

**EXPANDING A BUSINESS  
BY FRANCHISING**

## TABLE OF CONTENTS

I.	INTRODUCTION .....	1
A.	The Origins of Franchising .....	1
B.	Modern Franchising .....	6
C.	Types of Franchise Relationships .....	11
1.	Introduction .....	11
2.	Product Franchises and Selective Distribution .....	16
3.	Business Format Franchises .....	17
4.	Manufacturing Licenses .....	18
5.	The Conversion Franchise .....	19
6.	Quasi Franchise Relationships .....	20
7.	Single Outlet and Area Franchises .....	21
a.	Single and Multiple Outlet Franchising .....	21
b.	Area Development Franchising .....	22
c.	Subfranchising .....	24
d.	Area Representation .....	26
8.	Area Franchising Considerations .....	27
D.	The Economic and Financial Relationships of Franchisors and Franchisees .....	29
1.	General Economic and Financial Characteristics of Franchising .....	29
2.	The Franchisor as a Supplier of Intangibles and Services .....	30
3.	The Franchisor as Supplier of Tangible Products .....	31
4.	The Franchisor as a Source of Capital .....	32
5.	The Franchisor as Landlord .....	32
E.	In What Ways Can Franchising Be a Superior Expansion Method .....	32
1.	Benefits related to capital furnished by franchisees .....	33
a.	Rapid expansion of the franchise network .....	33
b.	Franchisees share risk of expansion of the franchise network .....	35
c.	A franchising company can realize a higher return on its capital .....	35
d.	Franchise networks can realize economies achieved by company-owner outlets through joint procurement .....	36
e.	Reacquisition of franchised business .....	36
2.	Benefits related to the motivated management of franchised outlets .....	33
a.	Franchisees are motivated owner-managers .....	36
b.	Franchisees are idea/information resources to a franchisor .....	37
c.	A franchising company has a simpler and more efficient management structure .....	38
d.	Franchising offers opportunities for employees to acquire franchises .....	38
3.	Personal Satisfaction .....	39
4.	Franchising from perspective of the Franchisee .....	39
F.	Significant Elements of a Business Format Franchise .....	32
1.	Trademarks and Trade Dress .....	41
2.	Business Format and Operating System .....	44
3.	Site Selection and Business Facility Development .....	46
4.	Advertising and Marketing .....	47
5.	Training .....	47
6.	Continuing Assistance and Guidance .....	48

7.	System Standards .....	49
8.	Term Renewal and Transfer.....	51
9.	Other Significant Terms and Conditions .....	53
10.	Fees .....	53
G.	A Comparison of Alternative Distribution Structures with Franchising .....	55
1.	The Vertically Integrated Chain.....	56
2.	Joint Ventures .....	62
3.	Independent Dealerships.....	64
4.	Cooperatives .....	64
5.	The Internet.....	66
II.	SIGNIFICANT ELEMENTS OF THE FRANCHISE RELATIONSHIP .....	9
A.	Introduction.....	9
B.	The Decision to Expand by Franchising.....	71
1.	The Decision to Expand.....	71
2.	Expansion Methods.....	71
3.	Sound Concept.....	73
4.	Ready to Franchise.....	74
a.	Prototypes .....	74
b.	Financial Criteria .....	76
c.	Business Plan .....	76
d.	Sufficient Capital .....	78
e.	Capable Management.....	79
C.	Grow The Franchise Network with the Right People, In the Right Places and At a Manageable Rate.....	80
1.	Selecting High Potential Franchisees.....	80
a.	Core Values and Other Characteristics .....	82
b.	Recruit High Potential Franchisees.....	84
c.	Evaluating Prospective Franchisees.....	85
d.	Do Not Mislead Prospective Franchisees .....	86
e.	Grant Franchises - Don't Sell Them.....	86
2.	Developing Leads to Prospective Franchisees.....	87
a.	The Internet.....	87
b.	Printed and Other Sales Materials.....	90
c.	Existing Franchisees .....	92
d.	Referral Networks.....	93
e.	Public Relations .....	95
f.	Evaluating Lead Sources.....	95
g.	Be Responsive.....	96
h.	Support of Franchisees.....	98
i.	Expand At a Manageable Rate.....	99
D.	Building and Maintaining Cooperative Franchise Relationships .....	101
1.	A Brief Analysis of the Franchise Relationship .....	101
2.	Current Franchisor Thinking.....	102
3.	The Critical Role of Franchisor Management .....	104
4.	The Profile of Current Franchisees .....	105
5.	The Importance of Trust .....	106

6.	Ending Wrong Relationships .....	107
E.	Effectively Documented Franchise Relationship.....	108
1.	Franchise Documents.....	108
2.	Uniform Franchise Offering Circulars and Franchise Sales Materials .....	108
3.	Operations Manuals .....	109
F.	Collaborative Relationships With Franchisees .....	114
1.	Franchisor Attitudes and Actions.....	114
2.	Respect and Response to Franchisee Concerns.....	115
3.	Franchise Experience and Innovation.....	116
4.	Negotiation With Franchisees.....	117
G.	Communication.....	118
1.	The Role of Communication.....	118
2.	Effective Communication .....	119
3.	How Do Franchisees Regard the Franchisor .....	119
4.	Intranets.....	120
H.	Franchisee Advisory Councils and Associations.....	121
1.	Advisory Councils .....	121
2.	Franchise Associations.....	122
3.	Working With an Advisory Council or Association.....	125
I.	Furnishing Valuable Services to Franchisees .....	126
1.	Operating System and Services .....	127
2.	Site Selection and Development .....	128
3.	Training.....	132
a.	Training Programs .....	132
b.	Training Technologies .....	133
J.	Advertising and Marketing .....	134
1.	Franchisor Advertising and Marketing .....	134
2.	Franchisee Advertising and Marketing.....	135
K.	Supply Programs for Franchisees and Restricting the Suppliers from Whom They May Buy.....	137
1.	Procurement Programs.....	137
2.	Supply Source Restrictions .....	138
3.	Buying Cooperatives.....	139
4.	Insurance.....	139
5.	Cost Reduction.....	140
L.	Field Service and Support.....	141
M.	Research and Development.....	144
N.	Financial Services and Guidance .....	145
1.	The Need for Financial Services.....	145
2.	Sources of Finance .....	146
3.	Franchisor-Lender Relationships .....	146
4.	Franchisor Credit Enhancement.....	147
5.	Small Business Administration (SBA) Loans.....	149
6.	Direct Franchisor Financing .....	150
7.	Other Types of Financing .....	151
8.	Financial Guidance .....	152

O.	Resale Programs.....	152
P.	Exploit Technology and the Internet.....	153
	1. Franchise Network Websites .....	153
	2. Single vs. Multiple Websites .....	154
	3. Business to Consumer Ecommerce Policies .....	155
	4. Intranets and Extranets.....	157
	5. Who Owns Electronic Databases.....	159
	6. Management Software .....	159
Q.	System Standards .....	162
	1. Formulating Standards.....	162
	2. Avoiding Causes of Noncompliance .....	163
	3. Inspections .....	165
	4. Enforcement.....	166
R.	Adapting to Change .....	167
	1. Resistance to Change .....	167
	2. Presentation of the Need for Change .....	167
	3. Opportunities Arising Out of Change.....	169
	4. Preparation for Change .....	169
	5. Change by the Franchisor .....	170
S.	Disclosure Regulation Compliance.....	171
T.	Audit Programs .....	172
	1. Purposes of an Audit Program .....	173
	2. Detecting Underreporting .....	174
	3. Audit Procedures.....	176
	4. Conducting an Audit.....	176
	5. Other uses of Audits.....	177
U.	Dispute Resolution.....	178
	1. Effective Dispute Resolution Procedures .....	178
	2. Preparation for Litigation.....	180
	a. Documentary Evidence .....	180
	b. Document Retrieval .....	181
	c. Monitoring Communications .....	182
	d. Arbitration and Other Litigation Considerations .....	182

## I. INTRODUCTION

### A. The Origins of Franchising

Franchising as we know it today is a relatively recent phenomenon. Although franchising has long been used by governments as a means of procuring public services, not until this century was franchising widely used by privately-owned businesses as a method of distribution and business expansion. In the private sector, franchising was used initially by manufacturers as a means of expanding the distribution of their products. Independent wholesalers and retailers then adopted franchising as a means of remaining competitive against chain stores. Business format franchising — the licensing of a trademark in conjunction with a prescribed business format and method of operation can be dated to the nineteenth century, but did not develop in earnest until the 1950's. Business format franchising accounts for most of the explosive growth in franchising that has occurred in the past five decades.

Franchising in its most fundamental sense, that of bestowing a valuable privilege, or "franchise," for a consideration, has probably been practiced since the beginning of civilization. A secular authority or ruler who had been vested with certain authority and powers found it practical to delegate some of those powers and to confer privileges on those who could provide needed services or money in return. Land rights might be granted to a person who could pledge the services of an army, or a person might be authorized to collect taxes in the name of the ruler, provided a certain portion of the revenues was remitted to the ruler.

The first example of franchising in the United States was probably the legislative grant of rights to privately owned businesses, which became public utilities, such as railroads and banks.

Even though the grant of these rights typically entailed some form of public control over the operation of these utilities, an exclusive right of exploitation provided an inducement for private businesses to make substantial capital expenditures to develop these utilities. In this way, franchising by the government provided a means for public utilities to be developed relatively quickly and without public funds.

Franchising by private businesses began when manufacturers granted exclusive distributorships. As early as the 1860's, Singer Sewing Machine Co. used franchised distributors to sell its goods throughout much of the United States. The McCormick harvesting Company began to utilize a similar distribution concept in the same time frame. Early in this century, automobile manufacturers began to establish franchised dealerships. Lacking the capital and the trained personnel to develop and operate a large number of company-operated retail outlets, these companies turned to franchising as a means of developing a network of retail outlets in a relatively short period of time. Somewhat later, around 1930, the oil companies followed suit and began to franchise gasoline service stations. Initially they had relied exclusively upon company operated outlets to sell their products, but within a short period of time franchised units were their primary method of distribution.

The soft drink industry also began to franchise around the turn of the century. A franchised bottler received a proprietary syrup or concentrate, or the right to produce syrup using a proprietary formula, together with the right to produce the soft drinks, identify them with the franchisor's trademark and distribute them in an exclusive area. The franchisor generally provided marketing and other support services, and required the bottler to produce the soft drinks in accordance with defined quality standards. Without franchising, it would have been difficult

for proprietary brands of soft drinks to achieve wide distribution. Soft drink bottling had developed as a localized business because the finished product could not be economically shipped over long distances, and because of the use of returnable bottles. These limitations on soft drink distribution did not apply to soft drink syrups and soft drink companies were able to increase the sales and name recognition of their products by selling syrups to bottlers and licensing them to produce the finished product. In doing so, however, they needed to maintain standardization and control over the quality of the soft drinks produced and distributed by their franchised bottlers. The franchised bottler's extensive role in production and sale of the soft drink product and the franchisor's control over the franchisee's production and distribution differentiated soft drink bottling franchises from typical product distribution franchises. The soft drink bottling franchise contained many of the elements of the modern business format franchise.

Although the early use of franchising was primarily by manufacturers, independent wholesalers and retailers soon found a use for franchising. Faced with the growth of corporate chains and other competitive factors, these independents found that franchising enabled them to compete more effectively. Around 1902, the seeds of the Rexall drug store franchise were planted when a group of independent druggists formed their own private label manufacturer. This cooperative arrangement made it possible for the druggists to decrease their product costs and increase their profit margins. As the cooperative flourished, it established its own chain of Rexall stores. After World War I, Rexall decided to franchise independent drugstores to use the Rexall name and sell private label products, finding it an easier and more profitable method of expansion. Other franchise networks established by independent wholesalers and retailers in the 1920's and 1930's were Western Auto, Ben Franklin and Super Value Stores. These and other wholesaler sponsored networks prospered, with franchised stores numbering in the thousands.

Thirty years after selling its first franchise, the Western Auto network had more than four thousand retail outlets in operation, while Ben Franklin stores totalled about twenty-four hundred by the early 1960's.

The oldest business format franchise network is believed to be the Harper Hairdressing Parlors, established by Martha Matilda Harper in 1891. Harper had been a domestic servant for many years. After she established her first Harper Hairdressing Parlor in Rochester, New York, she needed capital and motivated business operators to expand her new concept of hair and skin care for women to other cities. The business opportunity offered by Harper was designed to enable poor women, many of whom were former domestic servants, to become prosperous business owners. The Harper Hairdressing Parlor franchise offered comprehensive training and continuing guidance relating to the "Harper method." Training was conducted at the first Harper Parlor until a school was established in 1926. The training program used a textbook on the Harper philosophy and business operations. Candidates who successfully completed training were assigned a territory within which to establish a Harper Hairdressing Parlor. In addition to hair and skin care services, the parlors were retail outlets for various hair and skin care products that Harper manufactured.

Elements of modern franchise networks were utilized by the Harper network, e.g., conventions of Harper Parlor owners, regional associations of Harper owners and a network newsletter. By 1928, the worldwide total of Harper shops exceeded 500. The network continued until 1972, twenty-two years after the death of its founder, when its assets were acquired by a competitor. The Harper network was remarkable in its approach to training, guiding and supporting people without business experience or knowledge to become successful business

owners. It is ironic that these opportunities were made available to hundreds of women a century before women began to become major players in franchise networks as franchisees and franchising company executive officers, a subject that has received much press coverage in recent years. The principles of Martha Matilda Harper are at the core of modern business format franchising.

Franchising was introduced to the food service industry in the 1930's, when Howard Johnson established its first franchises. Johnson had successfully established two ice cream businesses and a restaurant, but lacked the capital to open additional restaurants. He agreed to help a former classmate design, furnish, and supervise a restaurant and to sell him ice cream and other supplies under a Howard Johnson's franchise. When the first franchise was successful, Johnson granted other franchises and opened additional restaurants of his own. By 1940, over 100 Howard Johnson's restaurants were in operation. Many of these were owned by franchisees who had no prior experience in the restaurant business. Through franchising, the restaurant owners obtained the benefit of the franchisor's expertise and guidance, and the opportunity to profit from a proven concept. In return, Howard Johnson's made a profit from the supplies it sold to its franchisees.

Until the 1980's, the utilization of franchising was significantly less in other countries than in the United States. In industries such as motor vehicles and gasoline, American companies and some companies based in other countries have utilized franchising type distribution relationships for many years, and American and some foreign companies that franchise travel related services (e.g., lodging and automobile rental) began to expand outside their domiciliary markets in the 1960's. The major growth of franchising outside the United

States and Canada, by both domestic and foreign franchisors, began in the 1980's. Cooperatives, which have certain attributes in common with franchising, have been extensively utilized in Scandinavian and other European countries for many years, but modern franchising is a relatively recent phenomenon outside the United States.

## **B. Modern Franchising.**

There are many definitions of a franchise. They all essentially describe a comprehensive relationship in which one party (the franchisor) grants to another party (the franchisee) the right to operate a business that sells products and/or services produced or developed by the franchisor, under the franchisor's business format and management system (also referred to as an "operating system") and identified by the franchisor's trademark. Franchising can also be thought of as a pooling of resources and capabilities. The Franchisor contributes the initial capital investment, development efforts, know-how and experience and the franchisee contributes the (usually far greater) supplemental capital investment, plus motivated effort, operating experience in a variety of markets and innovation. A modern franchise includes a format for the conduct of a business, a management system for operating the business and a shared trade identity. Franchising is a comprehensive business relationship, not just a buyer-seller relationship, and there is considerable interdependence between a franchisor and its franchisees.

Franchising is a business method and relationship, not an industry. Franchising is the predominant business relationship in many industries and business segments and is becoming more common in others. The industries and types of businesses utilizing franchising as a method of distribution are listed in the Franchise Opportunities Guide, published semi-annually by the International Franchise Association, 1501 K Street, N.W., Suite 350, Washington, DC 20005,

tel: (202) 628-8000 and fax: (202) 628-0812; website: [www.franchise.org](http://www.franchise.org) and e-mail: [ifa@franchise.org](mailto:ifa@franchise.org).

Although franchising became an established business relationship in the United States during the first half of the twentieth century, major growth in franchising occurred after World War II. Several factors made the post war period ripe for the rapid development of franchising. A booming economy and growing population created a rapidly increasing demand for goods and services, and an opportunity for enterprising businessmen to provide them. Returning servicemen had access to Veterans Administration loans to finance their business ventures. Franchising enabled these servicemen and others who were ambitious but inexperienced in business to start their own businesses with training and supervision from a franchisor. Businessmen who had innovative concepts or valuable business experience found that by franchising they could exploit their ideas and experience without the capital required for other methods of expansion.

An evolution in United States trademark law is also significant in the development of modern business format franchising. At common law, trademarks are an indicator of source. This concept made the licensing of a trademark by its owner to an unrelated person a questionable practice. Use by the licensee might not be deemed use by the owner and such use could not be relied upon to establish rights to a mark (and might even jeopardize ownership of the mark). A second concept of trademarks began to evolve in the 1930's: a mark could serve as an indicator of quality. A trademark that indicates quality could be used by its owner and others licensed by him, as long as the owner controlled the quality of the goods or services sold by licensees under the mark. This concept was codified in United States federal trademark law in

1946 (the Lanham Act) and is a fundamental legal basis for modern franchising. The recognition under United States trademark law of the service mark as a species of trademark that identifies a service, and has essentially equal status with a trademark that identifies goods, also facilitated modern business format franchising.

Convenience goods and services were the basis for many of the franchises established in the 1950's and 1960's. Fast food franchises, such as McDonald's and Kentucky Fried Chicken, proliferated during those years. Laundry and cleaning services and convenience grocery stores were among the other businesses that experienced significant growth through franchising during that period. Hotel and motel networks and travel and recreation businesses, such as campgrounds, catered to an increasingly mobile population. Holiday Inns, for example, developed a network of nearly fourteen hundred company and franchisee operated Inns in less than twenty years. Franchisors also responded to the needs of businesses and consumers by developing temporary help, employment, fast printing and tax preparation services, among others.

After two decades of explosive growth, outlets operated by franchisors and franchisees in the United States numbered over 400,000, generating sales of over 131 billion dollars during 1971. Ten years later, over 440,000 outlets accounted for nearly \$365 billion in annual sales. In 2003, there were more than 770,000 outlets operated by franchisors and their franchisees, with annual sales exceeding one and one-half trillion dollars. The number of product distribution franchise outlets (particularly gasoline stations and automobile dealerships) declined during this period as a result of consolidation and elimination of older, smaller or otherwise obsolete dealers and distributors (though they continue to represent a large share of the franchisor owned and

franchised outlets and franchise network sales) and the increase in the number of outlets of business format franchisor networks is thus more dramatic than indicated by the above totals. Franchise networks are estimated to account for approximately 40% of retail sales in the United States. Currently more than 10 million people earn their livelihood as employees of franchisees and franchisors and another 18 million people are employed in businesses that sell goods and services to franchise networks. Working in a franchised business (which typically offer many part-time jobs) is the first job for a high percentage of young people and franchised businesses have, as a result, assumed a significant role in job training of young people. At the other end of the age spectrum, senior citizens who desire to continue working on a part-time basis in order to supplement retirement income, or just to keep busy and interact with people, are increasingly finding employment in franchised businesses.

The proliferation of franchises in the United States has not occurred without problems. Some franchisors focused more on the sale of franchises than on selling goods and services to the public or on providing training and support systems to their franchisees. In some cases, franchisors made misrepresentations to franchisees about the franchise in which they were investing, or failed to provide important information. Franchisor and franchisee business failures attracted the attention of state and local authorities, who sought ways to prevent perceived abuses by some franchisors and to require the sellers of franchises to furnish pre-sale information to prospective franchise buyers that would enable them to make a more informed decision. In some cases, legislation was addressed to problems in a particular industry, such as the automobile industry and gasoline distribution. Such regulation addressed such problems as coercive practices of franchisors and the arbitrary termination of franchises. Many states passed legislation regulating pyramid sales plans, or the sale of certain kinds of business opportunities

and franchises. In 1978, the Federal Trade Commission adopted a rule requiring pre-sale disclosure of information to prospective franchise buyers and fifteen states have enacted similar regulation.

Today, the abuses once associated with franchising appear to be less prevalent. However, certain elements of the franchise relationship (e.g., network expansion conflicts with existing franchisees that do not have exclusive marketing territories and franchisor control of approved suppliers and use of that control as a profit center) continue to generate some tension in the franchise relationship and occasional litigation between franchisors and their franchisees. No federal regulation, and only one state law (Iowa), applicable to the franchise relationship generally (rather than the distribution relationships in a specific industry) has been adopted since 1980. However, it should be noted that the last two decades have been a politically conservative period and that the number of regulatory proposals introduced in state legislatures and Congress has not significantly diminished.

The growth of franchising outside the United States is rapidly accelerating. Scores of American franchising companies have successfully franchised in other countries and some are rapidly expanding their international franchising programs. In 1971, 156 American franchisors operated or franchised less than four thousand outlets in other countries. By 1981, 288 American franchisors operated or franchised more than twenty-one thousand outlets in other countries. Currently, several hundred franchisors based in the United States operate and franchise thousands of outlets in other countries. Canada, Europe, Japan, the Pacific Rim, Australia, Mexico, the Caribbean, South American and the Middle East are the principal markets of this expansion. China, India, Russia and Africa (which, collectively, contain one half of the world's

population), are currently the frontiers of franchising. If the legal and political climate in these countries and regions continues to become more friendly to business development, and to franchising, franchising will almost certainly continue to develop there. The number of franchisors of other countries franchising outside of their home countries is also growing rapidly. Canadian franchisors have expanded to the United States. Transnational franchising within the European Union is expanding rapidly and a growing number of European franchisors are eyeing the United States and Asian markets. International franchising appears to be on a fast growth track. Ever increasing numbers of franchisors are seeking franchisees in other countries and many individuals and companies are actively seeking to acquire franchises from franchisors of other countries.

The problems observed in franchising in the United States have been less prevalent in other countries, perhaps due in part to the slower growth of franchise networks outside the United States. Though government regulation of franchising was, until recently, less pervasive outside the United States, in recent years the number of foreign country laws regulating franchising has significantly increased.

## **C. Types of Franchise Relationships.**

### **1. Introduction.**

Franchising covers a broad spectrum of distribution relationships. Variations include whether the relationship primarily involves the sale of a product manufactured by or for the franchisor, the relative importance of the capital needed to establish the retail outlet, the significance of the franchisor's trademark, the complexity of the business, the level of services

needed by the franchisee, the capabilities of the franchisor to furnish services and the exclusivity of the relationship. Though the structure of franchise relationships varies from one industry to another (franchising relationships are used for the distribution of goods and services in more than 75 industries and business segments) and even within the same industry, a substantial number of structural elements are common to the great majority of franchises.

Some franchisors manufacture and sell products to franchised dealers for resale by the dealers (e.g., automobiles and petroleum products). In this type of franchise the structure of the relationship emphasizes product ordering, delivery, payment, financing dealer inventory and receivables, inventory, resale, warranty service and other matters related to the distribution of the franchisor's products.

The majority of franchisors fall into the business format category, which involves the license by the franchisor to the franchisee of a format for the development of a business, an operating system for the business and a trade identity under which the business will operate (e.g., food service and lodging). In a business format franchise network, the structural emphasis is on maintaining the specifications, standards and operating procedures that are essential to the establishment and operation of a business that reflects the franchisor's format, system and quality and service standards. However, elements of business format franchises are found in product distribution franchise relationships (e.g., showroom specifications in an automobile after market dealership franchise) and a business format franchisor may sell one or more products to its franchisees (e.g., an automobile after market service franchisor may sell parts to its franchisees).

There is a wide range of size, market power, experience and success found among franchising companies. At one extreme are the huge franchise networks that operate nationally

and internationally. These franchise networks have thousands of outlets, significant market shares, substantial financial resources, extensive operating and franchising experience, large advertising budgets and strong competitive positions (e.g., McDonald's, Kentucky Fried Chicken, Dunkin' Donuts, Taco Bell, Pizza Hut, Subway, Quizno's (food services), Holiday Inn, Marriott, Hyatt (lodging), Midas Muffler, Meineke (automobile after market service), Century 21, Re/Max (real estate brokerage), Service Master, Lawn Doctor (home services)). At the other extreme are hundreds of small companies, constituting a large majority of franchisors. These franchise networks have fewer than one hundred company owned and franchised outlets, insignificant market shares, generally have limited financial resources, less operating and franchising experience, fledgling advertising programs and relatively weak competitive positions. A large number of these companies are start-up franchisors, who may have only one or a few pilot operations and franchisees and very limited experience and financial resources. Between these extremes is a large group of franchisors that have grown beyond the start-up phase and are becoming stronger regional or national competitors.

The franchises granted by franchisors in these different groups are different in important respects. The stronger the franchisor the stronger its bargaining position vis-a-vis prospective franchisees. Large franchisors frequently offer franchises primarily to their existing, successful franchisees and maintain a waiting list of existing franchisees and others who are interested in acquiring a franchise that is transferred by an existing franchisee or newly issued by the franchisor. A person who is not already a franchisee of a large franchisor will find it relatively difficult to acquire a franchise from a company in this group of franchisors. The opportunities and relative bargaining position of the prospective franchisee improves as the franchisor's network size, geographic market exposure, experience and financial strength declines,

particularly when the franchisee must make a large investment to establish the franchised business or is negotiating to acquire a franchise in a geographic market that is relatively undeveloped by the franchisor. The prospective franchisee's relative bargaining strength is greatest with a start-up franchisor.

The largest franchisors generally offer a standard form franchise agreement and are unwilling to negotiate significant terms. They may offer no territorial protection or renewal rights (in practice, they do offer to renew a very high percentage of their expiring franchises). It is important to note, however, that in many large franchise networks, the franchises are owned primarily by large, experienced multi-outlet operators who, directly or indirectly (e.g., through a franchisee association that bargains with the franchisor), influence the terms of the standard franchise agreement. A prospective buyer of a franchise from a large franchisor is likely to have extensive experience with the network if it is an existing franchisee, or extensive opportunities to learn about the network from network franchisees, if it is not. Start-up and small franchisors also offer franchises pursuant to a standard form franchise agreement, but in contrast with large franchisors, will generally be willing to negotiate some of the terms of the agreement. As a franchisor matures, its network grows larger and achieves success and a level of financial security, it tends to be less willing to negotiate the terms of its franchise agreements.

Though there are no clear lines of demarcation, the level of risk to a prospective franchisee falls into three general categories corresponding to the size and competitive strength of the offering franchisor. From the perspective of the franchise buyer, a franchise offered by a large franchisor may be more attractive and involve a lower risk than a franchise offered by a start-up franchisor. The franchise offered by a large, well established franchisor has a proven

record of successful operations over a substantial time period in numerous markets. The trademark under which the franchisee will operate is well known and is generally enhanced by many points of distribution and a comprehensive advertising and marketing program. The franchisee will be able to rely on an established distribution network for the equipment, supplies and services it needs to operate the franchised business and on a well trained field staff to furnish assistance and guidance. Such franchise networks have developed comprehensive communications and information exchange capabilities linking the franchisor, its franchisees and suppliers, utilizing the internet. Perhaps most important, the large franchisor has survived competition with other franchised networks and integrated chains and this fact makes it more likely that it will continue to develop products, service, supply sources, operating systems and procedures, advertising and marketing programs and communication and information exchange that will enable it (and its franchisees) to remain competitive. The start up franchisor can offer few of these advantages, but may offer a franchise opportunity for a new product or service and at a lower cost. All large, well established franchisors began as start-ups, but relatively few start ups become large, multi-regional or national franchisors.

The risk associated with franchises offered by franchisors in the middle group usually diminishes as the network size, geographic market exposure, experience and financial strength of the franchisor increases. This inverse risk ratio applies when the franchise to be acquired is for a business to be operated in a geographic market that the franchisor has already effectively penetrated. If, however, the franchise is for a new geographic market for the franchisor, in which the franchisee will be a pioneer, the risk may be as high as the risk inherent in buying a franchise from a start-up franchisor; franchisors successful in one or more regions have failed in attempts to develop other regions.

## 2. **Product Franchises and Selective Distribution.**

Defining different categories of franchise relationships is a somewhat arbitrary exercise, involving generalizations. Nevertheless, certain generalized categories can be identified.

The product franchise is typically a distribution system for marketing goods manufactured by the franchisor, though the franchisor could also be, in part or entirely, a distributor of goods manufactured by others and sold under the trademark of the franchisor or the manufacturer. The fundamental distinctions between a product franchise and an ordinary supplier dealer relationship are greater identification of the franchised dealer with the franchisor's trademark, more extensive and comprehensive franchisor services to franchisees and exclusive or semi-exclusive franchisee marketing and service of the franchisor's product line. Instead of selling to a broad range of distributors and/or dealers, the franchisor sells its products exclusively or primarily to selected franchised distributors and/or dealers who deal exclusively or concentrate their marketing and service in such products (and frequently do not sell a competitive product). The franchised dealer may adopt the franchisor's trademark as its exclusive or principal trade identity. There is considerable interdependence between the franchisor and its franchised dealers.

Products requiring extensive presale or postsale service and possessing strong brand identity lend themselves to product franchise relationships. By franchising a limited number of dealers, and limiting or proscribing intrabrand competition (e.g., by granting each dealer an exclusive territory and prohibiting dealers from selling outside their territories), the franchisor-manufacturer assures each franchisee a sufficient market to induce the franchisee to furnish marketing and product service and thereby obtain market penetration. Achieving market

penetration is a key motivation for product franchising. Many franchisors can become effective interbrand competitors only by securing exclusive or semi-exclusive dealers. Automobile distribution is an example of product franchising (though the trend in recent years is for dealers to sell several brands, sometimes competitive brands, from the same or adjacent show rooms). Trucks, farm and construction equipment, gasoline, automotive products, alcoholic and nonalcoholic beverages, hearing aids and other products are distributed through dealer networks having characteristics of product franchising, sometimes termed selective distribution.

### 3. **Business Format Franchises.**

Business format franchising involves the license of a trademark, a format for the retail sale of products and/or services, a management system for the operation of the business and related know how. The business format franchisor typically manufactures no product, but may serve as a supplier of equipment, ingredients, packaging materials, computer software, promotional items or finished products used by the franchisee in performing a service. Business format franchisees typically perform services, but may sell and install a product in conjunction with such service (e.g., fast food restaurants, automotive after market product replacement services).

