have it, Jollibee emerged triumphant earning for itself the prestige of becoming the Philippines' No. 1 fastfood chain. Thus, from a start-up capital of only US\$47,000.00 in 1978, Jollibee's sales in 2004 rose by 23% to US\$630 million with net income rising by 34% from the year before to US\$27 million. The expansion of Jollibee can largely be attributed to its adopting franchising as a method of doing business. Its founder, Mr. Tan Caktiong once disclosed, *"franchising is a business concept that can create a win-win situation for the franchisor, the franchisee and the customer... our company's franchising systems and practices have played a significant role in developing not only our brand but also the franchising practices in the country"*. Today, the Jollibee brand has over 500 stores in the Philippines with half being operated through franchising.

If Jollibee reigns supreme in the food service franchise business, Mr. Ben Chan's BENCH would be its counterpart in the retail fashion business. Back in the 1980s, Bench's founder, Mr. Chan was deeply frustrated that there were not enough clothing brands to choose from especially in the men's wear. Fuelled by this frustration and motivated by his passion for fashion, Mr. Chan opened the first Bench outlet in 1987. From a single store, Mr. Chan's brand, through franchising, has expanded exponentially reaching markets in China, Saudi Arabia, California, Guam, Abu Dhabi, Dubai, Oman, Qatar, Canada and Palau. The brand Bench is now associated with trendy, quality clothing that can be worn over and over again without the same going out of fashion.

Jollibee and Bench are but two of several successful franchises produced in the Philippines. While it might be satisfying to share their stories with you, I cannot end this section without mentioning as well the small enterprises that have likewise done much for the growth of the local franchise industry. These small enterprises come in the form of food carts and kiosks, service establishments such as hair salons, spas, fitness & wellness centers and backdoor support services. Through the concerted efforts of both the private and public sector, start-up businesses have chosen to adopt franchising as a vehicle for conducting their business. Through the Department of Trade and Industry and the Small Business Guarantee and Finance Corporation (SBGFC), qualified small and medium enterprises are able to secure loans guaranteed by the SBGFC by up to 100% of the amount of the loan. All public and private lending institutions are likewise mandated by law to set aside as much as 6% of their total loan portfolio for use of such qualified small and medium enterprises. The PFA as well continues with its awareness and information campaign, educating would-be franchisors and franchisees through national and regional seminars, publications and the annual holding of the Philippine International Franchise Conference and Expo (PIFCE), the biggest and longest-running franchise event in the Philippines. PFA also continues to unite with the international franchise community by affiliating itself with the World Franchise Council and the Asia Pacific Franchise Confederation. By its affiliations and international participation, PFA is constantly updated on the latest global franchising trends, which it brings to the knowledge of the local industry. With the joint and fervent efforts of the public and private sector, the Philippine franchise sector will no doubt be a force to be reckoned both locally and internationally.



### *My Final Words: A Co-Regulatory Regime*

More than a legal relationship, franchising is largely a commercial and business relationship. Drawing bright lines between regulating the industry on the one hand and maintaining a free market economy may be close to impossible. A dynamic relationship such as franchising requires as well a dynamic method of regulation, which should probably not come from state authorities. As an economic vehicle, strict state regulation might not be the best method to have in place, especially where sector growth is expected to continue and contribute to national development.

Despite it's being a business-economic relationship, franchising does have unavoidable legal repercussions. Laws of general application, particularly those of contract and intellectual property laws should be able to provide for sufficient protection to would-be franchisors and franchisees. Enforcement methods must likewise be strengthened in order to give added assurance that protective laws shall be efficiently implemented. These laws should be supplemented further by allowing the franchise sector to regulate itself, relying in part on such private non-stock, non-profit franchise associations to lay down rules of conduct to govern specifically the franchise relationship. A general legislative policy of good faith dealing and best practices in franchising must likewise be adopted. Membership in franchise associations may also be made mandatory by law so that rules of conduct enacted by those knowledgeable in the field will apply to all who wish to venture into franchising. The state must also look into strengthening supportive laws that contribute immensely to the growth of the franchise sector. Laws giving fiscal and non-fiscal incentives to small and medium enterprises that have the capacity to adopt franchising as a method of doing business should be in place in order to encourage more growth and development in the sector.

The enactment of franchise laws may not be the only solution to potential problems in a franchise relationship. Although having the same in place might encourage the inflow of foreign investment, the same would likewise come at a high price as it might discourage local entrepreneurs from going into franchising as a business method due to the high costs that come with even minimal compliance with the law. In the end, while much is to be desired from a firm legal framework to govern specifically the franchise relationship, the state must not lose sight of the reality that a franchise relationship remains a commercial animal that requires supportive rather than prohibitive regulations.

*\*The Paper was presented by Mr. Ancheta during the 21<sup>st</sup> LawAsia Conference held on 29 October 2008 – 01 November 2008 in Kuala Lumpur, Malaysia*