Business format franchises share certain characteristics with product franchises. The business format franchisee generally deals exclusively in the franchisor's sponsored services and typically is required to adopt the franchisor's trademark as its exclusive or predominant trade identity. There is also a similarity in the typical franchisor services, such as training, guidance and advertising. In some franchise systems the demarcation between product and business format is blurred. For example, in the Baskin-Robbins Ice Cream store network, ice cream and

yogurt are manufactured in accordance with Baskin-Robbins formulas and specifications by a limited number of regional dairies, sold to Baskin-Robbins and resold to franchisees. In addition to selling these and ancillary products, both in bulk and individual servings, the Baskin-Robbins franchisee performs services for its customers that are identified in the customer's mind with the Baskin-Robbins trademark.

Examples of business format franchising are found in food service, lodging, automobile after market maintenance (e.g., muffler and brake replacement, tune-up, oil change, cleaning and waxing), convenience stores, automobile and truck rental, business services (e.g., bookkeeping, accounting, temporary and permanent employment) and consumer services (e.g., home cleaning and repair, lawn care, day care, educational services, tax return preparation and real estate brokerage).

#### **4. Manufacturing Licenses.**

Companies sometimes license other companies to manufacture a product that is patented or produced by means of a patented process and/or proprietary know-how. Manufacturing licenses are common in international commerce. If the relationship also involves the licensee's sale of the product identified by the licensor's trademark, and involves ongoing consultation and support by the licensor, it contains the significant elements of a franchise relationship. The best known example of manufacturing license franchises in the United States are soft drink bottling franchises. The franchisor supplies a trade secret syrup and licenses bottlers to use that syrup to manufacture, package and distribute soft drink beverages sold under the franchisor's trademarks.

## 5. The Conversion Franchise

Conversion franchising may be considered a separate type of franchising because it involves the conversion of independent dealers or unaffiliated businesses to franchisees. Conversion franchising commenced with real estate broker franchise programs in the early 1970's and franchising programs have been attempted by the suppliers of a number of other services (e.g., insurance brokers, financial service businesses, painting and decorating, computer training, dry cleaning, used car dealers, home remodeling, accounting and bookkeeping). The conversion of a non-selective distribution system (i.e., the manufacturer initially sold to a wide variety of distributors or dealers) into a selective distribution system (i.e., sales are made only to franchised distributors or dealers that agree to deal exclusively or to concentrate their sales efforts in the manufacturer's products and to perform specified presale and post-sale services and marketing activities) is a conversion franchising program in the context of product franchising. It differs from conversion franchising in a business format franchise context primarily by the significant role of the franchisor as a supplier of products for resale by franchised dealers.

In a conversion franchise network, the franchisor gains the expertise of an experienced, established businessperson, and though the former independent business owner surrenders a degree of its independence, it gains a stronger trade identity and system of doing business, as well as training, advertising, marketing, purchasing, research and development and other services. Conversion franchising speeds expansion since there is little or no start-up time or expense. The franchisee usually must adopt the trademark of the franchisor as its principal trade identity, though the franchisee may retain its original trade name as a secondary trade identity. The franchisee agrees to conduct its business in accordance with the franchisor's specifications,

standards and operating procedures and to pay fees to the franchisor. Conversion franchisees may be more resistant to franchisor control than are traditional franchisees in the early phase of their relationship.

Independent business owners may also have defensive reasons for converting to franchisees; for example, the need to become part of a franchise network in order to compete with national service businesses that may be vertically integrated, or with other franchise networks. A franchise network may furnish to each franchisee access to types of products or services that it needs to complete with vertically integrated regional and national companies (e.g., a full range of underwriting services and products that a casualty insurance broker requires to be competitive with a national broker). Conversion franchising has been attempted in a wide variety of professional services. These programs have had mixed success, due to regulatory barriers and resistance of professional service providers to the restrictions inherent in a franchise relationship. The greatest success in the medical services field have been franchise networks that sell eye glasses and other eye care products.

## **6. Quasi Franchise Relationships.**

Franchisor-franchisee management contracts are quasi franchise relationships. The franchisee owns the physical assets of its outlet, but to the extent that the franchisee relies upon the franchisor's management of the business, the franchisee is in reality a passive investor. Certain hotel management relationships have attributes of franchising. The investor furnishes the capital to develop the hotel and the hotel operator furnishes a trade identity, its reservation system and development and management services. These relationships differ from franchisor-franchisee management arrangements in one fundamental respect. If the hotel management

agreement is terminated, the hotel operator's trade identity and reservation system is withdrawn. However, the franchisor's management agreement can terminate without termination of the franchise, leaving the franchisee in the position of a traditional franchisee.

Usually in response to deteriorating network performance, some franchisors have sought to renegotiate their franchise relationships to provide for substantial reduction or complete elimination of franchisor services and corresponding reduction in the franchisee's fee obligations. The network becomes, in essence, a series of trademark licenses with minimal service and quality control. The inadequate managerial and financial resources of the franchisor are likely to result in wide variations in format and quality among franchisees and erosion of the essential attributes and benefits of a franchise network.

## **7. Single Outlet and Area Franchises**

A franchise network consists of a franchisor (the grantor of the franchise) and one or more types of franchisees (the operator of the franchised business). Franchise relationships can be somewhat arbitrarily divided into two classes and several subclasses. The two primary classes are single outlet franchises and area franchises.

### **a. Single and Multiple Outlet Franchising**

A single outlet franchise is simply a franchise for a single business outlet or territory and is both historically and currently the most common form of franchise. The franchisee may acquire rights to establish additional franchised businesses, initially or over time, in the form of options or rights of first refusal, or merely as a reward for cooperation and successful operation of its initial franchise, and thereby become a multiple outlet franchisee. Usually, the franchises

for the several outlets operated by the multiple outlet franchisee were acquired at different times. Most franchise networks in the United States have relied primarily on the single outlet franchise relationship, though in many networks, as an ever increasing number of franchisees acquired their second, third, fourth or tenth franchise, the predominant profile of the typical franchisee has changed from a single outlet owner to a multiple outlet owner. The acquisition by franchisees of additional franchises from their franchisor over time is a compelling (though sometimes overlooked) endorsement of franchising. Expansion of a franchise network by the grant of single outlet franchises will result in slower growth in fewer markets, but it avoids potential risks of growing the network by means of one or more forms of area development franchising.

**b. Area Development Franchising**

The multiple outlet franchise may evolve from an individual franchise, as discussed above, or may be contemplated and documented at the inception of the relationship. In the latter case, known as area development franchising, the franchisor and franchisee typically enter into a development agreement that grants the franchisee the right (usually exclusive) to open two or more franchised businesses in an identified geographic area and prescribes the development responsibilities of the franchisee and a development schedule. The franchisee must generally own a controlling interest in each franchise, but is frequently permitted to have minority investors (e.g., equity owning managers or passive inventors) in individual franchised outlets. If the area developer fails to comply with its development schedule, it risks losing its development rights. Generally an area developer will pay a fee for the exclusive development rights in a geographic area. Typically, individual franchise agreements are entered into as each outlet is developed and a portion of the development fee is sometimes credited to the initial franchise fee

due under each such franchise agreement. In lieu of an area development agreement for the agreed territory, and a separate franchise agreement for each outlet, the area franchisee may sign a franchise agreement for the first outlet that grants to the franchisee rights to establish additional franchised outlets, prescribes a development schedule (or specifies when such rights expire) and documents each additional outlet by attaching a signed addendum to the original franchise agreement.

When the area developer has met its development quota, the area development agreement may be extended with a supplemental development schedule or simply terminate, in which case the operating outlets in the area developers territory will continue to be governed by their individual franchise agreements (possibly subject to the franchisor's option to buy them at fair market value or a pre-agreed formula price). For area development to be effective, the area developer must have financial and managerial capabilities to develop and operate multiple outlets. If area developers are carefully selected to have the right attitudes, motivation, financial resources and management abilities, the pace of growth can be quite rapid.

The advantages of area development franchising include the opportunity for rapid development and early attainment of critical mass and better market knowledge and impact in developing markets; enhanced cash flow from the fees generated by the sale of development rights; fewer franchisees to monitor and support; and declining service and support requirements as multiple outlet franchisees gain experience in developing and operating the franchised business. It is, of course, essential to carefully choose area developers and prudently structure territories and development schedules. The risks of area development franchising include the greater reliance on a smaller number of franchisees and potential difficulty in dealing with

financially stronger and more independent area developers. Some companies that utilized area development franchising in the early stages of their growth to enhance rapid development and market presence, repurchased area development rights and operating outlets when their networks matured.

c. **Subfranchising.**

Subfranchising involves a relationship in which the franchisor grants to a subfranchisor (sometimes called a "master franchisee") the right (usually exclusive) in an identified geographic area, to grant franchises (actually, subfranchises) to third parties. The subfranchisor typically will also have the right to operate franchised outlets that it owns directly or through a controlled affiliate. Some franchisors require their subfranchisors to operate one or more outlets for a specified time period before granting subfranchises. The right to grant subfranchises reduces the capital requirements of the subfranchisor, to the extent that its subfranchisees furnish the capital required to develop franchised businesses in its territory.

A subfranchisor ordinarily has the right and obligation to offer subfranchises (i.e., to sublicense the franchisor's system and trademarks); to collect initial franchise fees and continuing royalties and advertising contributions; to provide training, outlet opening and continuing support services to its subfranchisees; to monitor system standards compliance by subfranchisees; and to take remedial action to correct substandard appearance and operations. Like an area developer, a subfranchisor will be required to comply with a development schedule. Typically there is some division of responsibility between the franchisor and the subfranchisor with respect to services to subfranchisees, with the subfranchisor undertaking services that are regional or local in nature and the franchisor assuming the responsibility for those that are

national in scope, such as advertising and research and development. The subfranchisor typically remits to the franchisor a portion of the initial fee and continuing royalties and advertising contributions paid by subfranchisees.

A pure subfranchising system involves two distinct contractual relationships: one between the franchisor and the subfranchisor and a second between the subfranchisor and the subfranchisee. There is generally no direct contractual relationship between the franchisor and the subfranchisee, though the franchisor may reserve final approval of the subfranchisee and/or the location of its business. However, in some cases, subfranchise agreements are three party agreements, to which the franchisor is also a party.

Except in international franchise relationships, where it is the most commonly used form of franchise relationship, subfranchising is not widely used by American franchisors. Though subfranchising has been successfully utilized by franchisors in the United States, it is a business structure that has been vulnerable to problems when subfranchisors have been granted, or have acquired by default, excessive control over the operation of the franchisor's operating system in their respective territories. Subfranchising suffers from all of the disadvantages discussed above with respect to area development franchising generally and a few disadvantages that are unique to the subfranchising structure. Subfranchising has a significant potential for loss of control. By inserting another party between the franchisor and the franchisee, control can be diluted and policing the operations of the subfranchisor and its subfranchisees may add additional cost. A subfranchisor may be less concerned about system standards compliance as long as royalties are paid by its subfranchisees. Loss of franchisor control can result in significant variations in operations among different subfranchisor controlled territories. In addition, compliance with

disclosure regulation is more complex in a subfranchising structure. Because a subfranchisor is acting as a franchisor, it must also register under state franchise registration and disclosure laws and deliver complete and accurate offering circulars to prospective subfranchisees in compliance with federal and state law. The franchisor has potential liability for the subfranchisor's noncompliance with such laws. The insolvency or bankruptcy of a subfranchisor also can pose difficult problems for a franchisor that does not have a direct contractual relationship with subfranchisees.

**d. Area Representation.**

A hybrid of subfranchising that developed in the 1980's is usually referred to as "area representation". The area representative (or area director, as it is sometimes called) relationship is not per se a franchise relationship (except for disclosure regulation purposes). It is essentially an agreement to share functions, service obligations and fees. For a fee, the area representative is given the right to solicit prospective franchisees, and in most networks, to provide certain services to existing franchisees, in a defined, generally exclusive, territory. The area representative has no right to contract with franchisees and all franchise agreements are entered into directly between the franchisor and the franchisee. In essence, a franchisor is delegating some of its responsibilities to the area representative. For example, in addition to its franchisee solicitation activity, the area representative might share with the franchisor responsibility for site selection, training, outlet opening, franchisee assistance and systems standards compliance. The rights granted to an area representative will generally be subject to a development quota.

The economics of the arrangement are very similar to subfranchising, with the area representative receiving a share of the initial franchise fee paid by each franchisee established in

its territory and a share of the continuing royalties and fees (exclusive of advertising fees or contributions) paid by such franchisees. An area representative may be obligated to, or may elect to, own and operate one or more of the franchised businesses established in its territory.

The primary advantage of area representation over subfranchising is that the franchisor has a contractual relationship with and retains direct control over its franchisees. The termination of the relationship with an area representative usually will not result in a significant interruption of the franchisor's relationships with franchisees in the territory. However, a franchisor that utilizes area representatives does have some of the concerns of a franchisor that grants subfranchising rights. Great care must be taken in selecting area representatives, who have disclosure regulation compliance obligations and whose diligence and skill in selecting franchisees and proposed sites, and whose services and assistance to franchisees in connection with training, outlet opening, operations and system standards compliance, can be critical to the success of the franchise network in the area representative's territory.

#### **8. Area Franchising Considerations.**

With respect to all forms of area franchising, certain considerations are important in formulating the relationship. These include a precise definition of the area for which the franchise (or area representation rights) is granted, the nature of the exclusivity that the franchisee (or area representative) will enjoy therein and the conditions for maintaining development rights and exclusivity. A development schedule is essential to avoid underdevelopment of a territory, but it is important to prescribe a realistic schedule and to anticipate external forces that may delay development (e.g., difficulty in securing acceptable sites at an affordable cost). Consideration must also be given to the consequences of the

franchisee's failure to meet the development schedule. Will such failure result only in the loss of exclusivity or the loss of development rights in order to facilitate refranchising the territory? Instead of termination of development rights, consideration could be given to reducing the franchisee's exclusive territory. However, the franchisor should have the right to terminate development rights if the area franchisee's failure to comply with the development schedule persists. Though, in theory, a franchisor may have a claim for damages against an area franchisee that fails to fulfill its development obligations, such claims have not been successfully asserted.

All forms of area franchising reduce a franchisor's administrative burdens, as many of the franchisor's customary obligations are delegated to the area franchisee or representative. Development franchising will result in fewer franchisees, which may simplify the introduction of new concepts and other system modifications and may facilitate the reacquisition of franchised outlets through the purchase of an entire area from a single developer and retention of its management team. Area franchising attracts franchisees with greater financial resources and business experience and can facilitate rapid and self-sustaining growth of a franchise network. However, it also creates large, sophisticated area developers, subfranchisors or area representatives with vested interests that may not always coincide with those of the franchisor. Such area franchisees or representatives may seek to negotiate a greater range of issues both at the inception of the relationship and as it evolves, which may impede a quick response to changing market conditions. Area franchisees and representatives may demand a voice in the development and implementation of advertising and other franchisor services. An excessive shift of power to area franchisees or representatives can ultimately impede the growth and performance of a franchise network.

## **D. The Economic and Financial Relationships of Franchisors and Franchisees**

### **1. General Economic and Financial Characteristics of Franchising.**

As noted above, the franchisor may serve in multiple roles in a franchise network. As the licensor of a trade or service mark, and a format for conducting business, the franchisor furnishes the trade identity and basic business plan of the franchise. The franchisor also furnishes know-how, operating experience and problem solving guidance to its franchisees. The franchisor may be the supplier of the principal product line sold by the franchisee or of equipment, ingredients and supplies that the franchisee uses in producing products or performing services. Franchisors administer centralized advertising and marketing programs. The franchisor may be a direct or indirect source of financing to its franchisees or develop programs to assist them in securing financing. The franchisor will frequently serve as a product and market research and development resource for its franchisees and develop programs and format changes to enhance the competitive performance of its franchisees. The franchisor may actively assist franchisees in selling their franchise businesses and, not infrequently, will be the buyer.

The economic and financial characteristics of franchising vary widely depending on the type of franchise, the type of franchise system, the investment required in the franchisee's outlet, the type of product or service and other factors. In a product franchise relationship, the primary economic and financial characteristics relate to the sale of the franchisor's product line (and accessory products) to the franchisee, the prices charged to the franchisee and the terms of payment. Warranty service payments and cooperative advertising reimbursements to the franchised dealer may also be significant. If the product sold is expensive and customarily financed (e.g., automobiles) the franchisor will probably furnish consumer finance services. If

the product requires ongoing service and parts replacements, the franchisor is likely to be a supplier of parts. The product franchisor usually does not finance the development of the dealer's business facility, though many manufacturers offer floor plan financing and some (e.g., automobile manufacturers) have offered other financing programs to their dealers, including equity financing for the dealership.

The business format franchisor generally charges an initial fee for the grant of the franchise. This is usually a single fee, but it is sometimes broken down into separate fees for the franchise, training, site selection, lease review, outlet development and/or other services. The business format franchisee also generally pays a continuing fee. This fee is usually a percentage of gross sales or revenues (excluding sales taxes), but may be measured by unit sales, products purchased, other transactions or the franchisee's gross or net profit, or be a flat fee payable periodically and subject to inflation adjustment. Business format franchisees are also typically required to contribute to a franchisor administered advertising fund that pays the costs of creating advertising and marketing materials and developing and implementing advertising and marketing programs. The business format franchisor may also lease real property, offer financing and serve as a supplier to its franchisees.

## **2. The Franchisor as a Supplier of Intangibles and Services**

A franchisor supplies a variety of intangibles and services to its franchisees. The franchisor is a supplier of intellectual property, granting to its franchisees the right to use trademarks, trade dress, confidential information, a business format and a management system. The franchisor is a trainer of and an advisor to its franchisees. Generally, the franchisor furnishes marketing services to its franchisees by collecting and pooling contributions made by

its franchisees and administering a marketing program that develops advertising and marketing concepts and materials, implements marketing programs and conducts market research and public relations. Finally, a franchisor supplies research and development services to its franchisees, evaluates innovations by franchisees and implements throughout its network those determined to be beneficial, giving the entire network the benefit of significant innovations by any of its members.

### **3. The Franchisor as Supplier of Tangible Products**

Some franchisors supply equipment to their franchisees. Franchisors also sell finished products to their franchisees for resale (e.g., automobiles, computers, gasoline, and inventory carried by convenience stores) or supply components and ingredients that the franchisee uses to make a product and/or perform a service (e.g., food products and packaging for a food service business and parts for an automotive repair business). The franchisor may be the exclusive supplier of certain equipment and products or merely an approved supplier along with other suppliers from whom franchisees may purchase. A franchisor may be a supplier, or designate a limited number of approved suppliers entirely for quality control or trade secret protection purposes, or to establish a convenient, reliable and low cost supply source for its franchisees and franchisor owned outlets (charging only small mark-ups on goods sold to franchisees and relying on fees as its principal source of revenue). A franchisor also may structure its supply program as a significant profit center (in lieu of or in addition to fee revenue).

#### **4. The Franchisor as a Source of Capital**

Though probably only a minority of franchisors offer financing, or make arrangements for third party financing, to their franchisees, it has become more common in recent years for franchisors to be a direct or indirect source of capital for their franchisees. Financing may be provided directly, indirectly through general or limited guarantees or buy-back or resale arrangements with third party lenders or suppliers, by leasing a business facility to the franchisee or by other means. In some cases, the franchisor may be granted options or other rights to buy equity interests in the franchisee's business as part of the consideration for loans made to the franchisee. Franchisors that furnish financing to their franchisees rely relatively less on franchisees as a source of investment capital for network expansion and more on the franchisee as a highly motivated owner-manager.

#### **5. The Franchisor as Landlord**

In some franchise networks, the franchisor may be the franchisee's landlord, either leasing to the franchisee a site owned by the franchisor or subleasing to the franchisee a site to which the franchisor holds the prime lease. Generally, only mature and well capitalized franchisors are able to act as landlords to their franchisees and this relationship is most common in food service and in franchise networks that lease sites in regional malls (where the franchisor will usually be a more acceptable tenant).

#### **E. In What Ways Can Franchising Be a Superior Expansion Method?**

Franchising is essentially a method of distribution that combines some of the advantages of an integrated corporate network with those inherent in independently owned and operated

businesses. A franchisor does not have to acquire and deploy the capital, manpower or organization of a vertically integrated chain. The franchisor is able to obtain the benefits of franchisee financed growth, owner management and avoidance of the costs of centralized management. Moreover, the franchisor is at least partially insulated from the failure of an individual outlet. The benefits usually attributed to franchising as a method of business expansion fall into two general categories: (1) benefits relating to the capital investment furnished by franchisees to develop retail outlets and expand the franchisor's network and (2) the motivated management by franchisees of the businesses in which they have made substantial investments. Relatively low entry barriers have made franchising an attractive method of business expansion. A franchisor does not require large amounts of capital to develop and implement a franchise expansion program. These benefits are enhanced by the interdependence that exists in the franchise relationship. The franchisor relies on franchisees to expand its network and enhance its trademark and the franchisees rely on essential services and support from their franchisor to be competitive and operate profitably. Franchising also offers personal satisfaction benefits to an entrepreneur that conceives an idea for a business, develops that idea in one or more prototypes and then expands the business into a regional or national network of similar business operated by independent owners who are enabled to become successful business owners.

1. **Benefits Related To Capital Furnished By Franchisees**

- a. **Rapid Expansion Of The Franchise Network**

Franchising enables a company to establish a large number of business outlets in a relatively short time period. The capital and part of the work to locate and acquire sites and

develop outlets is supplied by the franchisee. Many industries in which franchise systems are prevalent are characterized by capital intensive retail outlets (e.g., food service, lodging and motor vehicle rental) and the role of the franchisee as a source of capital is an obviously significant element of the franchise relationship. The traditional method of financing utilized by franchisees is a combination of their own resources, money invested or loaned by family members or friends and capital extracted from the equity in the franchisee's home or other investments. Banks and other lending sources utilizing the Small Business Administration business loan guarantee programs have financed many thousands of franchised businesses (a source of capital that is not available to a vertically integrated chain of businesses). In most situations, a franchisor does not have the asset base or business experience to raise the amount of capital that will be furnished by its franchisees to expand the franchise network. Such a company might be able to raise additional capital periodically for expansion (as long as the great majority of its outlets are profitable), but its growth rate would be severely constrained. It is the unique opportunity offered by franchising, for an individual to own a business that is part of a network of similar businesses, that motivates such individuals to offer substantial amounts of capital for the expansion of a franchise network. If good locations for outlets are not abundant and are being sought by competitors, rapid expansion of a network enhances its chances of acquiring better locations and thereby acquiring market share and economies of scale at a faster rate. Rapid expansion builds consumer recognition and understanding of the product or service sold by the franchise network and creates recognition and value of the network trademark.

**b. Franchisees Share Risk Of Expansion Of The Franchise Network**

Franchisees furnish most of the capital required to expand the franchisor's network. The franchisee furnishes equity and borrowed capital to pay for real estate, leasehold improvements, equipment, fixtures, furnishings, inventory and working capital required to establish the franchisee's outlet. In addition, the franchisee pays the franchisor a fee for the grant of the franchise that is usually set at a level that will cover a substantial part of the franchisor's cost of site selection, franchisee selection, training and opening assistance. The franchisor's cost of expansion is usually limited to the overhead costs associated with site selection, franchisee recruitment, training and pre-opening assistance that are not covered by initial franchise fees. Continuing fees paid by franchisees cover a wide range of services furnished to franchisees, advertising and marketing programs (which enhance recognition and goodwill of the franchisor's trademark), product and service development and expansion of the franchisor's network. A franchising company is less vulnerable to cyclical fluctuations and outlet failures. Changes in fee revenue due to the fluctuation of sales of franchised outlets are significantly less than fluctuations of profits at franchisor-owned outlets. A failing franchisee has a lesser financial impact than a failing company-owned outlet.

**c. A Franchising Company Can Realize A Higher Return On Its Capital**

Because the investment in the development of outlets is typically made by franchisees, a franchisor is able to operate with few fixed assets other than the outlets that it owns. Therefore, though its revenue from franchised outlets (composed primarily of fees and product sales to franchisees) is substantially lower than it would be from owned outlets, a higher percentage of

the revenue is profit and that profit is generated with a much lower capital investment, resulting in a potentially very high rate of return on invested capital.

**d. Franchise Networks Can Realize Economies Achieved By Company-Owned Outlets Through Joint Procurement**

Franchisors typically develop supply programs for equipment, fixtures, furnishings, signs, supplies, insurance, marketing and advertising services required by their franchisees. Such programs can furnish to a franchise network the advantages of combined purchasing power enjoyed by a network of company-owned outlets.

**e. Reacquisition Of Franchised Businesses**

A successful regional or national franchisor is in a position to buy back franchisee-owned businesses to expand the number of franchisor-owned and operated businesses in the network. Most large franchise networks consist of both franchisor and franchisee-operated businesses. In some cases, the principle owner of the franchisee will join the management of the franchisor following the acquisition.

**2. Benefits Related To The Motivated Management Of Franchised Outlets**

**a. Franchisees are Motivated Owner-Managers**

In a franchise network, the business plan is executed by business owners, not employed managers. A franchisee has a direct and continuing financial interest in, and a commitment to, his business and is usually a motivated manager. The opportunity to become a business owner is perceived to be of great value to many people, in particular those who are tired of working for

companies in which advancement is slow and uncertain and those who have lost a job one or more times and do not find the prospects of finding a comparable job attractive. A franchise offers such persons the opportunity to become a business owner in a network of businesses operating under a common trade identity, with tested and successful (at least in a local or regional market) operating and marketing systems and training, continuing support, economies of joint procurement and the other services available to franchisees. Also attractive is the relative low cost and financeability of many franchised businesses. Successful franchisees have the opportunity to acquire additional franchises and a great many have done so, becoming relatively affluent business owners.

The intensity of franchisee owner-management reduces labor costs and results in other operational economies. Outlets that cannot be profitably operated as company-owned outlets (i.e., at a rate of return exceeding the company's cost of capital) may operate profitably under the owner-management of franchisees. Franchising makes it possible for the network to reach smaller markets because an owner-managed outlet can operate more efficiently than a company owned outlet, and a business with an owner-manager can be profitable with a smaller population base. A franchised business owner constitutes a higher level of representation of the franchised network in his market, generally having a greater involvement with customers and community.

**b. Franchisees Are Idea/Information Resources To A Franchisor**

A business owner generally has a higher level of motivation to innovate than a nonowner-manager. Franchisees are a productive source of new products, services, operating methods and marketing concepts. If a franchise network is structured to collect, evaluate and disseminate

throughout the network the operational experience and innovative ideas of franchisees, the franchisor and all franchisees will benefit.

**c. A Franchising Company Has A Simpler And More Efficient Management Structure**

A franchisor is an administrator and service provider, furnishing information and other services to its franchisees. The operating responsibilities of its management personnel are reduced and they are able to direct their attention and energies to long-term strategic planning. A franchisor needs fewer levels of management. Fewer field supervisors are required to assist and inspect franchisees than are required for company-owned outlets. A franchisor's revenue is usually based on the gross sales of its franchisees, which are easier to monitor than retail outlet profits. The problems associated with hiring, training, compensating, insuring, supervising and motivating employees, and related "paper work," are shifted to franchisees.

**d. Franchising Offers Opportunities For Employees To Acquire Franchises**

Franchisors can offer franchises to experienced employees and thereby reduce the "dead end job" syndrome and motivate employees that have reached their highest likely management level. The opportunity to acquire a franchise may prevent the loss of experienced managers to competitors. Experienced employees frequently make productive franchise owners. Some franchisors offer special incentives to their employees, such as credits toward the purchase of a franchise earned during employment, reduced initial franchise fees and financing of an employee's investment to develop his or her franchised business.

### 3. **Personal Satisfaction**

In addition to the significant benefits related to franchisee capital investment and motivated management, franchising offers benefits in the form of personal satisfaction that some network founders will derive from teaching and assisting others to successfully establish and operate a business that the network founder conceived and developed. Though not everyone will consider such benefits to be important, the founders of most franchise businesses that have successfully grown into regional and national networks would agree that there is great satisfaction in working with people who are building successful businesses and helping the franchisor become a successful company.

### 4. **Franchising From Perspective of the Franchisee.**

For many persons, due to lack of experience and limited financial resources, a franchise is the only realistic means to become a business owner. A franchise confers a variety of benefits and imposes certain costs and obligations upon the franchisee. The key economic issues are the probable value of the benefits of a given franchise and the relationship of that value to the costs the franchisee will incur. If the franchisor furnishes some or all of a strong trade identity and consumer good will; valuable know-how and experience; effective site selection; financing assistance; outlet development assistance; training and start-up support; procurement programs; advertising and marketing services; research and development; and continuing guidance and support, the value of the franchise is likely to exceed the costs that the franchisee will incur. If the franchisor's services are focused primarily on the opening of the franchisee's business, the franchisee may find that the costs associated with the franchise will, in the long run, exceed the value of its benefits.

The cost benefit analysis involves a good deal of prediction and projection into the future of past operating history of the franchisor. There are many potential events which may change the performance of the franchisor, causing the costs of the franchise to exceed its value. For example, the illness, death or retirement of the founder of the franchisor; the acquisition of the franchisor; or changes in its management personnel, that result in new operating philosophies, may change the way the franchisor relates to its franchisees. A franchisor may be acquired by a company that has goals and objectives that are not consistent with those of its franchisees. A franchisee casts his lot with the franchisor and thereby becomes dependant upon the effectiveness of the franchisor in becoming and remaining an effective competitor in its market, because the franchisee will probably be restricted by contract from owning or operating a competitive business outside of the franchise network and may be able to disaffiliate from the network only by selling his or her business at a loss. The prospective franchisee should anticipate the possibility that the franchisor will become less competitive, that the cost-benefit analysis of the franchise may change, and that expansion within the franchise network may be barred by unavailability of additional franchises or the expansion of other franchisees or franchisor owned outlets. In any of these situations, the prospective franchisee should also consider the extent to which obligations and restrictions of the franchise will preclude business activity outside the franchise network.

The issue of the trade off the franchisee makes to join a franchise network — surrendering a degree of independence in the operation of its business in exchange for the guidance, support and other benefits of being a network member — has been extensively discussed. A franchisee's degree of independence may be measured by the extent to which the franchisee may operate the franchised business according to his/her own wishes. Franchisee

independence is limited by the mandatory specifications, standards and operating procedures with which the franchisee agrees to comply. The notion that franchisees are independent business owners has been overemphasized. No business owner is totally independent and free of controls, since all businesses are subject to controls and limitations imposed by government, suppliers, creditors, employees and accounting rules. Successful franchising depends upon the maintenance of uniform specifications, standards and operating procedures in the operation of the franchisee's business to ensure a uniform image and uniform quality throughout the franchise network. Such requirements, however, tend to lessen the degree of independence of the franchisee. Nevertheless, the franchisee typically has considerable latitude in the operation of his/her business, and ultimately determines its success or failure.

**F. Significant Elements of a Business Format Franchise.**

The following is a discussion of the most significant elements of a business format relationship. These elements are found in and are important to most business format franchise relationships.

**1. Trademarks and Trade Dress**

An important element of each franchise is the license of a trademark or service mark by the franchisor to the franchisee. Not all words and symbols are protectable or registerable as trademarks. In the United States, trademarks become valuable by extensive use and promotion. If a trademark is a collection of letters with no meaning (e.g., EXXON, KODAK and XEROX), a generic word used for an unrelated product or service (APPLE for computers) or suggestive (but not descriptive) of a product or service (e.g., 7-ELEVEN for convenience stores,

MATERNALLY YOURS for maternity clothing stores and SNEAKER CIRCUS for retail shoe stores), it may be protected against infringements and registered on the Principal Register of the United States Patent and Trademark Office without proof of long-time or extensive use and thereby gain significant legal protection. On the other hand, if a term is descriptive of a product or service (e.g., BEEF & BREW for restaurants, HOLIDAY INN for motels), it must generally be widely used and promoted for several years in order to acquire "secondary meaning" (i.e., the consuming public learns to associate the trademark with a single source (a single company or a company and its licensees) rather than as a term merely describing a product or service. (United States trademark law contains a rebuttable presumption that secondary meaning is acquired after five years of continuous, substantially exclusive, use and promotion).

A trademark owner acquires "common law" rights in its mark in the geographic area in which it conducts business by virtue of its use, even if the mark is unregistered. However, prior to filing an application for a federal registration of a trademark, anyone else who in good faith (i.e., without knowledge of the prior user) uses the same or a confusingly similar trademark outside the geographic trading area of the first user may gain superior rights in the subsequent user's geographic market. Therefore, the owner of an unregistered trademark, and its licensees, may face one or more other users that possess superior rights to the trademark in potentially large geographic trading areas. An unregistered "common law" trademark is, therefore, significantly less valuable than a trademark that is registered on the Principal Register.

Registration of a trademark confers certain legal rights. It does not, however, create commercial value. Commercial value can only be established by substantial use and promotion over an extended period. Thus, well established franchisors that have operated businesses and

administered a franchised network using a trademark over many years establish commercially valuable trademarks. The McDonald's trademark is an example. McDonald's operates and franchises more than 25,000 restaurants in well over 100 countries. Its trademark has very high recognition in these countries (and in the geographic areas that McDonald's has not yet entered) and is a key element in the high value of the McDonald's franchise. A start-up franchisor that owns a mark that has not been extensively used prior to offering franchises usually does not have a commercially valuable trademark (even if it is registered on the Principal Register) and its franchise will have a correspondingly lower value. This lower value will be reflected in greater difficulty selling franchises and usually in lower fees. It is typical for a franchisor to gradually increase the royalties that its franchisees are required to pay as its network expands and its franchise gains value.

The operating systems of many Franchisors also include distinctive, nonfunctional elements that constitute proprietary trade dress. Trade dress can be comprised of color schemes, distinctive shapes, music composed for and owned by a franchisor, decor and display items and distinctive clothing. Typically, trade dress must be distinctive to be protectable. Distinctiveness can be acquired through extensive promotion and use so that consumers recognize the trade dress and associate it with one source. Trade dress also can be "inherently distinctive," a combination of elements that is so unique or unusual or unexpected that one can assume, without proof, that the elements will automatically be perceived by customers as indicia of origin. Though functional items are generally not protectable as proprietary trade dress, a distinctive arrangement of functional items has been accorded trade dress standing (e.g., a food preparation area situated behind a glass wall in full view of customers). Whether inherently distinctive or not, the scope and extent of use and promotion plays a role by creating secondary meaning

(where required) and by enhancing consumers' association of the trade dress to the franchised network. Therefore, the more well-known and distinctive the trade dress elements, the more legally protectable the trade dress and the greater value the trade dress will have as an element of a franchisor's operating system. Trade dress is generally less important and valuable than a trademark in attracting customers to a business, though highly distinctive trade dress can partially compensate for a weak and unknown trade mark.

## 2. **Business Format and Operating System**

In addition to a trademark, franchisors license to their franchisees a business format and operating system. As in the case of trademarks, the more established and successful the franchisor's format and system, the greater the value of the franchise. The operating system of a franchisor will frequently include elements and operating information that constitutes a trade secret of the franchisor. Many franchisors are careful to protect their trade secrets by obligating franchisees (and requiring franchisees to obligate their managerial employees) to maintain the confidentiality of such trade secret information (e.g., by signing confidentiality agreements) and prohibiting franchisees from owning an interest in or maintaining any relationship with a directly competing business during the term of the franchise and for one or two years following the expiration or termination of the franchise. Such restrictions may also apply to members of the franchisee's immediate family and other members of the franchisee's management. The failure to protect trade secrets from disclosure or use in a competing business will cause them to lose their status as trade secrets and become part of the public domain.

Only certain types of information will qualify as a trade secret. For example, recipes and formulas for food products, ingredients and methods of preparation may be protectable trade

secrets. However, the layout of a restaurant, the materials used to construct and decorate the premises, the type of seating, the method of ordering and paying for food products, the type of cash register used, the use of a drive-up window and a myriad of other details of the facility and its operations that are observable by persons who have lawful access to the facility (e.g., customers) cannot become trade secrets because they are not and cannot be secret.

A business format and operating system usually evolves over time as the franchisor gains experience, technological changes occur and competitive pressure forces a reevaluation of formats, operating systems, equipment, standards, products, services and operating procedures. All businesses evolve over time and franchised businesses are under continuous competitive pressure to improve their formats and operating systems. The entry barriers are low in many of the businesses in which franchising is the predominant form of distribution. Food service is an example of low barriers to entry. Dozens of companies emerge each year as food service franchisors. Some of these companies are established food service operators who have decided to expand by franchising. Others are new companies with one or two prototype food service facilities. Each presents at least the potential to be a competitive threat to established food service franchisors.

The most successful franchised networks are those in which the franchisor (frequently working effectively with its franchisees) has made a continuous effort to improve its business format and operating system. The greatest risk assumed by a person who acquires a franchise is that his or her franchisor will not make the investment and effort required to improve its format and operating system and, as a consequence, will fail in the future to be an effective competitor. The history of franchising is replete with examples of franchised networks that failed to continue

to be effective competitors in a highly competitive industry. This risk is greatest when the franchise is acquired from a new franchisor that does not have an established record of improving its format and operating system and maintaining a competitive position.

### **3. Site Selection and Business Facility Development**

Business format franchisors typically furnish services to their franchisees relating to the selection of the site for the franchisee's business and the development of the franchisee's business facility. These services range from furnishing site selection criteria, approval of a site selected by the franchisee and furnishing layouts or preliminary plans for facility development (minimum services), to developing a complete facility at a site selected and purchased or leased by the franchisor and selling or leasing that facility to the franchisee (maximum services). Between these extremes franchisors offer such services as assistance in site selection and purchase or lease negotiations, the preparation of plans and specifications for the franchisee's business facility, recommendation of contractors and supervision of development, including the purchase and installation of equipment and inventory and advertising and marketing relating to the opening of the franchisee's business. Effective site selection and the timely development of the franchisee's facility in conformance with the franchisor's standards and specifications are critical to the successful start of a franchisee's business. Site selection is a critical service in a location sensitive business, e.g., food service. Franchisor services relative to site selection and facility development are important and valuable to franchisees and are generally most highly developed in larger franchised networks.

#### **4. Advertising and Marketing**

Most business format franchisors undertake to perform advertising and marketing services for their franchisees. Such services are usually furnished in the form of a central advertising and marketing fund established and managed by the franchisor, to which franchisees contribute. Such funds develop advertising and marketing programs and materials, place media advertising, conduct market research and purchase public relations' services for the franchised network. The pooling of resources of franchisee and franchisor operated businesses to create and implement effective advertising and marketing programs is usually of critical importance to the success of a franchisor and its franchisees. Some franchised networks do not rely heavily on advertising (e.g., regional mall based retail stores pay high rents for the large crowds attracted to the malls and usually spend proportionately less on advertising). However, most retail businesses must advertise and market. Many industries in which franchising is a prominent form of business organization are highly competitive and are dependent on effective advertising and marketing. A significant feature of a successful franchised network is usually an advertising and marketing fund effectively managed by the franchisor, usually with input from an advisory committee or association of franchisees.

#### **5. Training**

The great majority of franchisors furnish training to each franchisee, and frequently to the managerial personnel of the franchisee's business. Training is usually a combination of classroom instruction and actual hands on experience in an operating business. The comprehensiveness and effectiveness of the initial training of franchisee personnel is generally believed to be critical to the successful development and operation of the franchisee's business.

A franchisee whose management is inadequately trained will open the franchised business without the knowledge to deal with a variety of start-up problems. The franchisee will be overly dependant on problem solving assistance from the franchisor, which may not have the resources to furnish timely help. New businesses frequently open at high volumes, with sales declining somewhat after the novelty of the new facility diminishes. An insufficiently trained franchisee (who must, in turn, train other employees) can result in the franchised business being overwhelmed by the high volume at opening, resulting in numerous operational errors, poor quality and permanently alienated customers. Inadequate initial training is a cause frequently attributed to franchisee failure. In the most successful franchised networks, the franchisor usually furnishes a comprehensive training program. Such training programs vary considerably in length and in their allocating of time between classroom study and on the job training. The shortest training programs are usually about two weeks and the longest up to several months.

## **6. Continuing Assistance and Guidance**

Substantially all franchisors furnish some degree of continuing assistance and guidance to their franchisees. Continuing assistance and guidance takes several forms, including:

- (1) a comprehensive operations manual that is periodically updated (operations manuals describe in detail the elements of the operation of the franchised business and frequently are contained in several loose leaf binders consisting of several hundred pages);

(2) periodic written and electronic communications that address developments in the franchised networks' industry, information regarding competitors and operational and marketing information relating to the franchised network;

(3) field visits by franchisor personnel, during which the franchisor's representative (a) observes the franchisee's business facility and operations, explains any deficiencies observed and formulates, with input from the franchisee, a time table for the correction of such deficiencies; (b) consults with the franchisee with respect to any operational or marketing problems that the franchisee is experiencing; (c) discusses with the franchisee any changes in the franchisor's format, operations or marketing that are under consideration or have been decided, including a time table for their implementation; (d) and discusses with the franchisee any other concerns or issues that the franchisee raises; and

(4) continuing communication by telephone (the great majority of franchising companies maintain toll free numbers that their franchisees may use), telecopy and electronic mail.

All forms of continuing assistance and guidance are highly important to franchisees. As noted above with respect to advertising and marketing, comprehensive and effective assistance and guidance is generally present in successful franchised networks.

## **7. System Standards**

Business format franchisors formulate specifications, standards and operating procedures relating to the development and operation of the franchised business (generally known as

"system standards"). System standards are usually contained in an operations manual that is made part of the franchise relationship and may be periodically modified by the franchisor. The more complex the franchised business, the more comprehensive will be the system standards that apply to its development and operation and the operations manual that codifies those system standards. System standards include the appearance and maintenance of the franchisee's business facility; authorized products and services; restrictions on sources of supply for equipment and supplies; employee qualifications, training and dress; operating hours; insurance requirements; use of trade marks; production, presentation, packaging and delivery of products and services; use of standard forms and accounting systems; signs and advertising; credit practices; and other elements of the franchised business.

Consistent enforcement of system standards is important to the success of a franchised network and the most successful franchisors almost always are diligent in correcting deficiencies in the appearance and operation of franchisee operated outlets. If a franchising company fails to consistently enforce standards, customer dissatisfaction with substandard outlets will carry over to the network generally, the franchise will lose value to complying franchisees (whose businesses are hurt by noncomplying franchisees tolerated by the franchisor) and the network's competitive position will decline. Franchisees thus have a strong interest in consistent enforcement of system standards and consider such enforcement an element of value in a franchise. System standards are enforced by means of inspections made by franchisor field personnel, who are usually accompanied by the franchisee during the inspection. Any deficiencies found are discussed with the franchisee. If the franchisee fails to correct deficiencies, it is in default and its franchise is subject to termination.

## 8. **Term, Renewal and Transfer**

Franchise agreements typically include provisions governing the term for which the franchise is granted; whether, and under what conditions, the franchise may be renewed or extended when its initial term expires; and whether, and under what conditions, the franchise is transferable by the franchisee. From the perspective of a franchisee, a long term, renewal rights and reasonable transfer rights make the franchise more valuable. As franchising has evolved, the concepts and practices relating to term, renewal and transfer of franchises have changed. The terms for which franchises are granted have lengthened, particularly for franchises that require a substantial investment by the franchisee. Large investments in facilities and equipment must be amortized over the initial term of the franchise (renewal is never assured and the franchisee is frequently prohibited by a covenant not to compete from operating the same type of business at the location of the franchised business after the initial term of the franchise has expired) and amortization charges would become prohibitive if investments of several hundred thousand to several million dollars had to be amortized over a relatively short term. Equally important, franchisees would be unable to secure long term financing of their investments without a long term franchise. Therefore, the terms for which franchises are granted have increased and 10-20 years has become the common range. Franchises requiring large investments are generally granted for a term of 15-20 years. A longer term is viewed as enhancing the value of a franchise to the franchisee and improves the marketability of the franchise.

The majority of franchisors grant some renewal rights. To qualify for renewal, a franchise must substantially comply with the terms and conditions of its franchise during the initial term and agree to upgrade its business facility to current standards (or relocate the

franchise to a new facility that meets current standards). The renewal of a franchise is usually accomplished by the franchisor and the franchisee signing the franchisor's then current form of franchise agreement. Renewal rights, even when subject to preconditions, enhance the value of a franchise to the franchisee and the marketability of the franchise.

The right to transfer a franchise is very important to the franchisee. A franchisee may desire for age, health or other reasons to sell his business and will want to be able to transfer the franchise under which it operates to the buyer. The franchisee's business is likely to have a greater going concern value if sold as a franchised business. Franchisors have not always granted transfer rights. However, as the significance of such rights became better understood, they have become a standard component of the franchise relationship. Transfer rights are not unrestricted. Franchise agreements typically place a number of restrictions on transfer, relating to the qualifications and character of the transferee and the terms of the transfer. Nevertheless, the right to transfer the franchise in conjunction with a sale by the franchisee of his or her business is a standard component of the franchise relationship and regarded as essential by franchisees.

In mature franchise networks the franchisor or other franchisees are frequently the logical and frequent buyers of franchised businesses sold by franchisees. The franchisor may be an active buyer (particularly of high revenue franchises) and/or may maintain a list of qualified franchisees (and nonfranchisees) who are seeking to acquire its franchises. Many franchisors assist their franchisees in other ways in selling their businesses. A transfer of a franchisee's business, in a way that minimizes the franchisee's losses, is frequently the most productive solution for a failing franchised business or the resolution of a dispute. An active secondary market for the franchises of a network can greatly enhance the value of such franchises.

## 9. **Other Significant Terms and Conditions**

There are other significant terms and conditions found in franchise agreements. These include the territorial protection to be granted to the franchise (i.e., restrictions on competition in the franchisee's trading area by the franchisor and its other franchisees) and territorial and customer restrictions on the franchisee (i.e., limitations on where and to whom the franchisee may advertise and/or sell); covenants not to compete applicable to the franchisee (and members of his or her immediate family and senior management of the franchised business) during the term of the franchise and subsequent to its expiration or termination; the conditions under which the franchise may be terminated by the franchisor and the franchisee; and dispute resolution procedures. Though these terms and conditions can affect the value of a franchise, the impact on the value of a franchise of such terms and conditions is less than the impact of the value of the franchisor's trademark and trade dress, business format and operating system, system standards, site selection and facility development services, advertising and marketing programs, training and continuing assistance and guidance, and the term for which the franchise is granted, the franchisee's renewal rights and the franchisee's right to transfer the franchise.

## 10. **Fees**

Virtually all business format franchise relationships involve the payment of fees by the franchisee to the franchisor. Such fees are usually in the form of an initial franchise fee that is intended to reimburse the franchisor for services furnished to the franchisee in connection with the establishment and opening of the franchised business, and a continuing fee (a "royalty" or a "royalty and service fee"). The continuing fees payable by a franchisee are the significant consideration paid by the franchisee for the rights granted and services furnished by the

franchisor . In a typical franchise relationship, the cumulative total of the continuing fees paid over the term of the franchise will greatly exceed the initial fee for the grant of the franchise.

Continuing fees are usually calculated as a percentage of the gross sales (exclusive of sales taxes) of the franchised business. Though the fees in business format franchise relationships vary, they usually do not exceed eight percent of gross revenue. For some franchises, the continuing fee may be considerably higher, due to the fact that it compensates the franchisor for additional services. For example, in temporary employment agency franchisees, it is common for the franchisor to act as the employer of all the temporary employees, to pay their wages each week and to bill the employers to whom the franchisee has sold temporary help services (who usually pay once a month). The franchisor is performing administrative and financing services for its franchisees and the continuing fee reflects these additional services. In other cases a continuing fee may combine the actual fee and an advertising and marketing contribution by the franchisee or the payment for other goods or services furnished by the franchisor.

In establishing the level of continuing fees, a franchisor takes into consideration both the amount of revenue it will require from each franchisee, in order to furnish essential services, expand its network and realize a profit, and the percentage of revenue that the franchisee can afford to pay. If a franchisee's business achieves sales substantially above the average for the network, its continuing fees will decline as a percentage of its operating profit (because the incremental sales will produce a higher operating profit, but the same percentage of continuing fees). Conversely, if a franchisee's business achieves sales substantially below average for the network, its continuing fees will consume a higher share of operating profit or eliminate profit.

The standard method of calculating fees thus places a franchisee at some risk that its continuing fee obligations will force it to operate an unprofitable business for some period.

Though other formulas for calculating continuing fees do exist (e.g., fixed periodic fees subject to adjustment for inflation; gross profit sharing formulas; fees based on the number of units of a product or service sold or purchased used by the franchisee), a fee denominated as a percentage of the gross revenues of the franchisee's business is by far the most common.

#### **G. A Comparison of Alternative Distribution Structures with Franchising.**

Franchising is certainly not the only method for expanding a business. Alternatives to franchising do exist and one or more alternative distribution structures may be more suitable than franchising for a particular company. A company planning expansion should investigate franchising merely as one of the available structures. In examining available expansion relationships, a company should keep in mind that franchising is a well developed business relationship. The growth of franchising since 1950 has been phenomenal and by every measure has been beneficial to the economies and societies in which this growth has occurred. The extensive development and growth of franchising is one of its strongest advantages; franchising is an increasingly well understood business relationship, which facilitates its utilization in the expansion of a distribution network.

It is also important to recognize that franchising relationships are quite varied, running the spectrum from simple trademark licenses with minimal supervision and assistance to comprehensive ongoing relationships with substantial franchisor assistance and service. Franchise networks also vary widely in the relative investment made by the franchisor and the

franchisee in the franchisee's retail outlet. At one extreme, the investment is made solely by the franchisee. At the other, the franchisor may furnish all assets other than inventory and share the gross operating profit with the franchisee (e.g., certain convenience store franchises). A company planning expansion must not only consider the alternatives to franchising, but also which of the variations of franchise relationships is most suitable to its type of business, objectives and human and capital resources. Though franchising offers some unique advantages over other methods, no company should decide to develop a franchise expansion program without first considering other methods. Several alternative distribution structures are discussed below.

#### **1. The Vertically Integrated Chain.**

A commonly suggested alternative to franchising is a vertically integrated chain of distribution outlets. On the assumption that a company can more effectively impose controls and standards on retail outlet managers than on independent franchisees, the vertically integrated chain may have an advantage over a franchised chain in terms of maintaining quality control. A related advantage is the speed with which the chain can react to changes in its market or in its costs of doing business requiring modifications in format, image, products, services, equipment, pricing or operating procedures. At least theoretically, vertical integration should facilitate implementation of the requisite modifications. There are no independent franchisees to convince (by persuasion or contract enforcement), merely employees to direct.

Proponents of franchising counter with the argument that not even employees can be merely directed to adhere to standards and procedures or to implement changes. Employees, like independent franchisees, must be persuaded that they will benefit from following directions, or

policies and standards will not be effectively implemented. The negative reinforcement of the threatened loss of employment is not a sufficient motivator, particularly in a dynamic market where innovation, change and readjustment are continuous processes. A store manager has less motivation to perceive and react to a changing market or competitive conditions and is less likely to conceive or advocate corrective strategies. A manager may make suggestions to his immediate supervisor, but is naturally reluctant to "go over the head" of his supervisor, who can terminate his employment or influence his future with the company. A franchisee has greater motivation to go to top management of his franchisor if he perceives market or competitive problems for his business that the franchisor can remedy or opportunities that the franchise network can exploit.

Proponents of franchising further contend that controls on franchisees can take several forms and, if reasonable and enforced, can effectively maintain the standards established by the franchisor for the franchisee's business and adjust to changes in the market for the franchise's product or service. The franchise agreement and operations manual typically prescribe mandatory specifications, standards and operating procedures relating to the franchisee's facility, equipment, signs, maintenance, decor, supplies, personnel (e.g., training, appearance, uniforms or type of dress); products and services offered; permitted sources of supply (e.g., specifications and designated or approved suppliers); bookkeeping, record keeping and reporting; business hours; and many other aspects of the franchisee's business. These specifications, standards and operating procedures ("system standards") are subject to change when required in the judgment of the franchisor. Failure to comply with one or more of such obligations, after notice, is generally sufficient legal grounds for termination of the franchise. Franchisors have other means

to motivate franchisee compliance, such as offering additional franchises, new product and service opportunities and renewal to those franchisees whose compliance record is good.

There are, of course, limits on the right of a franchisor to require franchisees to comply with modified system standards. If such modifications will require a substantial capital investment by the franchisee, materially increase its costs of operation or otherwise significantly impact on the profitability of its business, and the franchisee has not expressly agreed to such modifications in its franchise agreement, they may be legally or practically unenforceable. It is generally impractical to obtain advance agreement by franchisees to modifications involving substantial capital investments or impact on outlet profitability, because the types and scope of investments or operational charges that may be required are difficult to even estimate at the inception of the franchise relationship. However, courts have enforced franchisor requirements that the franchisee's business be open twenty four hours each day, based on the right to specify hours of operation reserved by the franchisor in the franchise agreement, despite proof by franchisees that they would incur operating losses during the extended hours.

Once convinced of the benefits of a given specification, standard, procedure or modification (generally by demonstration of its results in franchisor or other franchisee owned outlets), franchisees generally become supporters of the policy. In fact, franchisees are a fertile source of innovations in franchise networks. It is not infrequently the franchisor that must be convinced to change product, service, format, advertising, procedures, pricing, etc., by franchisees with a direct sense of market and competitive conditions.

The proponents of franchising further argue that there is no form of compensation that compares to the motivational effect of business ownership, with its income and estate building

potential if the business is successful — and its inherent risk of loss of invested capital (and other assets to the extent the franchisee has personally guaranteed loans and other obligations) if it is not. As an owner of its business, a franchisee will generally be more highly motivated than a nonowner-manager, notwithstanding any bonus system adopted by the company for compensation of managers. Of course, as franchisees themselves have become multiple outlet owners, this argument has been questioned. Does the franchisee who owns two or more outlets not encounter similar difficulties in motivating managers and supervisors? The motivational power of business ownership may be weaker in a network composed mainly of multiple outlet franchisees. However, even such franchisees are in much closer and more frequent contact with their businesses than would be a distant management in a vertically integrated chain.

As a device for raising capital, franchising – compared to the vertically integrated chain – is similarly the subject of both support and criticism. Proponents point out that franchise networks have attracted capital investment from a broad spectrum of individuals seeking ownership of their own business and that the aggregate of this investment far exceeds what could have been raised from traditional sources of equity and debt capital. For an illustration of the capital raising potential of franchising, consider a food service concept utilized by a company in a few successful outlets. Assume that this company has a net worth of \$500,000 and good earnings. The owners decide to expand to a two hundred outlet chain over a ten (10) year period. At an average investment of \$500,000 per outlet, the aggregate capital required for this expansion will be \$100,000,000. Only a small fraction of this sum could be generated by cash flow from existing and new outlets. Thus, even if the company could arrange to finance the balance of the capital it will require (which it most likely could not), the resulting equity dilution would be unacceptable.

Critics of franchising as a capital gathering device point out that capital raised, in effect, by selling ownership in retail outlets is, in the long run, more expensive than either debt or equity capital raised from traditional sources. The franchise network may expand faster than a vertically integrated chain, but it builds no asset base. Further, proponents of ownership argue that a franchise relationship necessarily involves relinquishment of an excessive portion of the retail outlet profits.

Both the proponents and critics of franchising make valid arguments. This is perhaps best demonstrated by the growth of dual distribution (a combination of franchisor owned and franchisee owned retail outlets) in franchise networks. Many franchise networks have from their inception expanded with a mix of owned and franchised outlets. Other networks have turned increasingly to owned outlets as they have matured and developed the financial capacity for a greater number of owned outlets, only to revert to greater franchisee ownership when outlet profit margins come under pressure and the need to operate more efficiently, with greater outlet manager incentives, or the need to raise cash (e.g., to pay down debt or continue expansion of the network) from the sale of company outlets, becomes more pressing. Dual distribution networks obviously have not found it impossible to motivate managers and supervisors (though the conventional wisdom is that company owned outlets are generally not managed as well as the best franchisee operated outlets). In an increasing number of dual distribution networks, an incentive to managers of franchisor owned outlets is the potential to acquire a franchise, some times at a reduced cost or on other favorable terms. The future availability of a franchise opportunity, possibly at a discounted cost and with financial assistance from the franchisor, can be a very positive motivator of outlet managers and other management personnel who face limited advancement opportunities in the company.

The franchise versus ownership debate frequently overlooks the fact that some businesses can operate successfully only with franchisee ownership (e.g., businesses with relatively low sales volume), whereas others can operate effectively with company and franchisee ownership. At least some managers can be motivated by means other than an ownership interest and can and do operate retail outlets as effectively as franchisees.

In an effort to achieve the advantages of vertical integration (i.e., greater control over retail operations, higher profits) and at least some of the advantages of the franchise relationship (i.e., owner management and capital investment at the outlet level) a few companies have developed hybrid systems. The common thread found in such relationships is minority ownership of the retail outlet by its manager. The remainder of the equity is owned by the network sponsor. Provisions for repurchase (at a formula price) of the manager's equity, upon his death, disability or termination of employment, are typical. In a variation of the concept, the retail outlet manager has the right to a share of the profits of the outlet he manages, but has no actual ownership in that outlet. The manager may be required to make a capital investment in the retail outlet, which may place the relationship in the joint venture category, discussed below. Under either approach, it is necessary to clearly define outlet "profit," including agreement on the charges that the company may make for various services performed for the outlet and the gross profit that the outlet will realize on goods bought from the franchisor. Because a manager does not typically control all of the elements (or even the key elements) of outlet profitability, it can be difficult to formulate manager profit sharing structures that are fair to both company and the manager and are sufficient to motivate high manager performance.

The franchise versus ownership debate will likely continue, but it is interesting to note that companies that have the means to expand entirely or predominantly with owned outlets are continuing to grant franchises (some are even increasing the percentage of franchised outlets). Some among these franchisors will readily admit that many of their most successful innovations have come from their franchisees. Thus, irrespective of whether ownership or franchising is the optimum method for raising capital, maintaining standards or motivating managers, a system that relies, at least in part, on franchising may have a better chance of being innovative, a critical capability in a rapidly changing market.

## 2. **Joint Ventures**

A business may also be expanded by developing joint venture relationships. Joint ventures may take the form of limited partnerships, general partnerships, limited liability companies or corporations. In one type of joint venture, the sponsoring company manages each outlet and the joint venture partner is a passive investor that contributes capital. Such relationships are found in the lodging industry. The hotel management company contributes know-how, development plans, its reservation system, its trademark and management services, and its joint venture partner(s) contributes capital to develop, equip, staff and operate the hotel. The hotel management company will generally receive a base fee and will share profits with its joint venture partner(s).

In a much less common form of joint venture, the sponsoring company acts as a passive investor, furnishing capital for outlet development, along with its joint venture partner, who has responsibility for the management of the outlet. This relationship differs from a company-owned outlet whose manager shares in profit or cash flow, because the joint venture manager has an

actual ownership interest in the outlet he manages, not just a compensation package that includes a share of profits. Automobile manufacturers have entered into relationships of this type with owners of automobile dealerships as a means of financing the dealership. The manufacturer and the dealer intend that the manufacturer's ownership interest in the dealership will be redeemed by the dealership out of its profits.

A variation of the joint venture is the combination franchise-management contract. The franchisor actually grants a franchise to an investor and simultaneously enters into a second agreement providing for management of the franchisee's business by the franchisor. Though significantly different in legal structure from a joint venture, it is similar in practical application to a joint venture in which the sponsor assumes responsibility for management of each retail outlet. Combination franchise-management arrangements may be subject to regulation under both franchise laws (as franchises) and securities laws (as investment contracts).

The joint venture business structure has been used mainly in the lodging industry and to a lesser extent in automobile distribution and food service. Outside these industries, there is little experience with the legal and practical problems that may develop in such relationships. Joint ventures are typically complex legal relationships and may involve negotiation, documentation and legal regulation at least as complicated as franchising relationships. For example, the legal problems associated with the expiration and termination of such relationships may prove even more troublesome than they have in franchise relationships. In franchise-management relationships, there are practical and legal problems in tying together a long term franchise and a customarily shorter term management contract. One is inclined to speculate that the absence of

more extensive utilization of joint ventures and franchise-management arrangements is evidence of their drawbacks.

### **3. Independent Dealerships**

Some companies can effectively expand their distribution network with nonexclusive, independent dealerships (or distributorships). Such dealerships may carry other products, including competitive products, and the network will not have the degree of interdependence found in a franchise network. This type of distribution network may be suitable for a manufacturer, particularly a producer of a relatively low cost product with minimum pre-sale and post-sale services, or a product that consumers are used to buying at a retail outlet that carries multiple brands of the same product (e.g., appliances, television sets, stereo equipment, furniture, kitchen utensils). For such products, a wide range of distribution outlets may be the best marketing strategy. Non-exclusive, independent dealers generally are not suitable for the distribution of a service.

### **4. Cooperatives.**

In some industries (e.g., the manufacture of bedding products, retail grocery and hardware stores) manufacturer and retailer owned cooperatives are common. Several major bedding product lines in the United States are manufactured by independently owned factories operating under patent and trademark licenses granted by a cooperative owned (in equal or unequal proportions) by its licensees. In one such cooperative network, the Sealy Mattress Company, after years of bitter litigation between a large member-licensee and the cooperative-licensor (relating to the cooperative's acquisition of other member licensees that the plaintiff

member-licensee also sought to buy and related territorial restrictions on where member licensees could establish factories and sell their trademarked bedding products), resulting in a substantial verdict for the licensee, the licensee purchased the cooperative and several of its remaining licensees and become a vertically integrated chain. Similarly, there are a number of large retailer owned grocery and hardware store cooperatives. The focus of a cooperative is usually the economies to be gained from combined purchases of goods and services and pooled advertising under a trademark owned by the cooperative and licensed to each member. Some cooperatives also furnish a variety of other services including financing the acquisition, expansion and remodeling of member outlets and product research and development. Cooperatives generally are formed by a group of participating retailers, though a sponsor might induce existing retailers and/or new investors to join a cooperative established by the sponsor, which enters into a management contract with the cooperative.

Cooperatives have some of the advantages of franchise networks (e.g., the acquisition of capital for the development or expansion of retail outlets), though they may not be able to police system standards as well as franchisors and generally do not furnish as much service. In certain franchise networks, the franchisees were established business owners when they elected to join the network. Real estate broker franchises are the best known example (e.g., Century 21, Re/Max and Coldwell Banker), but this type of franchising, known as conversion or affiliation franchising, has been utilized or attempted by insurance brokers, banks, savings and loan institutions, painters, used car dealers, accountants, home remodelers, repair services, medical professionals and other businesses. Cooperative systems might have been adopted by these businesses as a form of organization. There have been press reports of retailers of common

products or services forming cooperative associations for advertising and the purchase of goods and services. The extent and permanence of such cooperative associations is unclear.

The substantial increase in the incidence of franchisee associations and advisory counsels, and the expanded role of such franchisee organizations in the planning and operation of franchise networks, has somewhat narrowed the differences in the operations of franchise networks and cooperatives. Franchisees have no control over their franchisor by means of ownership, but in a growing number of franchise networks the franchisees are gaining considerable influence, with respect to both current operations (e.g., in advertising programs) and long term planning, through associations and advisory counsels.

## 5. **The Internet.**

Finally, the internet must be considered as a business model that is a potential alternative to franchising. The growth of the internet as (1) a source of all kinds of information and entertainment services, (2) a method for a wide variety of businesses to implement procurement programs that can improve the quality and reduce the cost of the goods and services purchased and, sometimes dramatically, the efficiency of the procurement process (so called B2B — business to business — e commerce) and (3) a method of selling directly to the consumer (B2C — business to consumer e commerce), is in a period of exponential growth. That growth will undoubtedly continue. Of the three principal elements of internet growth, B2C e commerce is the most uncertain. The number of people buying on line and the number of on line sellers to consumers is rapidly expanding. However, the business models that have developed in B2C e commerce have only recently demonstrated a clear cut profit potential. If the evolution of

these business models does demonstrate profitability, the internet will certainly become a viable method of business development and expansion for many goods and services.

In evaluating e commerce as an alternative distribution model, it is important to keep in mind a number of factors. Though a wide variety of products and services can be sold on the internet, a system for delivery and post-sale service must be established as an adjunct to such sales. The consumer must have a level of confidence that he or she can return a product, within the terms of the seller's return policy, and can secure reasonably convenient and affordable warranty and post-warranty service for the product. For many products, a traditional dealer or franchise network has supplied these functions. The explosive growth in mail order commerce facilitated by the growth in the use of credit cards, has amply demonstrated that for relatively small, moderate cost products, consumers are willing to buy without a dealer network for convenient return or service, relying on the mail or other shipping services to return products that they decide not to keep. Interestingly, many successful mail order companies have adopted e commerce as an adjunct to — but not a full substitute for — the periodic mailing of catalogs, but have also established chains of retail outlets. Franchisors are increasingly utilizing e commerce to augment marketing and sales, but not as a substitute for franchised outlets.

Many services can only be delivered at a specific location (e.g., lodging, food service and motor vehicle repair and service) or physically performed in the consumer's home or place of business (e.g., cleaning, repair and decorating services). Such services can be sold on the internet, but that method of selling does not eliminate the need for a delivery system. It seems likely that B2C internet commerce will, with respect to many products and services, develop as

an adjunct to more traditional systems for marketing and delivery, and will be a substitute for relatively few products and even fewer services.

## **II. SIGNIFICANT ELEMENTS OF THE FRANCHISE RELATIONSHIP**

### **A. Introduction**

This chapter discusses a wide range of subjects that bear on the development of franchise programs and management of franchise relationships. Other than starting with elements of successful franchising related to the development of a program to expand a distribution network through franchise relationships and the establishment of such relationships, the order in which these subjects is presented is not intended to imply relative importance. Though intelligent planning and testing before granting franchises, selecting high potential franchisees, effective training, furnishing valuable support services and maintaining effective communication are critical to successful franchising, each of the nine subject areas — elements — discussed in this chapter is significant to the expansion and management of a successful franchise network. Except for critical elements, the relative importance of these elements will vary from one network to another. Some of the elements discussed in this chapter are covered in greater detail, or from a different perspective, in other chapters of this book. This chapter largely reflects the author's views of these elements of the franchise relationship that contribute to — or impede — successful franchising. Subjectivity is inherent in analyzing a subject as complex and varied as franchising and though the views expressed have been widely endorsed by many franchising company managers and attorneys, and by franchisees, not every observer of the franchise relationship will agree with everything written in this chapter.

It will also be obvious that most franchising companies will take years to adapt and implement all of the elements outlined and many will never implement all of them. The author nevertheless believes that this chapter can serve as a useful road map for companies that range

from start-ups to mature companies developing franchise programs to mature franchise networks that are endeavoring to establish durable franchise relationships with high potential franchisees and effectively manage those relationships.

There is one other issue that readers should bear in mind as they review the elements of successful franchising discussed in this chapter. Several studies have suggested that the "failure" rate among franchisors is very high, as much as 75% over the ten year period after the company commences franchising (see e.g., Bates, T., 1995a Analysis of Survival Rates Among Franchise and Independent Small Business Start-ups. J. Small Bus. Manage. 33(26-36); Bates, T., 1995b Survival Rates Among Newcomers to Franchising. J. Bus Ventur. 13 (113-130); Shane, S., Spell, C., 1997 Enhancing New Franchisor Survival: A Model and Empirical Test. Society of Franchising Conference Proceedings. International Society of Franchising, Nova South Eastern University, Ft. Lauderdale, FL. USA). Though these studies do not definitively determine franchisor failure rates, observation over the past five decades does reveal that the rate is quite high. It is tempting to ascribe high franchisor mortality to a large number of ill conceived, poorly planned, executed and underfinanced efforts to develop franchise networks; undoubtedly these mistakes are a principal cause of high franchisor mortality. However, it should also be apparent that surviving the difficult start-up phase; the equally difficult growth to a network size that produces positive cash flow to the franchisor; and beyond that plateau to a network with positive and stable relationships, in which profitable franchisees are expanding, new franchisees are being added and new markets successfully entered, is far more difficult than might appear when looking at franchise networks today. A great deal of smart thinking and hard work has

gone into the franchise business over the last five decades. This chapter attempts to capture the knowledge and understanding that has been gained over that period.

## **B. The Decision To Expand By Franchising**

### **1. The Decision To Expand**

Most franchise networks do not begin with firm plans, or any thought at all, relating to franchising. Without regard to whether the business operates from a single location or several outlets, whether to expand, and if so, the method to use, frequently is a question generated by the success of the business after several years of operation. Whether to expand at all should, of course, precede consideration of method. Many businesses are not easily expanded into a network of outlets. Many entrepreneurs are not temperamentally suited to manage expansion and will be happier, and probably more successful, operating their original businesses or growing only to a second or third outlet in the same city. The determination of whether or not to expand can be considered the first step.

### **2. Expansion Methods**

Once the decision to expand is made, the different methods by which expansion can be accomplished will naturally be considered. One obvious method is the establishment of additional outlets patterned on the original business and financed with its net cash flow, debt, equity from friends and relatives or a combination of one or more of these sources. Expansion by this method is slow and may strain the management (see the Introduction to this book for a discussion of this method of expansion). A variation on this method would be the establishment of first ventures, either with passive investors (a financing device) or active operators to insure

that owner-operators will be responsible for the management of each outlet). Finally, the business owner will likely consider franchising.

The method chosen is likely to be influenced in part by the goals of the business owner. If the goal is a relatively small, local chain of outlets, expanding with company owned outlets, or possibly joint ventures with passive investors, probably is the most sensible method. If the goal is to build a regional or national, network of outlets, franchising is the logical choice. In many instances a decision is made to expand with both company owned outlets and franchisees, perhaps by establishing the original market as a company store territory with franchising reserved for other metropolitan areas. In order to develop in new markets, a few franchise networks have established company outlets in such markets and ultimately sold them to franchisees. In many larger franchise networks the ratio of company and franchisee operated outlets has fluctuated greatly during the past two decades, most recently tending toward a greater percentage of franchisee ownership. The selection of the method(s) of expansion can be considered step two.

The selection of franchising as an expansion method should be made subject to meeting the criteria, and the willingness of the owner to follow the guidelines, discussed in this chapter. The success of the company's brand will be determinative of the success of its expansion by franchising and developing and enhancing a successful brand in a franchise network is a complex and demanding endeavor. As will be discussed at length below, franchising is much more than selling franchises and opening outlets.

### **3. Sound Concept**

Franchising has been used extensively as a method of expanding businesses in 75 or more business classifications, and has therefore been an effective business relationship for a wide variety of businesses. This rapid growth of franchising in a wide, and ever increasing, variety of service and product businesses has influenced many would be franchisors to believe that franchising is a relatively simple business technique, readily applied to almost any business. As noted above, this is not a realistic view. To be ready to develop and implement a franchise expansion program that has a reasonable prospect for success (even survival), a business must meet certain criteria and its management must be prepared to follow certain guidelines. If the business has an operating history of several years and operates in more than a single location, these criteria already may have been met, at least to some degree.

The first criteria is a product or service for which there is an established and growing demand, or at least good potential to achieve such demand. A start-up franchisor with a sensational product or service concept is nevertheless at a disadvantage vis-à-vis established franchisors in attempting to sell franchises to high potential franchisees. If the demand for the company's product or service is not expanding relative to business generally, or is little different from the offerings of many other franchisors, its start-up handicap is increased.

It is also important for the company's business to have some degree of distinctiveness. The more unique or distinctive the business concept (subject, of course, to a proven demand for its products or services), the easier it is to attract franchisees and develop a market for the franchise network's goods and services. A copycat business will have difficulty attracting high

potential franchisees. The market for high capability franchisees is increasingly competitive. Different elements of a franchised business can make it distinctive: (1) its operating systems, (2) its products and/or services, (3) its delivery systems, (4) its trademarks and trade dress, including a unique feature or symbol that is easily remembered and can be prominently featured in advertising (e.g., McDonald's golden arches, the Remax red, white and blue hot air balloon), and (5) its marketing, including both regular advertising and marketing, sponsorships and public relations that generate publicity.

#### **4. Ready To Franchise**

##### **a. Prototypes**

When is a company ready to franchise? Fully tested prototypes of the business are essential. Prototypes test and refine the business concept, products/services and operating system that the franchisor will license to franchisees. They are the models of the business to be franchised. Prototypes should be tested in different types of markets and locations - and for a sufficient time period. The operation of one or more prototypes will afford the prospective franchisor the opportunity to test and refine: (1) designs, layouts, décor and signage; (2) products and services; (3) customer reactions and satisfaction; (4) equipment and fixtures; (5) training methods; (6) advertising and marketing; (7) job descriptions; (8) number of employees needed at different times; (9) required skill levels; (10) wage levels and benefits; and (11) other operating characteristics and costs. Problems will be identified and the prototypes can be modified to test proposed solutions. Such testing of the business concept and operating system in prototypes of the actual business will prepare the company for effective franchising. Using franchisees to debug a theoretical business model is a high risk approach to franchising.

The operation of prototypes also enables the business to develop the operating system standards (sometimes called “brand standards”) — the aggregate of the specifications, quality and other standards and operating procedures that will define the network brand and serve as the guide and the legal standards for the franchise relationship. System standards, of course, are not static, and will continue to evolve as the network expands. Nevertheless, it is essential to have the basics of the operating system and standards developed and understood before franchise expansion is launched.

Before implementing a franchising program, a company should evaluate what the pilot operations, have shown about the business. Will the products or services satisfy current and probable future consumer needs, be readily adapted to other areas of the country and be salable at projected price levels? Does the business have a significant incidence of repeat customers? Are there proprietary elements of the operating system that cannot be easily duplicated? Can the operating system be effectively communicated in an operations manual? Can managerial and other employees quickly and effectively learn the operating system of the business? Can the operating system and standards be readily teachable to — and implemented by — persons of varying education, ability and experience? Is the design of the outlet significantly flexible to be scaled up or down, or otherwise modified, to fit into the variety of sites that are likely to be available? Are there major financial or operational problems to resolve? And perhaps most importantly, does the business operate profitably and is the return on investment satisfactory? If a company has operated for several years in multiple locations, these outlets will be its prototypes. However, if expansion with franchisees will include difficult types of markets or facilities, additional prototypes may be desirable to test those markets and facilities.

**b. Financial Criteria**

To be effectively franchised, a business must be capable of producing a reasonable return on the franchisee's investment — after deducting the value of the franchisee's labor. In other words, a reasonable return on the franchisee's invested capital. The profit potential of the business must appeal to high caliber franchise buyers and compare favorably with other franchises. The business must also be able to generate sufficient revenue to the franchisor to support essential franchisor services and generate a sufficient return on the franchisor's investment in franchising.

A business cannot be successfully expanded by franchising if it has any major operational or financial deficiencies. This does not mean that a business outlet cannot be more profitably operated by a franchisee. Franchisee owned outlets frequently, though by no means uniformly, have higher revenue and profit and better system standards compliance than franchisor operated outlets. An owner-manager has greater motivation and incentive than an employee to make the business successful. Thus, a business with multiple retail outlets, some or all of which are underperforming, or even struggling financially, could convert those outlets to franchisee ownership and realize an improvement in their operations and financial performance. However, owner management will not overcome a fundamental operational defect or financial deficiency.

**c. Business Plan**

A business plan is the design for the business model and the expansion of the business. It has been accurately observed that a design is the first signal of human intentions. This proposition applies equally to architectural designs and plans for a business and its expansion.

An individual or company management that is developing a franchise expansion business plan should keep in mind that the plan will reflect, and signal, the intentions of the individual or company with respect to the many elements of a franchise relationship. The plan can reflect the intention to develop a network of franchise outlets as fast as franchises can be sold, at any available locations, without regard to the qualifications of the franchisees, the viability of the locations or the long-term success of either. The only real criteria is rapid expansion and positioning the company to sell its business in one form or another, an exit strategy for the individual or company owners and managers. Alternatively, the plan can signal the intention to develop a sound business model and expand the franchise network with high potential franchisees, at high potential locations and at a rate and in geographic locations that can be effectively managed. This book assumes that the individual or company management will adopt the latter type of plan, signaling the intention to develop a first rate franchise network. The author hopes that this book will be of value to such individual or company; it will not be of such value to the individual or company whose primary focus is on its exit strategy rather than the franchises it grants and the franchise relationships it develops.

A company considering franchising as its expansion method needs a business plan. A sensible business plan for a would be franchisor includes actually testing prototypes of the business that franchisees will be required to operate. The very fact that a franchisor proposes to develop a business concept and format that will be implemented by independent contractors requires that its business plan be carefully developed and thoroughly tested before it is implemented. A company that develops a business plan that will be implemented by its own personnel will have opportunities to adjust elements of that plan as it is executed. Though a

franchisor can make adjustments as its business concept and format is expanded (franchisors invariably do make such adjustments), if its basic plan has not been well structured and sufficiently tested, making significant adjustments, which typically will require the cooperation of franchisees and additional capital investment, will be difficult at best and may result in confrontation with franchisees (e.g., demands for fee reductions). One element of a business plan for franchise expansion that is sometimes overlooked is the need for the company to transition from an operating company to a franchising company. This transition is not always readily accomplished and can strain the relationships with the initial franchisees of the network. Recognizing the differences and planning to develop management properly attuned to dealing with independent business owners attempting to implement the company's operating plan can avoid frustration with franchising as the company's franchise network expands. No business plan can be foolproof, but a franchisor needs to come fairly close to that standard to avoid problems that can easily cripple its expansion through franchising.

#### **d. Sufficient Capital**

To develop and implement a franchising program, a company needs sufficient capital. Both a franchisor and its franchisees contribute capital to an expanding franchise network. The franchisor contributes the capital to develop, test and refine the business concept and operating system that the franchisor licenses. Franchisees contribute some of the capital (frequently, most of the capital) that is used to develop and grow the network. A franchisor needs capital for many essential elements of developing a franchise network: (1) operating system; (2) products and services; (3) trade identity; (4) prototypes; (5) professional fees; (6) experienced personnel; (7) marketing and advertising; (8) regulatory compliance; (9) franchise sales; and (10) assisting

franchisees. A company that does not have sufficient capital, exclusive of initial franchise fees, to develop and implement its franchise programs, will be dependent on franchisees for that capital. Such dependence leads to granting franchises to low potential franchisees, which can significantly, often fatally, hamper the growth and success of the franchise network. Following a period of relatively easy access to debt financing for franchisees, this source of capital has become more difficult to secure. The franchisees of an undercapitalized franchisor will find it considerably more difficult to secure financing and such a franchisor will be unable to offer the assistance and credit enhancements to its franchisees discussed below.

**e. Capable Management**

Expansion by franchising requires experienced management personnel. Franchisor management must have real skills in franchise network management to recruit, train, communicate with and support franchisees. Required experience and skills span a wide range of functions: (1) franchise sales; (2) franchisee training; (3) site selection and outlet development; (4) start up assistance to franchisees; (5) legal compliance; (6) monitoring franchisee compliance with system standards; (7) continuing operational assistance to franchisees; (8) communications with franchisees; (9) network and franchisee advertising and marketing; and (10) developing and implementing technology for the franchise network. At the commencement of its expansion, a typical franchisor will generally have limited management and most managers will perform two or more functions. As the network expands the franchisor's management will become more specialized, growing both by promotion from within and hiring experienced franchise company managers from other companies. The relative importance of different specialties and skills will change as the network grows. The entrepreneur who made the decision to expand by franchising

and guided the early expansion (probably knowing each franchisee and his or her family on a personal level) may not be the appropriate CEO when the network has expanded to a regional or multi-regional level. There is usually a meaningful role for the founder long after considerable growth has occurred, but that role frequently is not as the manager in charge of operational and financial decisions. Franchise networks outgrow other managers as well. The existence of a large group of skilled managers with extensive franchise network experience facilitates the addition of new managers as a network grows.

**C. Grow The Franchise Network With The Right People, In The Right Places  
And At A Manageable Rate**

**1. Selecting High Potential Franchisees**

The greatest obstacle to growing a franchise network successfully is finding and recruiting the right franchisees. The capabilities, resources and attitudes of the franchisees of a network will have an enormous influence on the network success. The best concept, operating system, site selection and marketing will not result in a successful franchise business and network if franchises are granted to the wrong people. In contrast, high potential franchisees can overcome deficiencies in the franchise business and the locations of franchised outlets. The most productive and successful franchisees are far more valuable to a franchisor and its network than average franchisees in terms of revenue and outlet growth, fewer problems, lower operating costs and brand enhancement.

Recruiting franchisees that have a high potential to become multi-unit owners is a key strategy for expanding a franchise network. A recent survey by the International Franchise Association Educational Foundation on multi-unit franchise owners involved a survey sent to

830 franchisors, resulting in 145 responses (17.9%). 80.1% of the franchisees of these franchisors were single unit owners and 19.8% were multi-unit owners (averaging 4.5 units). Significantly, the multi-unit franchisees owned 52.6% of all franchised units in the responding franchise networks. In addition to being a powerful statement about franchising as a business model and relationship, these statistics are a road map for the expansion of a franchise network.

Many franchise networks have expanded because their franchisees had the skills and work ethic to become multi-unit owners. The Restaurant Franchise Monitor's 2003 annual survey of the largest 200 food service franchisees reports that this group of franchisees operated 16,223 units, had gross revenues of \$17 billion and ranged from \$20 million to \$750 million in annual revenue. Many of these food service franchisees operate large numbers of outlets of one or two franchise networks. Such multiple outlet ownership and management by a single franchisee organization is a powerful engine for network expansion, results in faster growth of the network, enhances the capital formation in the network and probably reduces franchise turnover rates and expansion risk. However, the development of multi-unit franchisees, controlling large numbers of franchise outlets, can result in substandard operations that are more difficult for the franchisor to monitor and control and a greater dependency on a small number of franchisees, whose financial or operational problems can have a far greater impact on the franchise network than comparable problems of franchisees operating one or two outlets.

The restructuring of management by corporate America, and significant improvement in technology and communication have eliminated, probably permanently, hundreds of thousands of middle management jobs. In addition, many people have decided that they do not want to work in the conditions of job insecurity, declining compensation in a new job, frequent relocation and other aspects of corporate life. This has greatly expanded the pool of potential

franchised business owners with the people who have lost these jobs, or might have sought them. Within this pool of prospective franchise owners are large numbers of people who have the talent and work ethic to become successful, multiunit owners of franchised businesses. Thus, the pool of prospective franchisees has not only become larger, it has improved in terms of skill sets and other characteristics. This is a significant benefit to expanding franchise networks, but it does not lessen the need for careful selection of franchisees.

**a. Core Values And Other Characteristics**

Though no selection criteria will be 100% predictive, and franchisors emphasize different characteristics of successful franchisees, there is general agreement on the importance of the franchisee's core values (sometimes termed "character"). A very important core value is a positive attitude toward employees (viewing employees as an asset rather than as a cost, a willingness to treat employees with respect, a willingness to invest resources and effort in the training and mentoring of employees and the leadership qualities to build an organization to operate the franchise business). A franchisee who takes a participative approach — as opposed to an autocratic approach — to managing employees will have a happier, more productive staff and lower employee turnover. A more satisfied staff reduces training costs for replacement employees and improves customer relations. Leonard Roberts, then the CEO of Radio Shack, observed that "before a store can be a great place to shop, or a restaurant a great place to eat, it must be a great place to work. And franchisees dictate that culture."

Other core values that franchisors have identified include positive responsiveness to customers — even unreasonable customers; the motivation to be successful (people who believe they can and will be successful, and have positive attitudes toward life and business, tend to be

successful; people with negative attitudes look for excuses for failure, do not accept responsibility and will usually blame the franchisor); a strong work ethic (managing a business is hard work and can require long hours for many years); the ability to work independently, with a mindset of “how can I make this business perform better;” receptivity to new ideas relating to marketing, selling and operations; a willingness to share ideas and work cooperatively with others (e.g., the employees, suppliers, the franchisor, other franchisees); sociability (the ability to work interactively and effectively with large numbers and different types of people (employees, customers, suppliers, the franchisor’s management personnel and other franchisees) in a variety of situations — an attitude toward working with people that will bring out the best qualities and efforts of those people); a willingness to become involved in the community (which can be helpful in building a customer base). In general, the success of franchisees will depend upon and correlate well with the character of the relationships they establish and maintain with their customers, employees, suppliers, fellow franchisees and the franchisor.

Other characteristics cited by franchisors as correlating with the successful operation of a franchise business are the franchisee’s willingness to execute the franchisor’s operating system; a positive attitude regarding the franchisor’s business and the franchise network; and success in prior business, professional or other endeavors (success in life generally). Some franchisors attempt to recruit persons with a specific business background (e.g., experience in a business that requires good customer relations skills) or with specific skill (e.g., a relaxed and comfortable attitude toward selling — a view of selling as a positive and rewarding part of the business that will be conducted on a daily basis, an opportunity to meet and help new customers, not just a necessary evil of franchise ownership to be avoided whenever possible).

Selecting the right people to be a company's franchisees is particularly important when the franchisor grants territorial franchises that convey the rights to establish multiple franchise outlets. Some franchisors believe that this type of franchisee will result in much faster network expansion and development in a greater number of markets. However, such franchisors will be more dependent on a small number of franchisees and each such franchisee can be the source of greater damage to the brand and the network. Some franchisors have expanded their networks effectively by granting single unit franchises, with a significant number of such franchisees proving their capabilities and ultimately developing into multi-unit operators. There is no right answer to the question of which type of franchisee to seek, but a full understanding of the potential risks and rewards of each approach is essential for intelligent planning and design of the franchisee profile for a network.

**b. Recruit High Potential Franchisees**

A franchisor should make the effort to recruit franchisees with the highest potential. Many individuals are not appropriate to be a franchisee of a specific franchise network (or any franchise network). Selecting prospects that match well with the franchised business results in successful, motivated, productive and happy franchisees. A franchisor should endeavor to match a prospective franchisee's interests, operational ability and financial resources with the requirements of the franchised business. Granting franchises to the wrong people is probably the most common mistake made by new franchisors. Franchise sales are difficult to pass up, but a franchisor can do so secure in knowledge that the lost revenue and expansion opportunity is small compared to the cost of a wrong person. Expansion with the wrong franchisees is a road to failure.

A franchisor should develop and adhere to a profile of a high potential franchisee. This profile should focus on the characteristics that are important to successful operation of the franchise business and be realistic in terms of the candidates likely to be attracted to the network. This profile will include a variety of criteria, such as financial resources (undercapitalized, overleveraged franchisees have a high failure rate); personality traits; motivation; education; experience; human relations skills; general skill sets; a positive attitude about selling; success in a prior business and other endeavors (has the candidate maintained long term business or professional relationships or moved frequently from one relationship to another); goals; a demonstrated interest in the franchised business (will the candidate be likely to maintain a long term relationship with the franchise network and acquire additional franchises — or suffer from “burn-out” early in the relationship); and an understanding of a franchise relationship (e.g., the need to operate in compliance with system standards). Different franchise businesses will have different skill requirements. Written and spoken fluency and good comprehension in English will generally be essential for a franchisee to learn the operating system and standards and communicate effectively with customers, employees, suppliers and the franchisor. Some businesses require above average math skills.

### **c. Evaluating Prospective Franchisees**

Franchisors can use effective tools to assist in franchisee selection and a variety of selection tools are available for evaluating prospective franchisees. Such tools include structured, behavior oriented interviews that require the candidate to state how he or she would react to and resolve hypothetical situations — tests of core values. Some franchisors use psychological and personality testing techniques to assist in franchisee selection. A variety of tests are available for prospective franchisees. Such tests are designed to determine various

characteristics of a prospect and relate those characteristics to the franchised business. Some franchisors believe that personality tests may not be as effective as interactive interviews and protocols designed to test real world reactions and problem solving skills. Personality traits vary widely among successful people, but core values are common to such people.

**d. Do Not Mislead Prospective Franchisees**

Franchisors seek accurate and complete information about a prospective franchisee and will be quickly turned off by a candidate whose veracity is in question. It is equally important for a Franchisor to furnish accurate and complete information about the company and its franchise business to a prospective franchisee. Franchise buyers are much more sophisticated than they were in the past and they have much more information available to them. Avoid misleading prospects with respect to profitability; the time likely to be required to become profitable; investment and working capital requirements; the time and effort required to operate successfully; the competition the franchisee will face; or the risks inherent in acquiring the franchise. It is far safer and sounder to undersell and overperform. Creating realistic expectations avoids disappointment and disputes.

**e. Grant Franchises — Don't Sell Them**

It is important to understand (and easy to overlook) that the relationship with a franchisee begins during the period in which the prospective franchisee and the franchisor are deciding whether to establish a relationship. The way a franchisor approaches establishing franchise relationships will influence the future relationship. The franchisor has many such explorations; the franchisee has only one with that franchisor and will remember how the franchisor approached and implemented the process. Did the franchisor fully and fairly explain the relationship, the obligations and responsibilities of both parties, the role of the franchisee in the

network, the effort required to build a successful business? If the franchisor makes the effort to explain its operating system, network, business and the franchise relationship it offers, the franchisee will have a positive view of the franchise grant process. The more the process resembles a mutual exploration of whether the prospect and the franchise business are a good match, the more positive is the beginning of the relationship. “Grant” the franchise when the match is good. Certain elements of a “sales” environment are inescapable for most franchisors, but “granting” a franchise should more closely resemble the process of establishing a long term business relationship — a soft sell approach. Overly aggressive “selling” of franchises has turned off many qualified prospects — resulting in lost opportunities for both franchisors and franchisees. A prospect should be encouraged to talk with existing franchisees and to get professional advice. It should be made clear to a prospect that it is important that both the company and the franchisee make the right decision.

## **2. Developing Leads To Prospective Franchisees**

A franchisor must develop strong lead generation sources. This can be approached by first determining the characteristics of the network’s successful franchisees. How were those franchisees attracted to the network? What characteristics of the network influenced them to acquire a franchise? How can similar prospects be located and motivated to join the network?

### **a. The Internet**

The internet has become the most important source of leads for many franchisors. For many companies, the internet is responsible for a majority of leads and a high percentage of franchise sales. This trend is likely to continue as more information about franchise

opportunities is posted on franchisor websites and by various organizations and prospective franchise buyers become increasingly aware of the availability of this information. The internet is an efficient and inexpensive communication channel for a large volume of information. Though relatively few franchisors put their Uniform Franchise Offering Circulars on their websites in read only format for downloading by a prospective franchisee, the number of franchisors that include their UFOCs on their websites is increasing and many franchisors are steadily allocating a larger share of their recruitment budgets to generating leads via the internet. As the regulatory issues relating to electronic transmission of UFOCs are resolved, and broad band capacity and faster modems become more widely utilized, the use of the internet to deliver disclosure materials is likely to increase. Franchisors need to pay careful attention to state and federal law relating to the offer of franchises on their Web sites. Such offers are exempt from the requirement to submit the Web site as advertising for franchisees for review by state administrators, provided specific rules are followed. In other respects, the laws relating to offers and sales of franchises (e.g., the use of earnings claims) apply equally to Web sites and other franchisor franchise sales activity.

To attract interest, a franchisor's website must have a professional appearance, be attention grabbing, be user friendly, enabling a visitor to quickly and easily find the information about the franchisor and its franchise that will be most important in his or her initial investigation, including the way to contact the franchisor for additional information. The website should convey enough information to stimulate an interest in learning more — and therefore induce contact with the company — including franchisee testimonials, and streaming video giving a virtual tour of the franchised business and a description of the process of becoming a franchisee (e.g., completing an application, executing franchise documents,

completing the training program and the development of the franchised business). Some franchisors use a password accessible intranet to enhance the sales process. Prospects can access information not available to the general public after an initial qualification process. This is an efficient and effective method of both educating, and demonstrating interest in, a prospect.

In designing the portion of the website that relates to franchise opportunities, keep in mind the concept of granting franchises to qualified and interested persons — of establishing a long term business relationship. Avoid the appearance of selling to any buyer that can afford the franchise. Make it clear that comprehensive information about the franchisor, the terms of the franchise and the franchise business is available — if and when the prospect is interested in having it. It is important to keep in mind that a website is a sales aid, not a substitute for a professional sales process.

Email descriptions are used to respond to inquiries on the franchisor's website and can include short video and voice presentations. These are generally not expensive to produce as attachments to an email reply. Some franchisors require the website visitor to furnish a limited amount of information (e.g., address and telephone number) in order to access the emessage. Customized software can filter out unqualified prospects and encourage qualified prospects to seek additional information, saving staff time. A short (ten minutes or less) professionally prepared video cassette description of the franchise business, network and opportunity can be very effective in stimulating interest. Video is a communications medium with which virtually everyone is familiar. A well designed and produced video cassette can be mailed to prospects, used in discovery day meetings and at trade shows. A video description can include positive testimonials from existing franchisees (not actors). The major cost is design and production — multiple copies are not expensive.

Though a source of quality leads and franchise sales, the internet, being the most widely available and utilized medium for information, will produce a high percentage of leads that are unqualified for the franchise. A flood of unqualified leads can be ameliorated, in part, by making minimum qualifications clear in the website. Franchisor websites increasingly request information from the visitor to determine financial qualification, geographic area and time frame of interest and how the visitor learned about the franchise. A franchisor will need to make an effort to screen out the unqualified candidates early in the process — being careful not to alienate potentially qualified candidates.

At some point in the sales process, franchisors deliver a Uniform Franchise Offering Circular (UFOC) to a prospect. The timing of delivery varies from one company to another, but the trend seems to be moving toward earlier rather than later. The “first personal meeting” requirement under the FTC disclosure rule is now (or will soon be) obsolete and the only requirement is (or will soon be) delivery of the UFOC a specified number of days before any documents are signed or money is paid to the franchisor. An increasing number of franchisors are complying with disclosure requirements by delivering a UFOC and related documents by compact disk and a few franchisors are using on-line disclosure. On-line disclosure will likely increase significantly as the rules and procedures or its use become more settled and franchisors and prospective franchisees become more comfortable with this medium. Disclosure regulation rules for internet offers of franchises are currently evolving. It is important to keep updated on these rules. Particular care should be taken to avoid unlawful earnings claims.

#### **b. Printed And Other Sales Materials**

Print advertising continues to be a significant source of both quality leads and franchise sales. As franchisors allocate more of their recruitment budgets to the internet, they are reducing

the share of their budgets devoted to print advertising for franchisees. However, print advertising continues to be the second or third best source of franchise sales (behind referrals from the internet and existing franchisees) and is a cost effective recruitment method. Print advertising includes newspapers, trade publications, magazines, direct mail and other types of printed advertising.

A franchisor needs sales materials that appeal to prospective franchisees on logical and emotional level. The focus should be the story of the franchisee's brand and why a franchise relationship will benefit the prospective business owner. Sales materials should be of high quality. A professionally prepared, multicolor, comprehensive brochures generally is the principal franchise sales tool. This brochure will have attractive, four color pictures of a franchised business, some of which should depict the business in the midst of a busy period, conducting lots of business. Specific terms of the franchise relationship should be omitted from the brochure or included as inserts that can be inexpensively modified. Simpler, one or two page descriptions are used for trade shows, direct mail and in-store use. Counter cards and short brochures advertising the availability of franchises, displayed in franchisor and franchisee operated outlets, can also be a cost effective source of leads. Each outlet advertises the franchisor's brand. If the brand is strong, customers have a good experience and the availability of franchises is promoted in the outlet, leads will be generated.

It is very important that all forms of sales materials (website, printed brochures, email responses and videos) conform factually to the information in the franchisor's Uniform Franchise Offering Circular. Sales materials must be submitted for review by franchise law administrators in nine states. This review should be completed after such materials have been reviewed by legal counsel and before they (and the UFOC) are printed or produced in volume. Beware of using

words such as “profit” and “success,” which are red flags for state administrators and can be helpful to new franchisors.

**c. Existing Franchisees**

Existing franchisees are a significant source of leads. Referrals from existing franchisees (and their employees) are likely to be the most cost effective source of leads. Satisfied franchisees will tell friends and relative about their experience and their positive experience will predispose those prospects to approach the franchisor with a positive attitude. Many franchisors offer incentives to their franchisees for leads that turn into sales, including various types of perks (e.g., free registration and transportation to the network convention). A few franchisors maintain more formal broker relationships with their franchisees. Operating franchisees can be effective advocates for a network’s franchise. They know the benefits and problems better than a professional salesperson; they are frequently better positioned to answer questions about the franchise business and the network and they can be more credible than a salesperson.

It is important to advise franchisees who participate in the franchise sales process regarding the legal requirements applicable to franchise sales and proper and improper sales practices. It is also prudent for a franchisor to disclose that compensation is paid to an existing franchisees for a lead that becomes a sale. If the franchisee’s role is simply to pass on the name of a potential buyer and compensation is nominal, the franchisee is arguably not a broker. If a franchisee will act as a broker (will do more than identify prospects), he/she must be registered in Washington and Illinois and must be listed in UFOC Item 2. A franchisee who did not refer a prospect, and does not receive compensation if a sale is made, can disclose to the prospect the sales and profits of the franchisee’s business. A referring or compensated franchisee probably cannot disclose sales or profit information (other than the information contained in the

franchisor's UFOC). A franchisee acting as a broker definitely cannot disclose such information. A franchisor should recognize that without a formal broker arrangement or indemnification, it may have no recourse if a franchisee violates disclosure law in referring a prospect.

Existing franchisees also can be a good market for franchise sales. They have known capabilities, attitudes and performance and require less assistance. Multiple outlet owners can accelerate network growth and growth opportunities for an existing franchisee keeps it focused on the franchise business. A franchisee able to grow within his/her network is less likely to seek other business opportunities that can divert capital and effort away from the franchise business.

#### **d. Referral Networks**

Referral networks are a potential resource of leads and can be helpful to new franchisors. Referral networks are typically associations (or franchised networks) of independent businesses or real estate brokers who work together to offer regional or national referral resources to a franchisor. A referral network will generally perform preliminary screening and qualification of leads that they generate and attempt to match a prospect with a suitable franchise opportunity. However, a franchisor has no way of knowing whether it (or another client franchisor of the referral network) is receiving the best prospects. Most referral networks will not represent direct competitors at the same time, but this should be confirmed. Referral networks are compensated by payment of a percentage of the initial franchise fee or a flat fee; fees range from 25% to 50% of the initial franchise fee and \$5,000 to \$20,000.

Under federal and state law, referral networks are generally deemed to be brokers. If the members of the referral network strictly limit their activity to referring interested parties to one or more franchisors, they may avoid classification as brokers. However, the screening and

qualification of prospects and “matching” of prospects with a franchisor typically undertaken by network members places them in the broker category under federal and state franchise sales regulation. Such referral networks and their members must be registered as brokers in certain states and information regarding such networks and their members must be included in the UFOC of a franchisor that contracts with the network. Several referral networks prepare generic UFOC exhibits containing Item 2 biographical and Item 3 litigation information for the network sponsor, its management and each of its members. Such generic UFOC exhibits may also explain the role of the referral network — and the role of the franchisor — in the franchise sales process. When a new member affiliates with the referral network, a franchisor can choose to amend its state franchise registrations: (1) at that time; (2) prior to the sale of a franchise in which an undisclosed member of the referral network participated in the screening, matching and/or referral of the franchise prospect; or (3) when the franchisor’s registrations and UFOC are next updated. Though approach (1) is probably technically correct, it is not very practical. Approach (2) is safer than number (3). The registration and disclosure rules relating to referral networks are complex and compliance with disclosure regulation is more difficult when a referral network is employed to generate leads.

Franchisors who employ the services of a referral network should have their legal counsel assure that the referral network and the franchisor have fully complied with these rules. It is also important to secure written assurances from a referral network regarding the statements and representations that the network and its individual members will make to prospects with respect to: (1) the limited number of franchisors represented by the network; (2) the franchisor and the franchise it offers; (3) the role of the network and its members as agents for the franchisor; (4) the screening and franchise selection functions of the network; and (5) the manner in which

the network is compensated if the prospect acquires a franchise from a franchisor to which it is referred. Due diligence is required to assure that a network complies with disclosure regulation. It is important to check carefully a referral network's track record with other franchisors.

**e. Public Relations**

Public relations can play a significant role in a franchisor's efforts to recruit franchisees. A widely recognized franchise brand facilitates franchise sales and this can be particularly important when a franchisor enters a new market. The engagement of a public relations consultant can be a good investment for a franchisor that is building brand recognition in a competitive business.

**f. Evaluating Lead Sources**

It is important to track leads as to source, quality, follow-up, problems, disposition and lead and closing costs. The average cost of leads and franchise sales (excluding broker commissions) varies considerably by company and source. The cost of leads ranges from less than one hundred to several hundred dollars. Tracking leads includes determining which internet search engines produce the highest volume and quality of leads. A franchisor can use software designed to: (1) track and grade leads; (2) facilitate the recording of discussions with prospective franchisees; (3) record appointments and follow-up activities in the sales process with respect to each lead; and (4) evaluate the source, quality and closure rate for each type of lead. Tracking can help management allocate its advertising budget for franchise sales and enhances the efficiency of the sales process.

**g. Be Responsive**

A franchisor must be responsive to inquiries. Many franchisors do not respond effectively, sometimes because they have more leads than they can effectively process and select for response. It is not productive to spend money to generate more leads than a franchisor can handle effectively. Concentrating recruitment efforts and expenditures to generate high quality leads facilitates responsiveness. Lead management services can aid a franchisor in efficiently processing leads. Those that are clearly unqualified (e.g., for reasons of financial requirements or geographic interest) are segregated for a polite letter of rejection. Those that are doubtful, are segregated for a response requesting additional information. The remaining leads are routed to the franchise sales department or regional department or organization that may be responsible for initial screening and sales efforts. The lead management service will track all leads that remain in the sales process and issue periodic reports and/or secure website postings of the status of each lead. Lead management services are particularly helpful to franchisors that receive large numbers of leads from the internet.

It is easy to lose a prospect. First impressions are important. If a prospect is choosing between two or three franchises, other elements being relatively equal, the relative responsiveness of the franchisors can be a deciding factor. A franchisor's franchise sales representatives play a key role in assuring a prompt and effective contact with prospective franchisees. Such contact may be by e-mail, snail mail or telephone and may direct the prospect to a password accessible part of the franchisor's website for additional information and encourage contact with existing franchisees. A franchisor should periodically check up on sales staff responsiveness. Franchisors use mystery shoppers to test the responsiveness and effectiveness of their franchise sales staff. Some also "shop" competitors to monitor their

methods and responsiveness. Evaluation of the effectiveness of contacts by sales representatives with prospects can also include interviews with new franchisees. How do they evaluate the responses and follow-up contacts they experienced? What did they like and not like about the sales process? Responsiveness also involves follow through with prospects who do not initially respond to contact by the sales staff. Franchisors develop automatic response systems for recontacting the prospect periodically.

The gold standards of responsiveness is phone contact by a professional sales person within 24 hours of his or her log on or other contact. To the extent not already accomplished by the prospect's response to the website questions, this contact should qualify the prospect with respect to financial resources, work and business history, interest in the franchisor's business and geographic and time frame interest. Once qualified, a UFOC can be sent to the prospect (usually by mail, but, in the future, more frequently electronically) or can be invited to franchisor headquarters to learn more about the franchise and further discuss becoming a franchisee. The prospect may also be encouraged to contact existing franchisees and visit franchised outlets in his or her area. The last step frequently involves the preparation of a business plan by the prospect, with assistance by the franchisor sales staff (being careful to avoid unlawful earnings claims).

Many franchisors have prospects visit the company's headquarters and believe that such visits can facilitate a "discovery day" introduction to the franchise business, franchisor management and training and support facilities. Other franchisors believe that a prospect is most interested in the look and feel of an operating franchised business and substitute that experience for a headquarters visit. Some franchisors require prospects to spend one or more days working along side a franchisee in an operating business.

An inevitable element of the franchise sales process is the issue of negotiation of the terms of the franchise agreement. In its early years, a franchisor is generally more receptive to negotiating certain terms of its franchise agreement. As its network and the demand for its franchise grows, it will usually become less willing to do so. It is important for a franchisor to consider the issue of negotiability in advance and to determine which, if any, terms of its standard franchise agreement it is willing to negotiate, and in what circumstances. Franchise sales personnel are better prepared to respond to questions about or efforts to negotiate terms if this issue has been thought through and such personnel are informed regarding the scope and circumstances of such negotiations, the company's rationale therefor and the manner in which the company's position should be explained to prospective franchisees.

#### **h. Support Of Franchisees**

A franchisor needs the support of its franchisees to sell franchises. Franchise buyers have a wide range of choices and are increasingly sophisticated and diligent in investigating franchise offerings. A franchisor's UFOC must identify 100 current franchisees, and all franchisees whose franchises, during the preceding year, were terminated, not renewed, acquired by the franchisor or who otherwise separated from the franchise network. For preceding three years, the UFOC must disclose the network's experience with respect to terminations, expirations without renewal, transfers and acquisitions by the franchisor. Sustained growth requires satisfied franchisees. Prospective buyers contact current and former franchisees and they can influence purchase decisions. A high failure rate or dissatisfaction with the franchise cannot be hidden from or effectively explained to prospective franchisees. Unprofitable or otherwise dissatisfied franchisees are unlikely to refer prospective franchisees to their franchisor.

**i. Expand At A Manageable Rate**

A franchise network should be expanded at a manageable rate. Franchise networks must expand, sometimes rapidly, to acquire good sites, build market share, enhance brand identity and spread network development costs over a larger number of outlets. It is nevertheless essential to expand at a manageable rate. Such expansion is usually accomplished most effectively in markets where franchisees can be efficiently monitored, supported and supplied. Because capital and human resources are always finite, expansion diverts such resources from operating system development, marketing, problem solving and franchise relationship building. Franchisors find it most effective and efficient to concentrate outlets in a few markets, in order to achieve market share and brand recognition and cost effective operational support and advertising. Expanding in too many markets consumes capital and exposes the franchisor/franchisees to increased risk. If a company's goal is to become a national network, it is much safer to become first a regional, then a multi-regional network, before attempting national expansion. Not every national network has followed this path, but many franchisors have failed attempting expansion simultaneously in too many markets.

The rate of expansion of a franchise network can also significantly impact its ability to effectively screen prospective franchisees, adhere to its profile for high potential candidates and resist the temptation to grant franchises to prospects who do not fully meet its criteria, in order to meet predetermined expansion goals. Granting such franchises may enhance the rate of expansion in the short run, but is likely to result in higher franchise turnover, impeding net growth over time and causing losses to lenders and suppliers (and, not unlikely, unhappy customers) upon whom the franchise network depends to sustain its growth. Over the long term,

the only number that really matters is the number of operating franchised outlets, not the number of franchises granted.

It is also important to avoid the pitfall of expanding prematurely in other countries. International expansion is more difficult and costly than it may appear. Franchising continues to spread throughout the developed and developing countries of the world and with that expansion has come a rapidly rising level of regulation of the grant of franchises and the franchise relationship in such countries, a situation almost unknown before the 1990's. Such regulation is frequently unclear, is not fleshed out by judicial precedents and has potentially increased the cost of franchising in such countries by an unknown amount. In addition to generating regulation in many countries, the international expansion of franchising has resulted in considerably more intense competition, both for high potential franchisees and for the consumer dollar. In the early years of international expansion, American franchise networks had the field largely to themselves and American brands had a special appeal. American franchisors now face strong competitors from other countries.

Selection of the right partners in foreign countries is both critical and difficult. Modifying the operating system for foreign markets is time consuming and furnishing the necessary support to a foreign franchisee can be costly. Achieving satisfactory system standards compliance in a foreign market can be difficult. The risk of mistakes in expansion into a foreign market is high and can result in significant costs, diversion of management from the domestic market and damage to the network brand in an important foreign market. Many franchisors have experienced high rates of failure among foreign country franchisees. The lure of relatively high initial fees can be great, but the franchisor can end up losing money on the relationship. The

ability and willingness to pay a large initial fee does not necessarily indicate a good candidate for the franchise.

#### **D. Building And Maintaining Cooperative Franchise Relationships**

##### **1. A Brief Analysis Of The Franchise Relationship**

Assume that a franchisor has followed the steps outlined in the preceding sections. It has developed a product or service for which there is a growing demand. It has developed and fine tuned an effective operating system. It has operated successful prototypes of the franchise business and diligently applied the lessons learned in their operation to improve its business model. Its business and brand are acquiring distinctiveness in the market place. It has secured sufficient capital to operate its franchise program and be selective in granting franchises. It employs capable management with a knowledge of franchising. It has granted franchises and is attempting to expand in areas where it can effectively support franchisees and achieve a marketing impact. In other words, it has established a sound base for franchising and is poised to expand. What are the remaining elements of successful franchising that our hypothetical franchisor must understand and implement in order to expand a successful franchise network. Before discussing those elements, it may be helpful to consider the basic elements of a franchise relationship and how it has evolved over the past half century.

What are the basic structures and commitments of a franchisee relationship? The franchisor: (1) grants of a license to the franchisee to use the franchisor's intellectual property — its trade identity and operating system — and (2) commits to provide training, an advertising and marketing program controlled by the franchisor, some level of guidance and assistance to the franchisee with respect to development and opening of his or her business facility and continuing guidance, in a quantity, quality and frequency largely in the franchisor's

discretion. The franchisee agrees to: (1) utilize the franchisor's trade identity and operating system in the conduct of its business, in the manner prescribed by the franchisor; (2) commits to comply with the franchisor's operating system standards, which the franchisor may modify (within limits); (3) agrees to submit accurately and timely reports of its revenues; (4) agrees to pay fees in accordance with a prescribed measure and schedule; and (5) agrees to comply with a variety of other obligations relating to its ownership, the territory within which it may sell, local advertising, dispute resolution and other aspects of the operation of the franchisee's business, some of which may also be subject to modification by the franchisor.

What is the historical basis of this structure? During the period of roughly 1950-1980, there occurred a rapid growth in number of franchisors and the size of franchise networks. Many franchisors focused more on growth than on service and the philosophy of the relationship. The form of franchise agreements evolved in this environment and to the current date prescribe comprehensive franchisee obligations, modifiable within limits by the franchisor and minimal and flexible franchisor obligations to guide and assist the franchisee.

## **2. Current Franchisor Thinking**

How do franchisors approach the franchise relationship today? The basic structure of the franchise relationship, as reflected in franchise agreements, has not significantly changed (most of the changes made by franchisors to their forms of franchise agreements have been the result of judicial and arbitration decisions), but franchisors recognize that there is much more to the relationship than is reflected in the typical franchise agreement. Franchisors increasingly view their franchisees as partners in a joint enterprise.

Most franchisors and franchisees both recognize that they have common goals that outweigh their individual interests. Franchisors understand that franchisees who are not only profitable, but realize a good return on their investment: (1) acquire additional franchises, helping to grow the network and enhance its competitive position; (2) reinvest in their business in order to keep them updated and in tune with customer demand; (3) are generally supportive of the franchisor's efforts to expand its network and keep its business competitive; and (4) will pay the franchisor higher fees. It is widely recognized by franchisors that a partnership approach minimizes disputes and litigation.

What is the reason for the current emphasis on service and cooperative relationships? There are probably several key factors. There has been an enormous growth in the number, size and maturity of franchise networks during the past quarter century, and, consequently, considerable experience gained by franchisors and franchisees — a better understanding of what works and what doesn't. Many franchisor managers have had management experience in two or more networks and a significant number have also been or currently are franchisees. There has evolved a much greater understanding of: (1) the drivers of growth and success in franchise networks — strong, cooperative franchise relationships and successful franchisees who reinvest in their businesses and acquire additional franchises; and (2) of the components of these drivers that successful franchise networks have developed — provide value to franchisees and have a franchising friendly philosophy.

The modern franchise network does not have just two components, a franchisor and its franchisees. There are additional stakeholders, specifically, a wide range of suppliers of goods and services, lenders to the franchisees of a network and customers of franchisee and franchisor operated outlets, and their importance to, and interest in, the network increases as the network

expands. Thus, the relationships within a franchise network have impacts on stakeholders beyond the directly involved parties. If the network is to function effectively and expand, those stakeholders must perceive the dynamics of the network as positive and stable; they must be willing to supply, lend to, and buy from network outlets. This fact of the franchise relationship is well understood by franchisors and franchisees. To be sure, there are other factors that influence the willingness of these stakeholders to support a franchise network, but generally positive and stable franchise relationships is certainly a significant influence.

### **3. The Critical Role Of Franchisor Management**

A franchisor's philosophy and "culture" is reflected in its management's attitudes and actions: (1) how relationships are established (the sales process, training and outlet opening and start-up assistance); (2) how relationships are managed (continuing support, communication within the network, attention and responsiveness to franchisee concerns, the franchisee's perception of his/her status in network, how disagreements are resolved, the perceived fairness of the dispute resolution process and whether disputes usually are resolved informally and satisfactorily); and (3) how relationships are ended by termination, expiration, transfer and franchisor reacquisition.

Attitudes and policies crucial to building strong franchise relationships originate with senior management and will powerfully influence the attitudes and actions of middle management. Senior management must carefully monitor managers who interface with franchisees to insure that they thoroughly understand the history of the company and the company's philosophy of franchising, agree with that philosophy and are able to implement that philosophy in real world situations. Successful franchising requires managers who view the company's franchisees as valued customers and believe that their mission is to assist franchisees

to grow and improve their businesses. Successful franchisors periodically test manager knowledge of the network franchise relationships and attitudes about those relationships, conduct retraining for managers that have deficiencies in building and maintaining positive relationships with franchisees and eliminate managers who are unable to adopt or implement the company's franchising philosophy.

“Command and control management” may achieve short term conformity, but it cannot achieve loyalty, it will not earn respect, it will not foster pride in or commitment to the network and it will not motivate franchisees to reinvest in their businesses, acquire additional franchises or support a franchisor's efforts to expand its network by referring prospective franchisees or responding positively to inquiries.

A franchisor should avoid rigid compartmentalization of management functions. Independently operating departments can relate differently to franchisees, sending potentially conflicting messages that interfere with building strong and consistent franchise relationships. “Turf” battles within a franchisor's management can damage franchise relationships and inhibit the early resolution of problems and disputes.

#### **4. The Profile Of Current Franchisees**

Historically, franchise networks were franchisor driven. Today, they are driven to a much greater extent by franchisees. The profile of the typical franchisee has changed. They are smarter and better educated. A much higher percentage have middle and upper management experience or other business experience. Increasingly, current franchisees are experienced, multiunit owners. They have become de facto partners in their franchise networks. Some research indicates that franchisee satisfaction is most influenced by factors a franchisor manages

day to day, specifically initial and continuing training, the implementation of the franchise relationship, brand image (the competitiveness of the network) and the franchisee's financial results. Franchisees are less influenced by the amount of fees they pay, the controls under which they operate or the terms of their franchise agreements. Though there are certainly exceptions, franchisees appear to accept the terms of the agreements they sign. Franchisor management should focus on the elements that are predictive of overall satisfaction.

## **5. The Importance Of Trust**

Successful franchise relationships are built on trust. Franchise relationships are governed by contracts, which cannot anticipate all contingencies and issues. Franchising is a long term, cooperative, service relationship. The franchisor is seller of services and the franchisee is the buyer. Franchise relationships are characterized by interdependence, mutual reliance and shared identity and reputations. A franchisor trusts its franchisees to comply with system standards, to pay the correct fee amounts and to share experience and innovation. A franchisee trusts its franchisor to maintain a competitive business and high standards, to furnish valuable services and to consider the franchisee's interests. Without trust, it is difficult to develop cooperative relationships and for a franchise network to function effectively. A franchisor should always be honest and straightforward with its franchisees. Honesty and openness will build trust; a standard of less than full honesty destroys trust. It is important to adhere to stated policies. Such policies usually do not modify the franchise agreement, so a franchisor is not legally bound by them, but it does not make sense to announce a policy unless franchisees are expected to rely on it. Even if a policy is declared to be modifiable in the company's sole discretion, franchisees will nevertheless rely on it. If it is necessary to modify a policy, it is important to give franchisees reasonable notice of the change, fully explain the need to modify and consider the

impact of the change on franchisees who have an “investment” in the policy. It is particularly damaging to trust for the franchisor to frequently fail to act in accordance with an announced policy. Consistency in dealing with franchisees builds trust. Consistency is not easily maintained — no two fact situations are identical — but the effort to be consistent is worthwhile. A franchisor should be careful to make only the commitments the company can keep and keep the commitments that are made.

## **6. Ending Wrong Relationships**

A franchisor should generally end wrong relationships as quickly as possible. A franchisee that is seriously deficient in ability, motivation or honesty, or who refuses or fails to implement the franchisor's operating system, to comply with system standards or to make the requisite effort to develop his or her business, will not succeed over the long term. Such a franchisee will drain resources and can damage the network. A franchisor should make every effort to identify such franchisees early in the relationship. If reasonable efforts to resolve the franchisee's deficiencies are not fruitful within a relatively short period, the franchisor should initiate a process of assisting the franchisee to sell its franchise business to an approved successor or to the franchisor. This is likely to be the most cost effective method to remove a wrong franchisee from the network, avoiding litigation and a drain on management time (though the franchisor may be required to furnish extra assistance or effort to rehabilitate the former franchisee's business). Termination of the franchise should be a last resort, but is not infrequently necessary to end wrong relationships. When a franchisor makes a diligent effort to end relationships with the least possible damage to the franchisee, other network franchisees will usually be supportive.

## **E. Effectively Documented Franchise Relationship**

### **1. Franchise Documents**

Effectively documenting the franchise relationship is helpful from several perspectives in establishing and maintaining successful franchise relationships. Clear and complete documents facilitate a full understanding by franchisor personnel and franchisees of the franchise relationship and of the respective rights and obligations of the franchisor and franchisee. They reduce the scope for disputes and facilitate an early and less costly resolution of disputes that do occur. A franchisor should use complete, well organized and understandable documents. Franchise agreements need not be complex documents. A franchise agreement can be written in a simple English and, if written in a first person format, is more readily understandable and “user friendly.” Franchise agreements should be flexible, anticipate change and permit modifications to the franchise relationship. The franchise agreement should clearly explain the roles of the franchisor and franchisee and give franchisor tools to enforce system standards. The inclusion of such tools is essential — and not inconsistent with — developing and maintaining successful franchise relationships.

### **2. Uniform Franchise Offering Circulars And Franchise Sales Materials**

UFOCs and franchise sales materials should not overstate a franchisor’s stage of development, experience, capabilities or services nor understate the franchisee’s investment or create other unrealistic expectations. Full and accurate disclosure is a key element in managing expectations. Franchisor management should read the company’s UFOC as if they were prospective franchisees. Does it reflect the company’s franchising philosophy? Is the company’s history and franchise program fully and fairly described and easy to understand? Do the company’s training and support services seem adequate and realistic? Does the company

come across as fair and trustworthy? How does the company compare to other franchisors? Would the managers buy this franchise?

### **3. Operations Manuals**

A comprehensive, legally sound and user friendly operations manual is essential. A franchise network operations manual fulfills several functions. It can be used as the principal textbook of the franchisor's training program. It should contain the mandatory specifications, standards and operating procedures and rules for the establishment and operation of the franchise business (system standards). The operations manual should be very explicit in describing the obligations of the franchisor and the responsibilities of the franchisee and make very clear that, though the franchisee must implement and comply with the standards, specifications and operating procedures that constitute system standards, the day to day management and operations of the franchise business are within the sole and exclusive control of the franchisee. As expressed by one court, in granting summary judgment to a hotel franchisor, the evidence showed that no provision in either the franchise agreement or the system standards manual gave the franchisor the contractual right to control either the means, methods, or details of the hotel's maintenance and operation of the parking lot or the methods by which the hotel complied with the minimum standards set by the franchisor. Examples of the day to day management functions help to illustrate the franchisee's responsibilities. Such explanations and examples also facilitate the teaching of system standards and their understanding by franchisees and their employees. Portions of the operations manual can be used as a training tool for the franchisee's employees.

The operations manual also generally will contain a variety of recommended specifications, standards and operating procedures for the franchise business. Such recommended standards and procedures are furnished for the franchisee's guidance, but are not

mandatory, a distinction that is important if the franchisor is to avoid liability to franchisee employees, customers and others. Standards and procedures in this category would include employment relationships and practices, employee training, and utilization, security and safety procedures, discrimination and sexual harassment policies and procedures and local marketing and advertising.

Clearly distinguishing between mandatory and recommended standards and procedures can be particularly important with respect to employment relationships and practices and safety and security procedures and standards, which, if made mandatory, subject the franchisor to liability for claims arising out of damages caused by actions of franchisee employees or the failure of such safety and security procedures or standards to be implemented or to prevent injury. There are numerous judicial decisions that deal with the potential liability of a franchisor for the injury or death of employees and customers of franchised outlets and pedestrians and motorists injured or killed by drivers delivering products or services for franchised outlets. In many of these cases, the court has focused on the degree to which the franchisor controlled the element of the franchisee's business to which the claim relates. Those courts have rejected the proposition that general control over operating standards is sufficient to hold the franchisor liable. In a large proportion of these cases, some act or omission of a franchisee's employee is alleged to have been the cause of the injury or death. If the franchisor does not have any control over the selection, hiring, compensation, supervision, discipline, termination or any other personnel policies relating to the managers and other employees of the franchisee's business, and these decisions and policies are within the exclusive control of the franchisee, the franchisor is much more likely to be dismissed from a law suit that alleges negligence or intentional misconduct by a manager or other franchisee employee.

The operations manual should also clearly explain that some of the knowledge required to successfully operate the franchisee's business is beyond the scope of the manual. There are usually a range of practical, sometimes uniquely local, matters that the franchisee must learn by local inquiry and experience. State and municipal regulation may impact the business in ways the operations manual does not contemplate. The franchisee's specific competitive environment may impact its operations. The operations manual should clearly inform the franchisee that it is his or her obligation to acquire and apply such knowledge to the business and, when appropriate, to seek assistance from the franchisor or the network to do so.

In the same vein, both the franchise agreement and the operations manual should explicitly state that neither the franchisor's right to inspect the franchisee's business facility and operations, nor actual inspections made by the franchisor, constitute a guarantee or assurance that the facility or operation of the franchisee's business complies with applicable regulation, system standards or sufficient levels of safety and security for customers and employees. Field service employees are by no means infallible and it is important that every franchisee understands that he or she cannot rely on failure of the franchisor representative to point out a violation of law or system standards, or safety issues, during an inspection; that, notwithstanding inspections and the specific issues identified by them, the franchisee retains full and continuing responsibility for compliance with the law, system standards and maintaining a safe environment for its customers and employees.

Particular attention should be paid to the delineation of the responsibilities of franchisees in the wide range of franchise networks in which the franchise's employees operate motor vehicles or dangerous equipment, or use dangerous products (e.g, slicers, cooking equipment, toxic chemicals), or in which large numbers of the public have access (whether not as invitees) to

the premises of the franchisee's business (e.g., lodging facilities), or which are open late at night or are otherwise robbery targets (e.g., convenience stores, quick service food outlets). Such franchise networks are more likely targets of customer and employee claims and are more likely to invite a probing judicial examination of the respective obligations (and, therefore, liability) of the franchisor and its franchisees. Trial and appellate courts have frequently ignored the typical franchise agreement provisions that assert that the agreement does not establish an agency relationship, the usual predicate for holding the franchisor liable for the acts or omissions of its franchisee. It is sensible for a franchisor to: (1) assume that such a disclaimer, though it definitely should be included in every franchise agreement (unless, and to the extent, that an agency relationship is intended), will not be sufficient to persuade a court to dismiss it from a claim arising out of an occurrence at or connected to its franchisee's business; and (2) ensure that the franchise agreement and operations manuals explicitly state that the responsibility for day to day operations, compliance with the law and operating a safe business rest entirely with the franchisee; and that the responsibility of the franchisor is to support the franchisee and to ensure that the franchisee's use of the franchisor's trademark to identify its business does not erode the goodwill of that trademark or deceive consumers.

The operations manual should anticipate the possibility of disputes over a franchisee's compliance with system standards and explain the rationale for mandatory system standards in language that is readily understandable to a stranger to the franchise business (e.g., an arbitrator, judge or jury) and include concrete, real world examples of the function of system standards and the consequences of a failure to comply with them. A comprehensive and clearly written operations manual will aid in minimizing disputes over the specifics of system standards, the

reasons for specific standards in the context of the franchise business, the responsibilities of the franchisee and the obligations of the franchisor.

The operations manual also should indicate the information that the franchisor considers to be a trade secret or confidential, specifying which type of employee should have access to such information and, if the franchisor has important trade secrets, the use of confidentiality agreements for such employees, and other access, use and security procedures that the franchisee must follow to protect trade secrets and confidential information, with an explanation of the reasons that such information is deemed to be a trade secret or confidential.

Operations manuals should be updated whenever changes are made to mandatory system standards or recommended standards and procedures. A loose leaf format facilitates updating. The franchisee should be obligated to insert all updates in its copy of the manual and the franchise agreement should provide that the master copy maintained by the franchisor prevails in any dispute over the actual provisions of the manual. Maintaining the manual in a secure, password accessible section of the franchisor's website also facilitates regular updating.

It is important to understand that there are limits to changes to system standards that can be mandated merely by modifying the operations manual. A franchisor that attempts to reserve excessively broad powers to make changes by means of the operations manual may risk turning the franchise relationship into a contract that does not have sufficiently definite terms, which could impair enforcement. The manual is intended to be the mechanism to adapt operating standards to changes in the market, technology, competition and customer expectations. It cannot be properly used to radically change the franchise business model or the fundamental business or economic relationship of the franchisor and franchisee. If a franchisor attempts to

use the operations manual to require its franchisees to implement changes of this nature, without prior consultation with franchisees, testing and demonstrated positive impact of the changes for both revenue and profit, the franchisor could well face rejection of the dictated changes by a large majority of its franchisees. The franchisor's enforcement options at that point are not attractive. Changes to system standards that will require a significant capital investment by the franchisee, or materially higher operating costs, in the expectation of higher sales and profits, are particularly sensitive. Both testing and franchisee input should be sought before such changes are implemented.

## **F. Collaborative Relationships With Franchisees**

### **1. Franchisor Attitudes And Actions**

Developing and maintaining collaborative relationships with franchisees involves a combination of attitudes and actions by a franchisor. The fundamental attitude a franchisor management must have is the recognition and appreciation of the key role of franchisees in a network. Without this attitude, a franchisor will not be able to communicate convincingly to its franchisees that it recognizes and values their role in the network. The franchise relationship is in many respects a de facto partnership and the franchisees are stakeholders in that partnership. As stakeholders, the franchisees are entitled to be informed about network operations, problems, issues and planning and the franchisees should have input into the decision making process that affects the network. The success of the franchise network and of its franchisees is irrevocably linked. A franchisor's goal should be satisfied and motivated franchisees who consider themselves an essential element of the franchise network and who voluntarily work to improve the network. For a franchise network to function effectively, in both good times and bad, there must be a culture of cooperation imbedded in network relationships. Neither the franchisor nor

its franchisees can give a higher priority to parochial self “interest” than to the needs of the network as a competitor. The enhancement of the network brand must be the goal of both the franchisor and its franchisees.

## **2. Respect And Respond To Franchisee Concerns**

It is also important for franchisor management to understand and respect franchisee concerns regarding system expansion conflict, source of supply restrictions, franchise value in a transfer of the franchised business, renewal of the relationship when the initial term expires, network advertising and the competitiveness of network products and services. Franchisee profitability should be a high priority (many would say the highest priority) and franchisees with operating problems should find the franchisor willing to offer assistance. A franchisor should recognize good performance and give awards for achievement and innovation. Franchising is a “people” business. Good human relationships are critical to success. A franchisor should always keep in mind the human interrelationships that constitute a franchise network.

Franchisors need to be sensitive to signs that problems in its franchise relationships are developing. A number of such indications are obvious, other may be less so. An increase in franchisee complaints regarding the effectiveness of advertising or operating assistance, and declining franchisee revenue are obvious indications of developing relationship problems. A more confrontational attitude of members of the franchisee advisory committee or association leadership or instances of blame attributed to the franchisor for a problem or event are less obvious, but may nevertheless be real indications of developing relationships problems. Whatever the indications of brewing trouble, the approach most likely to effectively resolve it is

to address it quickly, investigate the causes, ignore blame, focus on resolution and involve the franchisees in achieving a solution.

### **3. Franchise Experience And Innovation**

It can be a serious mistake for a franchisor to fail to learn from franchisee experience, stimulate franchisee creativity and take advantage of franchisee ideas. Franchisees interface with customers, they know the competition and they are a highly valuable repository of operating experience. Franchisee experience is particularly important in predominantly franchised networks. Franchisees are a fertile source of innovation. Ray Kroc, the founder of McDonald's, observed that his best ideas came from his franchisees because they talked to customers every day and some of them listened to what customers said. There are many examples of franchisee innovation, such as new products, operating system improvements, cost reduction ideas and advertising and marketing ideas. A franchisor should encourage its franchisees to share ideas and should also develop methods to capture franchisee experience and innovation. Franchisees should be asked to submit ideas for evaluation. The best ideas can be presented by the franchisees who submitted them at annual or regional franchisee meetings. Awards can be given for the best ideas. Franchisee innovations that benefit the network business should be shared with the network, with credit to the innovating franchisee. Most people welcome and appreciate recognition and the willingness of a franchisor to acknowledge the good ideas that come from its franchisees, which benefit all network franchisees, will resonate well in its franchisee community.

#### **4. Negotiation With Franchisees**

A franchisor should be prepared to negotiate with franchisees. Change can precipitate the need for modification of the franchise relationship. Some modifications may be unilaterally implemented, but others may have to be negotiated. For example, it may become necessary to restructure the economics of the relationship, modify the territorial rights of franchisees, expand the advertising program or change other elements of the franchise relationship. Likely subjects for negotiations include e-commerce policies, expansion conflict, facility upgrades and renewal issues. Negotiation is common in the context of events such as the acquisition by a franchisee of a new franchise or an existing franchised businesses, the offer of a cobranding opportunity to a franchisee and a franchisee default. Negotiation may involve a single franchisee, all franchisees in an area or type of location or the entire network. Negotiation may relate to a specific issue or a broad range of network issues and may be with franchisees individually, an advisory council or a franchisee association. Negotiations may vary widely in difficulty and result, depending on the issues involved, the number of franchisees affected and the personalities of the franchisees with whom the franchisor negotiates. A mechanism is required to confirm changes negotiated with a franchise association or advisory committee. Usually this mechanism is an amended or revised franchise agreement offered to all or affected franchisees. Those who do not elect to sign this document do not participate in the changes that are advantageous to franchisees (e.g., extended term, advertising fee and royalty modifications).

## **G. Communication**

### **1. The Role Of Communication**

Effective communication is an essential predicate to maintain complex, long term relationships and it is fundamental to building a sound foundation for franchise relationships. Enhancing communication should be a priority in all planning with respect to implementation of franchise relationships and the day to day operation of the franchise network. A franchisor must positively encourage constructive communication, be receptive to it and act in response to it. Effective communication begins with accurate and complete information during sales process and continues by keeping franchisees fully informed about the experience of the network, operational changes and marketing strategies. Communication must include bad news as well as good, failures as well as successes. Nothing remains secret for very long and it is far better for franchisees to learn of problems directly from the franchisor rather than from second hand sources. All franchisors face the continuing challenge to effectively communicate the basis for their decisions and to demonstrate, in their communications, their interest in the success of their franchisees.

Effective communication is particularly helpful when a franchisor determines to make a significant change (e.g., the franchisor introduces a new product or service; makes a major modification to its operating system or business format; introduces, expands or changes advertising; makes material additions or changes to the business facility; or acquires or is acquired by a competitor or other company). In these circumstances, communications serves two functions: (1) to explain the changes that the franchisor believes are needed and secure franchisee support; and (2) to solicit both critique and ideas from the franchisees. Smart

franchisor managers now that they do not have all the answers, or even fully understand the factors precipitating changes. Franchisee input may well avoid costly mistakes and reduce the overall cost of implementing changes, and it will greatly facilitate securing franchisee support for change. The International Franchise Association has published a monograph, developed by the Association's Franchise Relations Committee, entitled Improved Communications Means Improved Franchise Relations. This monograph is an excellent guide to the issue of communication in franchise relationships.

## **2. Effective Communication**

Communication is most effective when it is: (1) delivered through multiple channels and media (e.g., annual and regional meetings; meetings with a franchisee advisory council or a franchisee association board of directors; intranet and printed newsletters; faxed bulletins; group teleconferences and a watts line; (2) is repeated frequently; (3) is delivered at the right times and kept updated if the implementation is over time; (4) has the right tone; (5) is delivered by different persons and (6) is sufficiently explained. People learn in different ways and a message is most effective when it is designed to attract the attention of a wide spectrum of the target audience and is delivered in a wide spectrum of media. Multiple messages in multiple media increase the likelihood that personal barriers to communication by one medium will be overcome by another medium. Working with a franchisee advisory council or association can result in a more effectively delivered message.

## **3. How Do Franchisees Regard The Franchisor**

A franchisor should develop methods to secure regular feedback of franchisee opinions. A franchisor needs to know franchisee perceptions and attitudes regarding franchisor services,

the products and services sold by franchisees, advertising and marketing programs, network competitiveness, overall franchisor performance and the franchisor's relationships with its franchisees. A franchisor should also determine what its franchisees expect of the franchisor, what they find positive in the franchisor's management and what they consider negative. Franchisors use several techniques to get such feedback, including periodic written evaluations; quarterly conference calls with senior management — open to all franchisees; small group teleconferences; and one on one discussions with franchisees and the franchisee advisory council or association. Franchisee perceptions and attitudes may be negative, but that information is nevertheless invaluable. It is more important for a franchisor to be aware of negative franchisee perceptions regarding its performance than to know that franchisees give it a high approval rating. A franchisor that is unaware of what franchisees are thinking will have difficulty improving performance and managing its network. A franchisor should be open minded, welcome constructive criticism and recognize the possibility that a critical franchisee has a valid point or a good idea. It is important to respond quickly to franchisee questions, concerns and objections. Franchisees voicing concerns should be asked for suggestions and the franchisor should show respect for their concerns and ideas.

#### **4. Intranets**

A franchisor can use an intranet to enhance communication within the franchise network (i.e., between the franchisor and its franchisees and among the franchisees). An intranet greatly enhances communication, but it does not substitute for face to face meetings and direct communication by telephone, a “live voice” telephone contact. Many franchisors that require calls from franchisees be answered by management personnel (i.e., either the executive or his or

her assistant) or a help desk operator. It is also common for franchisors to have a 24 hour response policy from the appropriate department.

## **H. Franchisee Advisory Councils And Associations**

### **1. Advisory Councils**

Franchisors generally establish advisory councils of franchisees (in lieu of or in addition to a franchisee association). A franchise network may have a single, all purpose franchisee advisory council or several, specific purpose councils (e.g., advertising and marketing, operations and procurement). Some franchise networks have only a national council, others a national council and regional councils, each with a representative on the national council. Members may be elected by the franchisees, appointed by the franchisor or a combination of election and appointment. Election by franchisees is more likely to result in the council having credibility with the franchisees. The franchisor should consider eligibility standards (e.g., a minimum time period as a franchisee; compliance with the franchise agreement and system standards; geographic diversity; and single and multiple outlet owners).

The council should have freedom to develop its own mission and operating rules (e.g., bylaws). For an advisory council to be effective, franchisees must believe that the council will seek regular, periodic input from franchisees and will be an effective means of franchisee input to the franchisor; can work with the franchisor to effect necessary changes; and will represent the interests of all franchisees (e.g., not be a rubber stamp and not represent just larger, multiunit owners).

Some franchisors designate an executive to serve as the full-time member of or liaison to its advisory council. Franchisors differ in their views on whether a franchisor executive should be a member of the franchise advisory councils or their committees. Some view such membership to be beneficial; others believe that it detracts from the independence that franchisee advisory committees must have — and appear to the franchisee community to have.

Meetings of the franchisee advisory council and franchisor management should be with franchisor senior management; be carefully planned; focus discussion on the most important subjects; and use allotted time effectively. Results of meetings should be disseminated to the network by the franchisee advisory council with minimum franchisor oversight or control and with the comment and suggestions invited. The council should have full access to franchisor management. Most franchisors financially support their advisory councils by paying travel expenses and some reimburse other expenses incurred by council members.

## **2. Franchise Associations**

Franchise associations may be formed for a variety of reasons: (1) operational problems; (2) the perceived high costs or other problems relating to goods subject to source restrictions; (3) network expansion conflict caused by the granting of franchises for traditional or nontraditional outlets or the opening of new channels of distribution; (4) the perceived need for new products or services and/or improved advertising and marketing; (5) the terms of successor franchises offered by the franchisor; (6) new technologies that the franchisor requires franchisees to implement or that franchisees want the franchisor to offer; (7) or a desire by franchisees to perform one or more functions that the franchisor does not perform or is believed not to perform well (e.g., procurement of equipment and supplies or regional and local advertising); (8) a

proposed or actual change in the ownership of the franchisor; (9) franchisee resistance to structural changes proposed or imposed by the franchisor; (10) perceived franchisor indifference to franchisee issues or a threat to their businesses; (11) a sufficient number of franchisees — or influential franchisees — believe that the network’s franchisee advisory council is not adequately representing the franchisees; (12) to acquire the stock or assets of the franchisor; and (13) to lobby for legislation to protect the interests of franchisees. Each of the above have contributed to the formation of a franchisee association. The underlying motivation and purpose of a franchise association is to gain influence in franchisor decisions (a seat at the table).

The causes underlying the formation of an association are likely to guide its initial goals and activities. The association may begin life with an adversarial perspective and posture, with the individual grievances of the founding franchisees the dominant issues. The association will likely hire a lawyer at or soon after its inception. The association’s goals will generally expand over time, with emphasis on protection of the rights and investments of network franchisees; improved communication between the franchisor and franchisees; greater participation in decisions that affect the goodwill of the network brand and the profitability of franchisee owned outlets; and achieving the status of the bargaining agent for the franchisees in negotiations with the franchisor.

Without regard to impetus for the association, a franchisor should not unnecessarily make it an enemy. If it represents a significant group of franchisees, the franchisor should accept that it exists. The rights of franchisees to form an association are protected under some state laws, but even where unprotected, overt or covert acts to frustrate the formation of an association that

is popular with a significant number of franchisees may do considerable harm to relationships and can result in liability and impeded management of the network in cases where it is not clear whether the actions taken by franchisor management were for sound business reasons or in retaliation for a franchisee's role in the formation, or some act, of the franchisee association. It is important to understand the interests and motives of the association and to view the association as a potentially useful two way communications channel and a source of ideas that may be of value to the network. If the association is bona fide, its leaders should be respected. A franchisor should not discriminate against the leaders or members of the association.

If successful franchisees are the leaders of the association, they can help the franchisor communicate to franchisees the value of the franchise relationship and they can be a good sounding board for franchisor management. Such franchisee associations are more likely to adopt common-sense attitude and endeavor to work constructively with the franchisor. Good communication between the association leadership and the network franchisees is important to provide the leadership with an understanding of franchisee concerns and problems; to enhance the value of the association as a communications channel to the franchisees; and to build a consensus for network policies. Some franchisors require all franchisees to belong to a franchisee association and some financially support their franchisee associations. The franchise agreement may require dues payments by the franchisee to the association. Network suppliers are also a source of revenue to a franchisee association. A franchisee association may have its own website, a web page on the franchisor's website or intranet capability to facilitate communication with franchisees

An independent franchisee association will have significantly more bargaining leverage than a single franchisee (even a large, multiunit franchisee). An association can pool the resources of its members to engage legal counsel and other professional services. Franchisors frequently negotiate agreements with their franchisee associations that they would be unable to negotiate with individual franchisees. However, an association may not be an unmixed blessing for franchisees, some of whom may disagree with the policies it pursues. The adjustments required when an association is formed can be time consuming and strain relationships in the network, but an association can also be a significant asset to the network and help facilitate essential change.

### **3. Working With An Advisory Council Or Association**

It is important for a franchisor to work with a franchisee advisory council or association and to take advantage of the many benefits that can be gained by establishing and maintaining an effective working relationship. A franchisor should endeavor to make effective use of a franchisee advisory council or association to enhance communication and to compensate for the barriers to communication created by expanding levels of management. An effective working relationship can be a significant help to the franchisor in attempting to resolve network issues and reduce the motivation of franchisees to seek judicial solutions (e.g., network expansion conflict; e-commerce policy; marketing and advertising policies and programs; the structure, funding and operation of regional advertising cooperatives; restrictions on sources of goods and services). Working effectively with a council or association can also demonstrate that the franchisor seeks the input of franchisees before making decisions that affect them. Councils and associations are also used by franchise networks for long-term planning; to give franchisees the

opportunity to participate in the evolution of the network; to secure franchisee reactions and ideas in connection with fundamental changes to the network; to enhance franchisee support for franchisor decisions; and to deal effectively with network threatening issues and implement crisis management decisions (e.g., food contamination).

A willingness to consult (and negotiate with) a franchisee council or association need not constitute an abdication of the franchisor's management role and responsibilities for the network brand and financial health and progress. The franchisor must balance its need for ultimate control and decision making flexibility with the needs of its franchisees to have a sense of participation in the evolution of the network.

#### **I. Furnishing Valuable Services To Franchisees**

Franchisors furnish a wide range of valuable services to their franchisees. Every franchisor needs to ask itself what services it provides to its franchisees that adds value to their businesses. A new franchisor usually focuses on network growth, but its focus must shift fairly early to service and value. Some functions in a franchise network are generally performed best by the franchisor, e.g., operating system and product/service development; training and support; advertising; and procurement. If the franchisor performs these functions well, its franchisees are able to undertake the functions they perform best, e.g., high quality operation of the franchised business; customer service and satisfaction; building community relationships; and sharing experience within the franchise network.

## **1. Operating System And Services**

Successful franchisors offer their franchisees a well designed and tested operating system and distinctive business format; a distinct and protected trade identity; business facility development specifications; equipment, fixture and decor specifications; product/service, packaging, order processing and delivery specifications; quality and operating standards; operational guidance; staffing specifications; marketing techniques; record keeping, accounting, cost control and inventory management procedures; functional and cost effective technology platforms; and other services designed to enhance franchisee profitability. The benefits of such services are not always obvious and may not always seem important, but franchisor services can be the difference between a growing franchise network, with profitable, expanding franchisees, and a franchise network that stagnates or declines. Effective franchisor services are particularly important when the economy is soft, or competition increases, and sales gains are difficult to achieve. The specific categories of services discussed in the following sections can all help franchisees to operate their businesses more productively and efficiently, realize a higher level of profit, expand into multiple outlet ownership and realize the benefits of their investment and efforts when they sell their outlets.

A comprehensive menu of franchisor services, that is periodically adjusted to the needs of network franchisees, increases the value of the franchisee's business. A franchise business in a high service, competitive and growing network is more readily salable than a franchised business in a low service or noncompetitive network and is an important incentive for franchisees interested in growth.

Every franchisor should have a franchise services department. This department may be identified as the operations department, or by another name, but its primary function is to guide and assist franchisees to implement the network operating system and operate their businesses effectively and profitably. It may initially consist of only one person. As the network grows it should expand to meet the needs of franchisees, including expansion of the field service support staff and regionally based personnel able to assist franchisees on short notice. Franchise service personnel should provide responsive and helpful service, nurture the company's relationships with its franchisees and act as the franchisee's advocates within the company — giving the franchisees a voice.

To furnish valuable services to its franchisees, a franchisor must receive a variety of information from its franchisees on a regular schedule, including sales and revenue information, operating cost data, profit and loss information and information relative to local advertising and marketing. The right to receive this information should be clearly spelled out in the franchise agreement and the franchisor should enforce its rights to such information. To the extent that such information is contained in the franchisee's computer, a right to download that information into the franchisors database can facilitate data transfer.

## **2. Site Selection And Development**

Site selection begins with an accurate understanding of the types of locations that are suitable for the franchise business. Site selection has changed considerably since the early standard approach of locating a quick service food outlet near a McDonalds or KFC outlet, though even the current techniques will frequently dictate the selection of such sites. Highly refined demographic and traffic flow analysis now play a key role in site selection. A number of site analysis and selection companies offer such services, basing their analysis on the family

income levels within a prescribed driving distance to a location, the side of a street that has predominant going-to-work or returning-from-work traffic, on which side of a stop light the business should be located, ingress and egress issues (particularly where drive-up windows are utilized), how the sun will shine in the eyes of drivers at peak business hours and other visibility issues.

In addition to demographic and traffic factors, site selection analysis must focus on cost. Every business does not require a high visibility, high traffic and very expensive site. High visibility at a large numbers of sites does, of course, enhance brand development and augment advertising and marketing. Many franchisors seek such sites for these reasons as well as high traffic counts and favorable demographic factors. This type of site is found in central business districts, regional malls, other suburban locations, airports, sports stadiums, hospital cafeterias and office buildings. Such companies will have facility designs for each of these types of locations, varying in size, layout, signage, menu and other features.

But many businesses are less dependent on high visibility and traffic and can prosper in less visible, lower traffic areas and even in areas where income demographics are less favorable. It is important for a franchisor to understand the demographic, traffic, visibility, other site features and cost factors that are important to its business, and to target sites that have those features and cost levels. Setting site targets too high can be as costly as setting them too low. The higher costs that will be incurred, and paid by franchisees, will waste money, increase the franchisee's investment and the break-even revenue level of the outlet and can make the difference between success and failure. Similarly, facility design should also match the franchisor's business. The size of the facility, the equipment and fixtures utilized and the décor package all have an impact on cost, the franchisee's investment and break-even revenue level.

Many franchisors have found that their businesses can operate efficiently and effectively in smaller locations than they originally projected. It is essential for a franchisor to understand the demographic, competitive, geographic, cost and other factors essential for a successful outlet for its business.

There is a wide variation in the site selection and development services offered by franchisors to their franchisees. At one end of the spectrum, the responsibility for site selection and facility development is entirely the franchisee's; the franchisor furnishes specifications and limited guidance (e.g., site criteria; basic plans or layouts, equipment, fixtures, materials, décor and signage specifications; and referral to an architect and a contractor). Such franchisors customarily retain site and facility approval rights. At the other end of the spectrum is franchisor development of a turnkey facility, at a site selected by the franchisor, and the sale of that completed facility to a franchisee. The site selection and facility development services of most franchisors fall between these extremes. Such services consist of site selection and analysis; lease or purchase negotiation assistance; detailed plans and specifications; supervision or consultation relative to facility development; and furnishing equipment, fixture and sign packages. A franchisor needs to clearly define the site selection and approval services that it furnishes and explain the limits of predictability in site selection.

Of particular importance in connection with site selection and development is the negotiation of leases. Good leases, particularly those with favorable renewal options, are a valuable asset of a franchise network, whether controlled by the franchisor or its franchisees. Rent is a major and relatively fixed cost (unless percentage rent is payable) and projecting that cost far into the future, while revenues are increasing, can increase the profit realized on incremental revenue gains. Franchisor direct lease negotiation or assistance to the franchisee in

lease negotiation can be a significant service to franchisees, by lowering rent, increasing landlord build-out responsibility and extending the period of favorable terms. A franchisor will quickly gain experience and will be in a better position than a franchisee to negotiate favorable terms. Developing good lease negotiation skills and landlord relationships will enhance franchise sales. A company that offers lease negotiation services will have an advantage over one that does not in the eyes of a prospective franchisee who is intimidated by the prospect of negotiating a lease.

Franchisors should also consider the issue of lease control. The most effective control is achieved when the franchisor leases a site and subleases that site to a franchisee. The collateral assignment of a franchisee's lease can give the franchisor control of the premises to the extent that the collateral assignment is recognized by the landlord and enforced by a court. The lease/sublease relationship eliminates these issues. Control of the franchised premises can be important when it is appropriate to retain a site, but not the franchisee operating that site, in the network. A franchisor is also likely to be able to negotiate better lease terms when it is the tenant, because it is, in effect, guaranteeing the lease and offering the landlord a financially stronger tenant. However, such control and more favorable terms may come at a price — the risk the franchisor assumes when it leases sites for sublease to its franchisees. In some instances, franchisors are able to hold leases in a leasing company that may hold only a single or a few leases, thus insulating the franchisor from liability if the site is abandoned. Franchisor also can increase the rent in the sublease, creating a reserve, to which each franchisee contributes, to cover the lease liability of closed sites.

### **3. Training**

#### **a. Training Programs**

Successful franchisors provide comprehensive initial and continuing training. Training is a key component of a significant motivator to become a franchisee: experience and support in establishing, operating and growing a business. The length of initial training programs varies considerably among franchisors, ranging from one week to several months. The complexity of the franchise business and the degree to which franchise management determines to "front load" training, rather than supplement initial training with continuing training at the franchisee's business, influences the length of training programs. Periodic supplemental training is furnished by a variety of methods, including by field service personnel, at the annual network meeting, in periodic regional training programs and by means of video and computer based training programs. Effective initial and continuing training are critical franchisor services. Training also can function to weed out franchisees who are at high risk of failure or are likely to become troublemakers. Effective training greatly improve franchisee performance, reduces franchisee operating problems and the cost of support and enforcement. The cost of training franchisees varies widely, correlating primarily with the length of the initial training program, the franchisor's training facilities and personnel and the scope and type of the continuing training furnished by the franchisor.

Training should include both the traditional concept of training: how to perform operational and marketing tasks; and the concept of education: why tasks are performed in specific ways. Teaching "why" will reinforce the teaching of "how." The initial training program is a critical experience in the life of a franchise relationship. It will demonstrate that the franchisor has a genuine interest in the success of the franchisee — or will fail to demonstrate

such interest. It will equip the franchisee to be successful — or will fail to do so. The ideal initial training program should: (1) create a belief in the system; (2) teach the purpose and importance of system standards; (3) communicate the value of the franchise relationship; (4) build relationships with franchisees; (5) teach essential skills relevant to the franchised business and general business skills; (6) teach marketing, customer relations and retention skills and how to provide customers with an experience that builds customer loyalty; (7) teach the franchisee how to establish a presence in his or her community; an understanding that local marketing is a long term process that requires investment of time and money; and how to develop a marketing plan and budget and to measure the effectiveness of the plan as it is implemented; (8) teach human resources management, including employee selection and how to be effective teachers of employees; and (9) teach safety and security procedures to protect employees and customers. The training program should include comprehensive testing of franchisees on what they have learned and provide for retraining to the extent necessary to eliminate gaps in their knowledge of “how” and understanding of “why.”

Training can be effectively supplemented by a mentoring program. A franchisor can seek volunteer mentors among its high performing, experienced franchisees. Such mentoring can be very helpful to new franchisees and franchisees having operating or marketing problems. An understanding and helpful mentor can be the difference between success and failure.

#### **b. Training Technologies**

Successful franchisors utilize advanced education and training technologies, such as computer based, interactive systems, for training franchisees and their management personnel and for training the franchisee’s employees. Such systems include testing and certification functions. Most franchisees have or can inexpensively acquire internet access to utilize such

systems. The best programs combine visual, auditory and interactive components. Some training programs will be specific to the network; other programs may be generic for the industry of the franchised network (e.g., sales training, English language training). Some programs are designed for personnel who train other employees (train-the-trainer). Trainees utilizing internet training can complete training at convenient time periods, thereby avoiding travel time and expense, increasing effectiveness and reducing the cost of training. The use of internet training standardizes the training of network employees. Software products known as authorizing tools are used to create online training programs deliverable via the internet.

## **J. Advertising And Marketing**

### **1. Franchisor Advertising And Marketing**

Successful franchisors develop and implement effective advertising and marketing programs to enhance the network brand and the business of their franchisees. Pooling network resources to develop programs and buy advertising and marketing services is a key rationale for the development of a franchise network. Each franchisee acquires access to and the benefits of advertising and marketing programs at a level of professionalism, exposure and impact far beyond its ability as an independent business. Effective advertising is essential for a network's brand to gain recognition and strength vs. competitors. The failure of a network to be competitive is a significant business risk undertaken by a franchisee.

National and regional advertising programs of franchise networks are typically supported by franchisee contributions or fees, customarily a percentage of the franchisee's revenue, but some times a fixed amount, indexed to inflation. Some franchise agreements provide for such contributions or fees to be paid from the inception of the franchise relationship, while other defer the payment until the network has achieved a specific benchmark (e.g., 100 outlets). Practice

varies among franchisors with respect to the administration of the advertising function (i.e., in a separate corporation or trust or merely through a separate account on the franchisor's books). Typically, advertising funds may be spent for the development of advertising and marketing programs, advertising agency fees, various forms of print and other advertising materials, video and radio advertising, public relations services and website development and maintenance. Franchisors use various methods to track the effectiveness of advertising and marketing themes, materials and media.

Good coordination of national, regional (e.g., advertising coops) and local advertising and marketing can maximize the effect of the available funds. Advertising and marketing at different levels should be complimentary, with each effort enhancing the others. Delivery of a consistent message in all advertising and marketing is important. A franchisor should establish the guidelines for regional and local advertising to assure good coordination.

## **2. Franchisee Advertising And Marketing**

Many franchise networks have regional advertising cooperatives to which their franchisees are required to contribute. Each cooperative establishes the rate of contribution, up to a limit prescribed in each franchisee's franchise agreement. The territory of each cooperative is usually determined by the franchisor and all franchisees located within that territory are required to participate. Franchisor operated stores belong to the cooperative designated for the territory in which they are located. A franchisor representative may be a member of the governing board of each cooperative. Regional advertising cooperatives generally focus on regional (e.g., metropolitan area) advertising and marketing, which includes local newspapers and magazines, television and radio, billboards, special events and other regional advertising and marketing venues.

Franchisors assist their franchisees with local marketing by developing a local outlet marketing plan designed to support and compliment national and regional advertising and marketing. Franchise agreements typically obligate the franchisee to spend a percentage of its revenues or a specific amount (which may be indexed to inflation or periodically increased by fixed increments) for local advertising and marketing, including local media, classified telephone directory advertising, direct mail, bag stuffers, promotions and the like. Local advertising expenditure requirements may be reduced when national advertising contributions or fees, and/or regional cooperative advertising contributions, become payable or are increased.

Franchisors include comprehensive local marketing instruction in the franchisor's training program and typically design and assist franchisees to implement effective grand opening promotional marketing. Franchisors also develop a wide variety of print and other media materials and offer such materials to their franchisees directly or through independent suppliers with whom the franchisor and its franchisees have successful relationships.

Successful franchisors furnish advice and guidance on local advertising and marketing, counseling franchisees with respect to what has and has not worked, and/or what is and is not cost effective. Franchisors also arrange for successful franchisees to offer advice and guidance to other franchisees. Franchisees should be encouraged and guided to become involved in their communities through sponsorships of sport teams and civic events and civic and charitable involvement.

Franchise networks are expanding the use of loyalty cards — smart cards — that simplify buying the franchise network goods or services, offer rewards to the customer, identify customers and gather data on customer buying habits. Franchise agreements should require

franchisees to participate in marketing programs such as network specific, smart cards (e.g., by promoting and accepting the cards). Loyalty cards that have a stored value function require a mechanism for reimbursement of the franchisee who accepts as payment for goods or services a card sold by another franchisee.

**K. Supply Programs For Franchisees And Restricting The Suppliers From Whom They May Buy**

**1. Procurement Programs**

Many franchisors implement procurement programs for equipment, fixtures, inventory, supplies and services that their franchisees must buy to develop and operate their businesses. Such programs enable the franchisor to utilize the collective resources of its network to secure better prices and service, higher quality and greater reliability of supply and can potentially reduce significantly the cost of development and operations of franchised businesses (assuming that a substantial part of the savings are passed on to franchisees). The franchisor may buy and take title to goods and resell them to its franchisees (or to distributors who resell to the franchisees), or simply may operate procurement programs in which various suppliers sell directly to franchisees (or distributors). In addition to significant cost reduction potential, procurement programs enable a franchisor to more effectively police quality control in its network by specifying the goods and materials utilized by franchisees in the development and operation of their businesses.

When a network achieves a sufficient size, franchisors can use data processing technology and the network extranet to collect and analyze system wide procurement data, share procurement data with franchisees and use such data to enhance supplier relationships. Larger franchise networks have been able to shift some costs to suppliers (e.g., data processing costs).

Data is shared throughout the supply chain, creating an information hub regarding ordering schedules, goods on order, goods at distributor warehouses, goods in transit and in franchisee inventory, tracking supplier and distributor performance and contract compliance and helping suppliers and distributors improve performance by eliminating duplicative and redundant activities. Such programs can greatly improve efficiencies in the procurement process (e.g., rapid data entry to make information more readily available); resolve operational and delivery problems (e.g., increase frequency and speed up delivery of supplies to permit lower inventories at all levels of the supply chain); facilitate excess inventory transfers among franchisees; and implement rapid change in delivery schedules, rerouting of goods in transit and transferring goods between distributors. Multibrand franchisors can combine procurement functions that overlap two or more brands. Single brand franchisors may be able to combine procurement functions with other franchise networks for nonbranded products. These concepts can also be applied to the supply chain for equipment, fixtures and décor packages and the coordination of architects, contractors and subcontractors, in the development of new outlets.

## **2. Supply Source Restrictions**

In business format franchise networks, supply source restriction is a complex and controversial issue and can involve both disclosure and antitrust issues. There are three distinct rationales for restricting sources of supply from whom franchisees may buy: (1) to control quality and uniformity; (2) to establish cost effective supply program; and (3) to protect confidential information. Supply source restrictions may also function as a profit center. Such restrictions will typically benefit franchisees, but the profit center element has the potential to undermine franchise relationships. Franchisees may view restrictions as imposing an additional fee, which, if not fully disclosed, will be assumed to be high. Franchisees have an incentive to

evade the restrictions by buying unauthorized products, impeding quality control. Some argue that best practice is not to operate a procurement program as a profit center or to accept supplier payments based on sales to franchisees, except to the national advertising fund.

Many successful franchisors do derive revenue from supplying franchisees and/or from network suppliers. If a franchisor derives such revenue, it should be fully disclosed in the franchisor's UFOC and to existing franchisees. The benefits of the supply program, the franchisor's role in developing supply sources and the franchisor's costs (including credit risk, if applicable) should be explained. Managing expectations avoids franchisee resentment. Full disclosure affords a franchisor protection against antitrust claims and can mitigate franchisee suspicion that the franchisor is deriving a high profit from the supplier restrictions. Overdependence upon supplier payments does have risks. Though it appears unlikely, the law could change and supply source restrictions as a revenue source could become less secure under federal or state antitrust or other laws.

### **3. Buying Cooperatives**

Some franchisors have assisted their franchisees in establishing buying cooperatives. Cooperatives can supply both franchisor and franchisee owned outlets. A few cooperatives supply more than one network of the same or different franchisors. Cooperatives established to pay patronage dividends to each franchisee, based on the amount of business transacted by the franchisee with the cooperative, can qualify for favorable income tax treatment.

### **4. Insurance**

Every franchise network needs to develop cost effective insurance programs tailored to the industry and risks of the franchise business and needs of franchisees and their employees.

Such insurance includes general and excess liability, owned and non-owned motor vehicle, other specific risk coverages (e.g., alcoholic beverage), fire, vandalism, malicious mischief and similar coverages. Other insurance requirements include workman's compensation, life and health and accident. Some franchisors have developed insurance programs that offer such coverages to their franchisees. Franchisors work with insurance broker(s) and underwriter(s) to identify and reduce risks and lower premiums.

The franchisor should be included as an additional insured on all franchisee liability insurance policies and such policies should require notice to the franchisor of nonpayment of premiums or other default by a franchisee and any changes in the terms of insurance coverage. Many franchisee policies also contain a waiver by the insurance company of subrogation rights (e.g., the right to assert a claim against the franchisor for payments made on claims by customers or employees of the franchisee). The franchisor will have more control over the insurance carried by its franchisees if it designs and arranges for cost effective coverage that benefits the franchisees.

## **5. Cost Reduction**

The cost of operating a franchised business is just as important as the sales volume of the business in determining the franchisee's profit and return on investment. Reducing operating costs can in some circumstances be more readily achievable than increasing sales. For example, in a recession or weak economy, or in the face of new or increased competition, incremental sales gains may not be achievable. In those circumstances, reducing costs may be the only realistic means of increasing profits. Cost reduction guidance involves both supply and other costs. Reducing supply costs is usually the most effective method to reduce overall cost of operations and, as discussed in this section, can be accomplished by procurement programs in

which a substantial part of the cost savings from group buying are passed on to the franchisees. Franchisors have effectively reduced investment requirements, operating costs and break-even revenue levels by developing smaller outlets and otherwise reducing the cost of outlet development (e.g., developing prefabricated components of the business facility; shipping a complete equipment and fixture package as a unit to the site of the facility for rapid assembly — a store on a truck concept; modifying equipment and fixtures to reduce the cost of manufacture and installation; minimizing customization; leveraging volume purchasing to reduce cost). Other cost reduction initiatives include improved labor utilization, lowering energy consumption and cost and reducing the cost of services required in the operation of the franchised business (e.g., telephone charges, waste disposal, laundry, cleaning and maintenance, insurance). Relatively small reductions in a wide range of operating costs can add up to significant cost savings, lower break-even points and higher franchisee profit and return on investment.

To develop a cost reduction plan, a franchisor needs cost data from its franchisees. Such data can be combined to produce average and median cost data for the network, enabling each franchisee to compare its own costs with average and median cost data and determine where its outlet needs to improve. The franchisor can use such data to develop and implement cost reduction programs. Cost reduction that does not damage sales potential will increase profitability and enhance the value of the franchise.

#### **L. Field Service And Support**

Effective field service and support is critical to the success of a franchise network. Skilled and effective field personnel are essential to maintain constructive interaction between the franchisor and its franchisees. Capable field personnel can turn around a failing or uncooperative franchisee, but poorly skilled, trained or motivated field personnel can alienate

franchisees. A franchisor should recruit qualified field service and support personnel, train them well and implement procedures for evaluating field personnel and investigating and resolving franchisee complaints about a field employee.

Field service involves several functions: (1) a communication function: the communication conduit between franchisor and franchisee; (2) a guidance and mentoring function: furnishing guidance to the franchisees and helping franchisees overcome operational and marketing problems; and (3) an enforcement function: evaluating franchisee compliance with system standards and reporting noncompliance. Combining these functions in one person requires high skills and dedication. Though field personnel must perform system standards evaluations and report noncompliance, they will be far more effective if they approach franchisees as consultants and trainers whose primary function is to assist franchisees to operate their businesses more efficiently and effectively and provide to the customer an experience that will motivate frequent patronage. Though operational and appearance problems can require a relatively quick fix, the field person should be trained to develop longer term plans to improve operational performance, marketing and efficiency. The goal of the field person should be to convince the franchisee that fully implementing the franchisor's operating system, and compliance with system standards, will result in greater customer loyalty and higher revenues and profits. A relationship of trust between the field person and the franchisees with whom he or she works is an important predicate for maintaining a relationship of trust between those franchisees and the franchisor.

As is the case at all levels in a franchisor's organization, there will be turnover in the ranks of field service personnel. A new field person will face the potentially difficult task of establishing credibility with franchisees who have been in the network for more than a few years.

If the field person understands that franchisees are frequently the best source of innovation in a franchise network, and communicates to "older" franchisees a willingness to listen to their ideas and learn from them, the field person can insist on compliance with systems and standards (until modified after franchisor evaluation of the franchisees innovation) and the relative inexperience of the field person should not interfere with a productive working relationship.

Another challenge faced by field personnel is consulting with a franchise owner who does not operate his franchise business on a day-to-day basis. The field person will have to give the absentee owner an evaluation of the managers of the business and such evaluation may range from favorable to not entirely favorable to highly negative. Such evaluation confronts the owner with a range of undesirable choices, such as more training, closer owner supervision or replacement. The field person must assume that his evaluation will be communicated in part or whole to the managers, which can make his or her next visit to the outlet distinctly less pleasant. Again, the manner in which the evaluation is presented — a constructive critique with recommendations for improvement or negative complaint — can make a big difference in how it will be perceived and acted upon by both the owner and the managers. Reviewing the evaluation first with the managers will also help maintain a constructive and cooperative relationship.

The role of the field person as a communication conduit between the franchisor and franchisee should not be underestimated; and the fact that effective communication is interactive — it involves both listening and talking — should be fully applied in training field service personnel. The franchisee should view the field person as someone he or she can talk to about problems at his or her outlet and concerns regarding the performance of the franchisor and the direction of the network. The field person should be a good listener and should include the concerns expressed by a franchisee in his or her report to franchisor management and request

guidance regarding the appropriate response to the franchisee. If the field person listens to the franchisee and endeavors to obtain information and answers to his or her concerns, the franchisee is more likely to listen to the field person and implement his or her recommendation.

In the early states of network expansion, field service and support personnel will usually work from the franchisor's headquarters. As the network grows into new geographic areas, franchisors generally find it more effective to have field personnel live in the geographic areas that they cover, possibly working out of a regional office, minimizing travel time and enabling a field supervisor to effectively cover a greater number of franchisees. In a few franchise networks, field service functions are implemented, in part, by area directors that also have responsibilities for franchisee recruitment and site selection. Some franchisors find that separate headquarters and field personnel for franchisee and company operated outlets is more effective.

#### **M. Research And Development**

Research and development is an important service and involves: (1) collecting and analyzing operating and financial data from the franchisor's network and competitor networks; (2) monitoring competitor operations, products and services, operating systems, expansion and advertising and marketing; (3) monitoring technology changes; (4) experimenting and testing modified and new products and services; (5) developing better price/value relationships for the customers of its network; and (6) operating system improvement. The franchisor is (or should be) the organizer and manager of research and development, but recognize that ideas and innovation may originate with the franchisor, network suppliers and (usually, most importantly) franchisees. Each of these potential sources of ideas is important.

Research and development includes exploring alternative methods of distribution that expand opportunities for franchisees. For example, co-brand and multibrand (two or more separate brands franchised by the same franchisor or related group of franchisors) relationships can develop synergistic business combinations and/or combinations that reduce fixed costs. Co-branding can be an important expansion strategy for a franchisor that does not have a sufficiently large advertising budget to build its brand. If the company co-brands with a larger franchise network, it is relying on the advertising and customer traffic of that network to generate revenue and brand recognition for its network. Such a franchisor may also benefit from access to locations it would not otherwise be able to secure or afford. Co-branding and multibranding is a significant retail trend. Other examples include developing satellite and limited product/service outlets, seasonal or permanent kiosks and carts, outlets in nontraditional locations (e.g., military bases, airports, office buildings, department stores, sports stadiums and college campuses).

## **N. Financial Services And Guidance**

### **1. The Need For Financial Services**

The underlying concept of a franchise is that of a business opportunity sponsor assisting an investor to establish a viable business. Financing is generally an integral element of the development of a new business. A franchisor that develops programs to augment the ability of its franchisees to finance their businesses will have greater appeal vis-a-vis its competitors who do not offer such programs and will enhance its network expansion. Franchise networks need financing for new outlets, remodels and upgrades, equipment for new products and services; and the buyout of franchisees who are selling their businesses.

## **2. Sources Of Finance**

Bank and nonbank lenders are sources of financing for franchise networks. Commercial and savings and loan banks have traditionally based credit decisions on the availability of hard asset collateral. Nonbank lenders, insurance companies and leasing companies tend to base credit decisions on projected cash flow. Both types of lenders will loan to franchisees when conditions are favorable and are likely to restrict credit to franchise businesses in response to a rising level of nonperforming franchisee loans or deteriorating economic conditions generally, or in the secondary markets for such loans. New franchisees frequently do not have hard assets sufficient to meet the collateralization requirements of bank lenders.

## **3. Franchisor-Lender Relationships**

A franchisor needs to establish relationships with lenders who will work with its franchisees. Lenders can become a franchisor's strategic partners. A franchisor should seek relationships with lenders who have an understanding of the industry in which the franchise network operates and an understanding of franchising, especially lenders that are familiar with and have made loans to franchisees in the same industry/business classification. A steady flow of loan opportunities and prior approval of franchisees by a reliable franchisor can reduce the lender's underwriting and loan processing costs and shorten the period for loan approval and closing. Some of this savings may be passed on to franchisee borrowers. It is advantageous to establish lending programs with several lenders in order to cover all geographic areas where financing may be needed, to avoid overconcentration of franchisee borrowing with one lender and to avoid loss of financing if a major source of franchisee loans decides to exit the franchise lending business or to reduce its lending to specific industries or networks.

With respect to each lender, a franchisor should determine how the lender approaches underwriting at the franchisor and franchisee level; clarify the lender's loan size and hard asset and loan to value parameters and other lending guidelines; understand the lender's flexibility in structuring loans to meet specific situations that vary from the standard development parameters; and determine the geographic scope of the lender. What are the lender's preferred characteristics for a franchisee borrower? Will the lender prequalify the franchisees approved by the franchisor and issue a conditional commitment, subject to specific site approval? How complex is the loan application? How, and how quickly, will the decision be made and how long will it take to close the loan after it is approved.

A franchisor should prepare a detailed presentation of the franchise business and its network, including: (1) the components and development costs for an outlet; (2) the required franchisee equity investment; (3) revenue and profit projections for the first one to three years of operation; (4) the franchisee selection process; (5) the training program and support programs for new franchisees; (6) the development and financial guidance and assistance provided by the franchisor to new franchisees; (7) franchisor and network financial data; (8) the composition and expansion plan of the network (e.g., single and multiple unit franchisees; single purpose and cobranded outlets); (9) historical and projected geographic expansion; (10) historical network growth and franchisee turnover data (UFOC Item 20); and (11) a copy of the current UFOC.

#### **4. Franchisor Credit Enhancement**

Franchisors should consider credit enhancement techniques. Many franchisors offer credit enhancement to lenders in order to increase the lender resources available to the network,

reduce the cost of funds and improve terms. For example, franchisors issue comfort letter to lenders: (1) representing that no default exists under the borrower's franchise agreement; agreeing to copy the lender on default and termination notices; (2) consenting to the grant of a security interest in the franchisee's rights under the franchise agreement (exclusive of the franchisor's intellectual property), in accordance with the Uniform Commercial Code (Section 9-408(A)); (3) assuring the lender that in the event of default by the franchisee under the franchise agreement or the loan, the lender will have the right to cure the franchisee's default in accordance with the franchise agreement and that the franchisor will not immediately terminate the franchise, giving the lender certain temporary operating rights during a period in which a successor franchisee is sought; and (4) giving the lender certain rights to install substitute management at the franchisee's outlet (usually subject to franchisor approval) to whom or which the franchisor will grant a new franchise. Franchisors also agree to: (1) subordinate their security interests in the franchisee's tangible assets; (2) defer collection of royalties during periods in which a loan to the franchisee is in default (typically, subject to recouping deferred amounts as a condition of the franchisor's approval of a sale of the franchisee's business and issuance of a new franchise to the buyer); (3) operate and resell a franchisee's business if the franchisee fails; (4) repurchase equipment/inventory at depreciated cost; (5) guarantee a percentage of aggregate loan losses; and (6) wholly or partially guarantee loans for a limited period. Franchisors should, of course, commit all such understandings with lenders to a written agreement or memorandum of understanding. Relationships with lenders can be formal or informal. Even if relatively informal, it is advisable for the franchisor to memorialize the agreed terms of the relationship.

## **5. Small Business Administration (SBA) Loans**

Many franchisors seek relationships with lenders that have SBA preferred lender status and substantial experience in SBA lending. SBA guaranteed loans are senior debt that can be used to finance real property, leasehold improvements, equipment, fixtures and working capital. There are a number of SBA lenders who operate throughout the country and a much greater number of regional and local banks that grant SBA guaranteed loans. Most national SBA guarantee lenders are increasing the size of their minimum loan transaction. This has forced franchisors offering franchises that require relatively low amounts of debt capital to work with a larger number of regional and local SBA guarantee lenders. The borrowers (or the principal owners of the borrower) must personally guarantee an SBA guaranteed loan and pledge collateral to back the guarantee. The interest rate on SBA loans generally are tied to the prime rate (lower than comparable commercial loans) and floats during the term of the loan. SBA loans are usually amortized over a relatively long period and impose a prepayment penalty. The SBA has been a strong supporter of loans to franchisees for almost four decades and SBA guaranteed loans are an important component of the financing of franchise businesses in a wide range of franchise networks.

The SBA has established a franchise registry ([www.franchiseregistry.com](http://www.franchiseregistry.com)) managed by Frandata, a subsidiary of the National Cooperative Bank, for franchisors that submit franchise documentation to establish that franchisee borrowers meet the SBA's size standard criteria (essentially, that the franchisor does not maintain the type of controls that preclude treating the franchisee as an independent business). This website contains information and guidance on securing SBA guaranteed loans. The franchisor must pay a registration fee and an annual renewal fee to be registered and a fee if it amends its franchise documents and submits them to

the SBA registry. Registration means, at least in theory, that the SBA has done its underwriting due diligence on the franchisor and evaluation of its franchise relationship is not necessary each time its franchisee applies for a loan.

SBA lenders assist franchisees under two SBA financing programs. Under the Section 504 loan program, long term financing for land and buildings is provided under a financing plan in which fifty percent is contributed by a commercial lender, ten percent or more by the borrower and the balance by a Certified Development Company through the sale of SBA-backed securities (a CDC is a nonprofit corporation established to stimulate development in a community). Under the Section 7(a) loan program, widely used in franchising, the U.S. government guaranties of up to the lesser of 75% of the loan or from \$500,000 to \$2,000,000 (this ceiling on the amount of loans fluctuates periodically depending on the relationship of loan demand to the aggregate level of guaranteed loans the SBA can approve in a given fiscal period. This program makes loans available to new franchisees with limited collateral and little or no experience.

Both bank and nonbank lenders offer SBA guaranteed loans. Nonbank lenders may offer more flexible terms, including generally more favorable interest rates, terms are up to 10 years for working capital, 15 years for equipment and 25 years for real estate — or a blended term for a multi-purpose loan. Longer terms and favorable interest rates lower the franchisee's monthly payments. Prepayment penalties are generally small. A lender with preferred status can expedite SBA loan processing. SBA preferred lenders are listed at the SBA website, [www.sba.gov](http://www.sba.gov).

## **6. Direct Franchisor Financing**

Direct franchisor financing can stimulate franchise sales and help attract highly qualified franchisees who might otherwise be unable to acquire a franchise. Franchisors: (1) finance

initial franchise fees; (2) enter into business facility leases with prospective franchisees (a financing device that enables the prospective franchisee to operate the business under a lease type agreement and to gradually acquire ownership by applying his or her share of profits to the purchase cost); (3) structure deferred ownership agreements with lenders to share financing of qualified but undercapitalized franchisees; (4) finance employees who acquire a franchise; and (5) match talented operators with equity investors.

## **7. Other Types Of Financing**

Other types of financing are utilized by franchise networks, particularly when bank and nonbank financing is more difficult to secure. Examples include: (1) landlord financing; (2) sale/leasebacks; (3) equipment leasing; (4) vendor financing; and (5) government assisted financing programs for inner city development zones. Real estate sale/leasebacks are a rapidly growing type of financing for franchisees, offered by a wide variety of companies that arrange tax favored like kind exchanges, institutional lenders and real estate developers. A site with good demographics, traffic patterns, access and development characteristics is generally a prerequisite for sale/leaseback financing. A franchisee can finance the total cost of the site and improvements in a sale/leaseback and lease the site for a long as 20 years plus renewal options. Lease payments will usually be fully deductible by the franchisee. Personal guarantees of the lease may be required and the lease will be triple net (the franchisee must pay real estate taxes, repairs and maintenance and other expenses of the property). In a sale/leaseback, the franchisee gives up the appreciation in the value of the real estate, which can be substantial.

## **8. Financial Guidance**

A franchisor should offer financial guidance to its franchisees and be particularly cautious regarding excessive franchisee leverage. Too much debt increases risk of failure and reduces the ability of the franchisee to finance future growth and reinvest in its business facility. Cash flow pressure distracts a franchisee and negatively impacts the operations of its businesses. Soundly capitalized franchisees greatly strengthen a network's competitive position, are an important cushion against an economic downturn and significantly reduce a major source of franchise relationship problems.

## **O. Resale Programs**

Franchisors establish programs to assist franchisees who decide to sell their businesses. Some franchisees will not be successful. Others, without regard to relative level of profitability, will "burn out" or may decide to realize the increase in value of their businesses or simply to do something else. The interest and effort of some franchisees may decline due to illness, family problems or other distractions, and such diminished interest and effort will be reflected in the performance of their outlets, but the franchisees will not initiate a sale of their outlets. In all of these cases, the franchisor has an interest in facilitating the removal of "old blood" and the introduction of "new blood" into its network. Whatever the cause of failing or declining performance, it is important to identify such franchisees at the earliest possible date. If the cause is additional competition or other factors not attributable to franchisee interest or effort, appropriate operational and marketing solutions should be considered. However, when diminished franchisee interest and effort are the cause, it is important to focus corrective action on a transfer of the franchise's business to "new blood" in order to avoid a continuing decline in

performance and a high potential that the outlet will become unsaleable or fail, with consequent loss to the franchisee, the franchisor, the lender, the landlord and suppliers, and the possibility of costly litigation.

Franchisors assist their franchisees by developing a checklist of the issues relevant to the sale of a franchised outlet and the transfer of the franchise or the execution of a new franchise agreement. Franchisors also assist such a franchisee to prepare an offering memorandum for its business, notify other franchisees of the outlets that are for sale and expedite right of first refusal decisions and buyer approval and training. Franchisors and other franchisees are frequent buyers. A substantial pool of buyers establishes a strong secondary market for the franchised businesses of the network. The factors determining the value of operating outlets are usually readily determinable (e.g., sales history, cost structure, style of outlet, refurbishing requirements, location characteristics and lease term), the format and procedures of sale are established and such transactions can be completed quickly and inexpensively. A resale program may facilitate persuading a franchisee that is performing poorly, or is not in compliance with system standards, or has a declining interest in its business, to cash out and helps keep the network refreshed with new franchisees eager to build the franchise businesses they acquire.

## **P. Exploit Technology And The Internet**

### **1. Franchise Network Websites**

Internet websites, intranets and extranets and other technology are widely used by franchise networks for: (1) strengthening the network brand; (2) franchise sales; (3) promotion of products and services, (4) providing product, service and retail outlet information to

customers; (5) delivering online promotions/coupons; (6) electronic commerce; (7) various elements of supplying franchisees and franchisor operated outlets; (8) financial transactions; (9) data collection; (10) organization and reporting of financial and customer data; and (11) training and support of franchisees. An internet website can streamline many functions in a franchise network and is an important franchisor service.

A franchisor should take care to establish a website on a sound legal and technical basis. Agreements with website design, development and hosting service providers should comprehensively cover such essential terms as the specific services to be furnished and the cost of such services, and should confirm franchisor's ownership of the website and its entire content. A franchisor needs to carefully control the trademark usage inherent in website usage. A franchise network's website content should be fully consistent with the franchisor's UFOC, earnings claims rules under federal and state law and other disclosure law requirements. Websites must comply with privacy law obligations (e.g., with respect to information sought from people who transact business or log on to the website) and franchisor and franchisee privacy policies and their implementation should be coordinated and consistent. Franchisors need to develop rules with respect to linking to other websites. The franchise agreement should give the franchisor the right to use the advertising fund to pay the cost of the website.

## **2. Single vs. Multiple Websites**

A fundamental decision that must be made by a franchisor is whether to have a single website for its franchise network (possibly with a webpage on the site for each franchisee) or to permit each franchisee to have its own website, with a domain name that includes the network

trademark, subject to format, content and linking standards prescribed by the franchisor. A single franchisor website has significant advantages. It avoids confusion regarding the sponsor of the website; customer searches will always lead to the single network website. A single website facilitates a unified marketing strategy for the network. The franchisor maintains full control of its trademark. All data from customers will be collected at one website, facilitating marketing and network privacy policy implementation. The franchisor maintains control of the flow and distribution of information on the internet. Upon termination of the relationship with a franchisee, the franchisor can simply remove the franchisee's information and web page from its website; there is no need to inform internet directories and search engines or to enforce an assignment from the franchisee of a domain name that incorporates the franchisor's trademarks.

If each franchisee will have a webpage on the network website, the franchisor should develop the format and content of such individual webpages and determine the degree of customization that will be permitted and the procedures for approval of modifications proposed by a franchisee. The entire website should have a similar "look and feel," but permitting franchisees to be distinctive on their web pages can enhance their support for the website. Each franchisee should sign an acknowledgment of the franchisor's right to remove its web page if the franchise is terminated.

### **3. Business To Consumer Ecommerce Policies**

If the franchisor will make or facilitate internet sales of goods or services to consumers, it needs to develop a B2C policy for its network. In developing the policy, the franchisor should keep in mind that B2C commerce may or may not be successful. Even if successful, the enhanced revenue may not offset damage to franchise relationships if such sales are considered

by franchisees to violate their franchise agreement rights, or simply to be unfair. A comprehensive review is needed of the territorial rights of franchisees that may limit B2C sales by the franchisor. Even if the franchisor may legally sell via the internet to customers in the markets of its franchisee, (which may not be clear), the impact of such sales on the franchise relationship should be carefully weighed. Franchisees will not view the internet as unique or otherwise exempted from what they consider to be their explicit or implicit rights to be the exclusive seller of the franchisor's products and services in their markets. Ignoring such franchisee beliefs is likely to damage relationships. A transparent policy that reflects the interests of the franchisor and its franchisees is a prerequisite of avoiding conflict. The franchisor should maintain communication and avoid surprises while formulating the franchisees' role in e-commerce.

In many franchise networks (e.g., those whose business outlets sell services delivered to the customer at the outlet or in the customer's home or place of business, it is more practical for the franchisees to make all sales. If the network sells a tangible product, it may be feasible for the franchisor to sell such product over the internet. When such sales are made by the franchisor, franchisees can share e-commerce revenue (e.g., the franchisor can pay the franchisee a reverse royalty on B2C sales made in the franchisee's territory). Other policy issues include: (1) whether the franchisor or the franchisee will establish prices and terms of sale; (2) the responsibilities of the franchisor and franchisee for order fulfillment and delivery, pre and post sale service, warranty service, billing and collection and how each of these functions shares in the revenue from B2C sales; (3) who "owns" the B2C accounts and who has risk of loss for nonpayment and customer claims; (4) how will the franchisor allocate leads among its

franchisees. Several franchisors have structured their B2C ecommerce in a separate company in which the franchisees have ownership interests. A franchisor should reserve the right to remove from the B2C program a franchisee who does not comply with system standards or does not follow e-commerce policies and procedures. Franchisees should be involved in website and e-commerce policy development. Website and e-commerce rules and policies should be fully spelled out in franchise agreements, operations manuals and offering circulars.

#### **4. Intranets And Extranets**

In the last decade, franchise networks have adopted intranets (internet based communication systems limited to network members). Intranet systems offer many efficiencies and advantages to franchise networks. When non-network member companies are added to the intranet (such expanded intranets are referred to as extranets), additional functions and efficiencies can be exploited. A well designed intranet will enhance network communication. Franchisees can access the franchisor and other franchisees at convenient times and responses can be virtually instantaneous. All of the information on the intranet can be readily updated. Paper communication is reduced. Ideas and solutions that exist anywhere in the network are available to everyone in the network. Intranets can be used to publish network news. A franchisor can efficiently and quickly poll franchisees on various operational and marketing issues. Real time tracking of sales and cost data can be continually available to franchise and franchisors can obtain a great deal of information from franchisees and company operated outlets. Franchisees can access this data and download a variety of reports to compare to their own operating results. Intranets are increasingly used for on-line training programs and manuals, webcasts, operations manuals and a library of forms and approved advertising formats. Rapid

feedback from franchisees expedites modifications to advertising and marketing plans and gives franchisees an opportunity to participate in advertising and marketing decisions. Intranets also facilitate the customization of advertising for franchisees.

Intranets, expanded to extranets, are utilized for automated ordering from suppliers and supply system management. The extranet facilitates inventory management, the communication of online catalogs and product specifications and order processing. Vendors sponsor bulletin boards for franchisees covering new products/services, specification changes and technical information. Vendor sponsorship and advertising can defray some of the cost of the extranet.

Intranets are also utilized for reservation systems, customer databases, customer snail mail and email addresses, knowledge of customer buying habits to assist in targeted marketing and for intranetwork email communication. Franchise network intranet systems maintain a help desk for franchisees, discussion forums, online bulletin boards. They facilitate exchanges among franchisees of surplus equipment, products and supplies and the communication of questions, ideas and marketing tips among franchisees. They enable franchisors to monitor the issues that concern their franchisees. Many large franchisors are developing wireless internet connectivity for their franchise and company owned outlets.

A franchisor should seek franchisee input at all stages of development of the network website and intranet and extranet. It is important to secure this input before development plans have progressed to the point that modification is difficult or costly and to continue to seek franchisees views on effectiveness of the network website and intranet or extranet. Franchisees

can help detect the errors and bottlenecks and are in a good position — probably the best — to determine effectiveness and efficiency.

## **5. Who Owns Electronic Databases?**

Modern intranets and extranets accumulate a large volume of data, much of which may be contributed in whole or part by franchisees. Who owns this data? Many franchise agreements executed in recent years provide that such data is confidential and the property of the franchisor. Some agreements are silent on the issue of the franchisee's rights to the data after the termination or expiration of the franchise (the franchisee usually has explicit or implicit rights to such data during the term of the franchise). Some agreements provide for use without designating ownership or expressly make data the joint property of the franchisor and the franchisee. Other agreements expressly prohibit franchisee use after termination or expiration. In the absence of franchise agreement or operations manual provisions clarifying ownership and use, during and after the term of the franchise, courts are likely to hold that ownership or rights of use are joint.

## **6. Management Software**

Franchisors and franchisees increasingly utilize management software and “back office” services for the management of franchise and franchisor operated outlets. The availability and functionality of software programs for franchise businesses have increased significantly. Such programs enable franchisor management and franchisees to enhance the efficiency of many functions, such as document management; employee scheduling; electronic reports of sales, costs and other data; storage and distribution of a network data; and payment of fees. Franchisee and

company outlet data can be combined in a database and franchisees can compare their sales and operating costs with network averages and median performance. Such systems aid in customer data gathering and utilization and in customer relations management, developing such information as who is the customer, what and when does the customer buy, what is the customer's perception of the network business and what does the customer value? How can the network's product or service be modified to enhance its value and customer appeal? How can the frequency and amount of customer purchases be increased? How can the business secure new customers and how should it advertise? Management software is available for specific industries and includes systems for monitoring labor and energy utilization.

Management systems provide franchisor management with important information on each franchisee and make such information readily available on manager terminals. Such information for each franchisee can include: (1) sales, operating costs and other data; (2) recent communications between the franchisee and the franchisor; (3) inspection reports; (4) training scores; (5) operating problems; and (6) franchise agreement and lease data.

As management software programs for franchise networks improve and expand to cover more functions, franchisors must determine whether the cost of this software, and its maintenance and periodic upgrades, will be built into its royalty structure, or will be offered to franchisees at an initial and/or periodic fee. Since future costs are difficult to determine, it is sensible for a franchisor to have the flexibility to charge for management software even if it is initially furnished without a separate charge.

Certain “back office” systems and services for franchisees can be supplied by third party vendors. Many franchisees, often with the encouragement of their franchisors, have transferred responsibility for a variety of paperwork functions of the franchise business to independent service providers (e.g., payroll accounting and reporting, sales tax reporting). Such outsourcing can improve quality, timeliness and accuracy of accounting and reports and enable franchisee management to focus on marketing, customer relations and business operations.

Payroll services for franchisee and company outlet employees enhances the efficiency and accuracy of the collection and processing of payroll information, the delivery of payroll checks and collection of payroll and tax data for quarterly and annual filings and can reduce the cost of payroll processing. Payroll services can also be a vehicle for franchisor to communicate directly to employees of franchisees, using a regular bulletin or periodic communications to employees that are included in paycheck envelopes. The franchisor can use this communication to ask questions and invite employee comments via a watts line or website, enabling the franchisor to gain insight into labor relations at franchised outlets. Franchisee employees may communicate valuable ideas. However, franchisors should control the scope of the information sought from franchisee employees. Such information should be limited to operational issues and ideas. A franchisor should make clear that employee relations issues should be directed to the owner of the franchised outlet. For example, receipt of an employee complaint of sexual harassment can expose the franchisor to liability if its response is other than to direct the employee to his or her employer.

## **Q. System Standards**

### **1. Formulating Standards**

It is essential for a franchisor to formulate, communicate, monitor and enforce sensible and effective system standards. Standards are essential to protect a franchisor's brand. A franchisor's brand is its most valuable asset — the cornerstone of its business and franchise network. Maintenance of high quality and uniformity of products and services and operating standards cause the public to patronize businesses operating under the brand. Predictability of quality and service is important to the consumer. To be a repeat customer, a consumer must have positive feelings about the brand.

Consistently implemented competitive standards strengthen and preserve brand loyalty. Substandard outlets will adversely impact the brand. In general, consumer brand loyalty is declining and brand loyalty can easily be lost by poor standards formulation or execution, leading to product or service inferiority. Brand erosion can affect the entire network. Poorly formulated, communicated or executed standards will diminish the value of franchisee and company operated businesses.

In addition to the slow erosion of consumer loyalty to a brand that can result from the failure to maintain standards, franchise networks are continually at risk of sudden exposure to highly damaging publicity resulting from a well publicized occurrence that raises a question about the safety or security of patronizing the outlets identified by a specific brand. Such an event could be a food poisoning event involving a franchise network outlet; or a violent crime or

series of violent crimes at one or more such outlets. Or it could be an “expose” of sanitation practices by outlets of a food service network, such as a recent Dateline story on cleanliness practices at quick service food outlets of several franchise networks, or the effectiveness of the employee screening by companies that send service workers into peoples’ homes. The long term damage done by such occurrences and widely broadcast investigations is difficult to measure, but short term impact can be severe and recovery from that impact may be slow. It does not matter whether the specific outlets identified, the franchisor or its suppliers, are responsible, or how exaggerated the story is. Perception is reality. Such events can, of course, occur notwithstanding high operating standards and excellent monitoring and enforcement of those standards. However, high standards and diligent standards implementation will reduce the likelihood of an event that diminishes consumer confidence and will make it possible for a franchisor’s management to respond to the press with positive and accurate information regarding the efforts of the network to avoid just such occurrences.

Maintenance of standards is also important to franchisees who voluntarily maintain and value high standards. Long-standing neglect of system standards will weaken those standards. The number of substandard outlets in the network will grow, potentially damaging the image of the network and antagonizing franchisees who maintain high operating standards. It will then become difficult to raise the level of compliance.

## **2. Avoiding Causes Of Noncompliance**

A franchisor should understand and avoid the principal causes of noncompliance: (1) failure to maintain standards at company outlets; (2) failure to adequately train franchisees,

managers and employees; (3) retention of incapable or unmotivated employees due to the inattention of franchisees or management of franchisor outlets and the difficulty of securing and cost of training of replacements; (4) failure to communicate standards or keep the operations manual up to date; and (5) failure to establish a program of regular inspections. Notwithstanding that the franchisor has furnished a successful operating system, excellent training in that system and in system standards and achieves the maintenance of high standards throughout its network, there may be one or more franchisees in the network who continually "experiment" with the operating system or simply fail to follow it, or who do not regard system standards as an obligation or important to their businesses. Such franchisees present a challenge to the franchisor's patience and resolve to help every franchisee succeed. The rationale for ending wrong relationships is discussed in Section 4.F. Subsection (4) of this section discusses the means to end such relationships.

System standards should be covered thoroughly and emphasized during the initial training program and should be a major component of field service meetings with franchisees; addressed in newsletters and other communications to franchisees; and a major part of continuing training programs. A key focus of franchisor communications relating to system standards compliance should be convincing franchisees that implementing the franchisor's operating system and standards compliance will enhance their profitability. As is taught in elementary psychology, positive reinforcement is far more effective than negative reinforcement. If a franchisee is persuaded that the purpose of controls and restrictions placed on the operation of his or her business by system standards is to enhance the customer's experience, not to control the franchisee, and that fully implementing standards will generate more revenue and profit, that

franchise is much more likely to voluntarily comply. Threatening a franchise with "enforcement" is less likely to be effective on a long term basis.

### **3. Inspections**

At least some inspections should be conducted without prior notice to the franchisee. Inspections should be comprehensive and rigorous and a complete checklist of all significant system standards should be developed and used in such inspections. A detailed report should be prepared for each inspection and this report should be reviewed with and signed by the franchisee. Inspection reports and the follow-up inspections and communication with a franchisee should address the primary causes of poor system standards compliance by a franchisee. Such causes include a failure by the franchisee to accept and implement system standards and/or a failure to effectively motivate and supervise its employees. If an inspection discloses material deficiencies in the operations or appearance standards applicable to a franchisee's business, the franchisor should establish a timetable for correcting such deficiencies. Follow-up inspections should be scheduled (they may be prearranged with the franchisee or unannounced). Complying franchisees will recognize the function, importance and value of such inspections. They demonstrate the franchisor's efforts to maintain high standards and they help franchisees correct deficiencies in their operations.

A franchisor can monitor system standards by means other than periodic inspections. Some franchisors utilize "mystery shoppers" to observe the appearance and operations of franchised outlets (and sometimes to observe whether all sales are recorded on the outlet's cash registers). Franchisors also utilize customer comment cards, which franchisees are required to

display. Such cards ask for customer comments by mailing the card or calling a toll free number. It is important for a franchisor to motivate its franchisees to voluntarily comply with standards. Franchisors give awards and recognition for maintenance of high standards. Additional franchises should be granted only to franchisees with high scores. Peer pressure by other franchisees can be helpful. A few franchisors charge a lower royalty to franchisees (or rebate a portion of the royalty paid by franchisees) who maintain standards. Voluntary compliance by the great majority of the franchisees of a network avoids potentially difficult and costly enforcement problems.

#### **4. Enforcement**

It is also important for a franchisor to take appropriate enforcement action when it is unable to secure voluntary compliance with system standards. Some action is essential to demonstrate that the franchisor takes systems standards compliance seriously. Persuading a franchisee to sell its business is frequently the most cost effective resolution of substandard operations. A franchisee's right to add new products or services or acquire additional franchises can be made conditional on full system standards compliance. Termination of the franchise relationship can be difficult and expensive (some state laws give franchisees extensive rights against termination and nonrenewal) and frequently is not a productive approach. Instead of terminating, a franchisor can sue to enforce standards. In such a legal action, the franchisor is on the side of the consumer. The franchise agreement should give franchisor the explicit right to an injunction to enforce system standards and the right to recover the costs and attorneys fees that the franchisor incurs in connection with such enforcement. A successful suit for an injunction and attorneys fees sends a compelling message to other noncomplying franchisees.

Maintaining system standards in a franchise network requires the investment of time and money. Training, communication of standards, monitoring compliance, motivating voluntary compliance and enforcing standards all have a cost. However, the money and effort saved by a less than diligent program to maintain standards is likely to be more than offset by a decline in standards and brand loyalty by consumers, the profitability of network outlets and the value of the investment made by the franchisor and its franchisees in their businesses.

## **R. Adapting To Change**

### **1. Resistance To Change**

Many types of changes can impact franchise relationships. Examples are changes in demographic factors, technology, communications, competitive conditions, market organization, products and services, legal standards and consumer tastes and interests. Franchisees may resist changes needed to adapt the network to changing markets. There is a natural, emotional resistance to change. Effective adaptation may require changing one or more system standards, adding or changing products or services, upgrading business facilities, changing operating procedures, adopting different marketing strategies or modifying the image of the business. Such changes may require a capital investment by franchisees or result in higher operating costs. Franchisees may disbelieve that higher sales or profits will result from these changes or may resist change due to satisfaction with the level of income they have attained.

### **2. Presentation Of The Need For Change**

Change can be made more palatable by disclosure that it is likely to occur and by tying it to specific events, such as growth of the network. The way in which the need for change is

presented to franchisees can have a major effect on how much they will resist. If presented as an accomplished fact, it may be viewed as a threat to franchisee independence or the security of their businesses. If presented matter-of-factly, it may arouse suspicions. If presented through a franchisee advisory council or association as a serious matter for discussion, franchisee input and resolution, with supporting information, resistance is likely to be lower.

As noted in the discussion of communication (Section 4.I.(1)), seeking franchisee critique and suggestions with respect to changes that franchisor management believes necessary may result in avoiding costly mistakes, reducing cost and enhancing franchisee support for change. Implementing change in a franchise network is rarely simple or without cost, but the difficulties and costs may be greatly reduced if the franchisor involves its franchisees as partners, recognizes that it does not have all the answers, genuinely seeks franchisee input and accepts their good ideas, even if the end result is different from that envisioned by the franchisor at the beginning of the process. In other words, seek and secure a consensus for the change and the manner of its implementation. Effective preparation may involve securing expert service from outside the franchise network.

The implementation of change can also be made easier and less costly by making it less disruptive to the operations of network outlets. To the extent possible, franchisees should be given choices with respect to the form and timetable for implementing changes. Both the franchisor and its franchisees may have to make an investment to adapt to change. A franchisor should not expect its franchisees to make an investment in change that the franchisor is not also prepared to make. Franchisors frequently test changes in the outlets that they operate before

asking franchisees to adopt them. Such testing can serve to improve and reduce the cost of the new products, services, equipment, signage, operating procedures, marketing or other changes that are being introduced, and to demonstrate to franchisees that the franchisor is proceeding cautiously, in the interests of the entire network — and is willing to make an investment in the change — in order to improve the prospects that it will have a positive impact on both revenue and profit at the outlet level.

### **3. Opportunities Arising Out Of Change**

Change can create opportunities. Change in the competitive environment may help a franchisor persuade its franchisees to fund or expand the network advertising program or upgrade facilities. Technological changes may provide the opportunity to improve the network operating system, network communication, information gathering and utilization, marketing or other elements of operations.

### **4. Preparation For Change**

Effective preparation for change requires flexibility in documentation and good working relationships with franchisees. Franchisees are likely to be supportive and cooperative if: (1) they trust and respect the franchisor; (2) there is good communication with franchisees; (3) careful planning and testing precedes the change; (4) the need for change is effectively explained; (5) changes are implemented on a reasonable timetable; (6) cost and financing factors are properly addressed and (7) operational and financial assistance is provided.

## **5. Change By The Franchisor**

A franchisor must also adjust its services to change, which may involve enhancing its services and developing new services. The business environment is never static for very long. The support service needs of a franchisee will change during the term of the franchise relationship. A franchisor must understand those changing needs and modify existing services and develop new services in order to be relevant to franchisees and help them remain competitive.

As a franchise network grows, the number of franchisees operating two or more outlets is likely to increase. Multiple outlet franchisees require different services and assistance than single outlet owners. Operating system changes involving capital expenditures can have a greater impact on multiple outlet owners. A test of the changes in one or two outlets by a multiple outlet owner may be reasonable prior to a full rollout. A multiple outlet owner may require financial assistance for significant capital investments.

The experience of multiple outlet franchisees is valuable to a franchisor and some franchise networks have a separate, formal or informal organization of multiple outlet franchisees. The franchisor management may meet with multiple outlet franchisees on a regular schedule, or ad hoc, to discuss network operational and marketing issues. Multiple outlet franchisees tend to require less service relative to site selection and outlet development, operations, local marketing and employee recruitment and training, and may focus on other franchisor services, such as regional and national advertising, procurement of equipment and supplies, research and development, financial services, development of new business

opportunities for franchisees, acquisition of franchises from other franchisees and technology enhancements.

## **S. Disclosure Regulation Compliance**

The offer and sale of franchises is regulated at the federal level by a Federal Trade Commission rule requiring franchisors to deliver a disclosure document to prospective franchise buyers, and at the state level in states covering about one-half of the population of the United States. Most of the state laws require a franchisor to register its offer of franchisees and deliver a disclosure document to prospective franchisees. Federal and state regulation of franchise sales is complex and a failure to understand the rules, and diligently comply with them, can result in substantial and unnecessary legal risk and expense. Every franchisor needs to develop and implement a disclosure regulation compliance program. That compliance program should be designed to avoid disclosure violations, for which the liability can be substantial and the costs of defending a claim can be high. A counterclaim for disclosure violations can place a franchisor at a disadvantage in disputes unrelated to the sale of a franchise.

A disclosure regulation compliance program should also be designed to develop evidence of compliance. A compliance program has the following components: (1) the franchise sales process should be subject to specific operating procedures and record creation and maintenance systems; (2) responsibility for disclosure compliance should be assigned to an executive with real authority; (3) prospective franchisees should be debriefed to determine whether unauthorized claims or promises were made to them and established procedures were followed; (4) changes in franchise sales regulation should be carefully monitored; (5) particular attention

should be given to the rules relating to earnings claims (i.e., representations of historical or projected revenue or profits); and (6) the background of franchise sales personnel should be thoroughly investigated and sales personnel should be fully instructed on the requirements and purpose of compliance and the consequences of noncompliance.

#### **T. Audit Programs**

As its franchise network expands, a franchisor should begin the development of an audit program for franchised outlets. Many franchised businesses collect large amounts of cash. Franchisees have an incentive to underreport cash sales to reduce both income and sales taxes and royalties and advertising fees. Underreporting of revenue and underpayment of royalties and advertising contributions deprives the franchisor of revenue needed to expand its network and enhance the competitiveness and value of franchised businesses, and is unfair to franchisees who accurately report revenue and comply with payment obligations. Franchisees who comply with their obligations support programs to weed out cheaters.

A policy issue that franchisors should address in conjunction with the development of an audit program is the disposition of the portion of recoveries from underreporting franchisees that is attributable to underpaid advertising fees and the allocation of the cost of the audit program generally, or the unrecovered costs of collection from a specific franchisee, among the royalty and advertising fee portion of the recovery. An underreporting franchisee has cheated both the franchisor and the franchisee supported advertising fund. Thus, the argument that recoveries should be divided between them. However, the franchisor bears the full cost of the audit program and frequently fails to recover all the money owed by an underreporting franchisee

and/or all of its costs of recovery. Viewed in that light, allocating a part of the recovery to the advertising fund would likely overcompensate the fund. Whatever approach a franchisor elects to adopt, it is advisable to clarify up front the franchisor's obligations to seek recovery of unpaid advertising fees and its obligations, if any, to turn over such recoveries to the fund.

### **1. Purposes Of An Audit Program**

A principal purpose of an audit program is to foster compliance well beyond the small number of franchisees who can be audited in any year. A program of regular audits that targets both franchisees suspected of underreporting and franchisees selected at random will be viewed as fair. Such an audit program sends a message to all franchisees who might be tempted to underreport revenue, or fail to comply with other operating standards, that they are at risk of exposure and the consequences that will follow. A general description of the audit program can effectively convey this message and once implementation begins, the word will spread quickly among franchisees. The sanction for intentional underreporting is usually termination, i.e., intentional underreporting should be an incurable breach, though a franchisor may permit the franchisee to sell his or her business. An opportunity to cure reduces the consequences of being caught to an insubstantial penalty.

To be effective the program must be designed to detect underreporting and be implemented on a continuing basis. The comprehensiveness of an audit program should be based on a cost-benefit analysis. An audit program can involve a significant cost, but underreporting of revenue can also be costly. Audit procedures may be made less expensive by limiting the period examined and the number of outlets of a multiunit franchisee that are

included in the audit. If a limited audit discloses a problem, the audit can be expanded. Franchise agreements generally shift the cost of an audit to the franchisee if underreporting in excess of a specified threshold (e.g., 2% of revenue) is uncovered.

Designating a franchisee for an audit can be viewed as confrontational, showing a lack of trust, and at odds with the concept of a cooperative business relationship. However, well planned, regularly implemented audits need not appear confrontational to franchisees. Complying franchisees will not feel threatened by an audit program and they will appreciate the necessity of audits to insure that all franchisees pay their fair share of the cost of maintaining the network and the good will of the brand. Basic fairness supports a franchisor's efforts to insure that all franchisees follow the rules. An audit can also be a benefit to a franchisee by disclosing various problems that the franchisee may be having and help him to improve the operation of his business (e.g., excessive operating costs, weak cash and inventory controls and internal theft).

## **2. Detecting Underreporting**

Franchisors use a number of methods to detect underreporting. A franchisee's profit and loss statement can provide clues and a franchisor should enforce franchisee obligations to furnish monthly (or quarterly) and annual profit and loss statements. Franchisee behavior inconsistent with the financial performance of his or her business may indicate underreporting. A franchisee showing no profit or a loss should be seeking help. If he or she is not asking for assistance, the reason may be higher revenue and profit than has been reported. Cost of goods sold or labor that is higher than the standard range for the business may indicate unrecorded revenue. An underreporting franchisee may buy some supplies for cash, but usually will not buy a

proportionate amount of all supplies for cash – so individual categories of supply cost may be high. Employment of illegal aliens that are paid in cash is a collateral problem of underreporting. Weekly or monthly sales and customer count reports enables a franchisor to track reported sales and customer counts against other franchisees in the same market. Off premises sales (e.g., catering) are frequently a source of unreported sales. A franchisee's lifestyle may be a clue to underreporting. A lifestyle that is out of sync with reported income is suspicious and a franchisor's field staff should be aware of major lifestyle indicators (house, vacation home, automobiles, boats, country club memberships, etc.).

Various types of surveillance can effectively augment an audit program. For example, (1) the franchisee's delivery truck can be followed to detect possible unreported off premises sales; (2) unannounced surveillance can be conducted inside the business to observe (and video record if possible) sales not entered in the sales register; (3) customer counts can be made from outside the business and compared to customer counts reported by the franchisee, or multiplied by average customer purchases and compared to reported sales; (4) announced surveillance can monitor sales for a typical week; and (5) an investigator can pose as a prospective buyer of the business. Surveillance is useful to confirm suspicions of underreporting.

Audits should be designed to produce evidence of intentional underreporting, but not the precise amount of underreported sales. The purpose of a program to detect intentional underreporting is to remove an offending franchisee from the network. Attempts to pin down exact numbers diverts effort and creates a basis for factual disputes. Simple tests based on reported sales and costs, bolstered by the results of surveillance, is effective evidence.

### **3. Audit Procedures**

A comprehensive outline of the audit procedures that will be followed should be developed, including: (1) procedures for selecting the franchisees to be audited; (2) the scope of pre-audit investigations to be undertaken in different circumstances; (3) whether employees or independent service providers (or both) will perform the actual audit; (4) the method and timing of notice to the franchisee and circumstances in which prior notice will not be given; (5) the scope and content of the actual audit; (6) the methods by which compliance with franchisee reporting of sales and other data can be tested; (7) the procedures to be employed when records are incomplete or full cooperation is not received; (8) the documentation to be prepared; (9) the nature and scope of the review of the audit findings with the franchisee; and (10) the manner in which the franchisor will use the information developed by the audit. A written outline of the audit program is a guide for the auditors. It is important to build in sufficient flexibility to deal with a variety of situations that the auditors may encounter.

### **4. Conducting An Audit**

When a franchise has been selected for audit, the manager in charge of audits should communicate to the franchisee regarding the records and documents the franchisee will need to produce, the timing of the audit and which franchisee personnel should be available for discussion during the audit. The franchisee's reaction to being selected for an audit may reveal whether the franchisee will resist the audit, the level of cooperation the audit team can expect to receive and whether records will be available and complete. Audits can last from one day to one week or more depending on the size of the audit team, the completeness of records, the

cooperation of franchisee personnel and the period being examined. Whether the franchisee is suspected of underreporting, or has apparent operating or financial problems, the audit team should endeavor to obtain (and record or copy) all records and documents before they depart.

After the audit is complete and the information obtained is analyzed, underreporting and other noncompliance should be addressed promptly and a comprehensive written report of the audit should be prepared, including: (1) who performed the audit; (2) the procedures used; (3) the completeness of the records and documents produced by the franchisee; (4) the cooperation of the owner and employees of the franchisee; and (5) the findings relative to reporting of revenue and other compliance issues. The report should be shared with the franchisee. If the noncompliance found is curable, steps toward achieving a cure should be implemented. If noncompliance is considered noncurable, but the franchisee will be allowed to sell his business and franchise, a timetable should be established for this to occur and the franchisee should be required to enter into a binding agreement to that effect, the consideration for which is the franchisor's forbearance from termination while the business is being sold.

## **5. Other Uses Of Audits**

Audit programs are not limited to underreporting of revenue. The audit can also include verification of compliance with other compliance issues, e.g., local advertising requirements and use of approved advertising; (2) the sale of required products and services and no sales of unauthorized products or services; (3) the use of approved equipment and supplies; (4) territorial and customer restrictions or limitations on areas within which products may be delivered or

services performed; (5) opening and closing times; and (6) compliance with wage and hour rules and rules related to the employment of minors and aliens.

## **U. Dispute Resolution**

### **1. Effective Dispute Resolution Procedures**

Franchise relationships are generally of long duration and many franchisors enter into a large number of such relationships. Each franchise relationship involves elements in which the interests of the parties are aligned and elements in which they may not be. The franchise relationship is therefore a natural breeding ground for disputes. Historically, far too many of those disputes have resulted in law suits, a large majority of which have been settled prior to formal adjudication, frequently at great cost to both franchisor and franchisee and without fully satisfactory outcomes for either of them. Some litigation is unavoidable, but a franchisor should select carefully the disputes that warrant binding dispute resolution and endeavor to minimize the number of such disputes. This is accomplished most effectively by assigning a high priority to informal dispute resolution. Internal dispute resolution also avoids drain on resources litigating disputes of no long term significance. Effective dispute resolution employs fair procedures designed to achieve a “business” solution, not to establish who is right or wrong or who has the better legal position.

Franchisors use a variety of internal dispute resolution procedures. Some franchisors refer disputes to a panel of franchisor representatives and franchisees. Others designate an ombudsperson to investigate a dispute and attempt to resolve it. Still others rely on mediation, which can be either internal (e.g., the mediation is conducted by a franchisor employee) or

external (e.g., the mediation is conducted under the National Franchise Mediation Program administered by the Center for Public Resources). A few franchise agreements (especially international agreements) require specific mediation efforts before either party may resort to binding adjudication. Some franchisors have all of these procedures available for the resolution of disputes. Whatever the dispute resolution methods utilized, the key to success is understanding the value of a fast and inexpensive resolution of a dispute, with an outcome that leaves the relationship intact, and may actually enhance it. Only a small minority of civil cases are resolved by trial and appeal, but enormous costs are incurred by litigants before settlements are concluded. Resolving such disputes early avoids wasting precious financial and human resources and the likelihood of a settlement that leaves both the franchisor and the franchisee dissatisfied and may irrevocably poison their relationship.

Litigation always involves risks. The issues that are ultimately determinative of the outcome of a litigated dispute may be significantly different than the issues that are initially identified. Adverse facts may be disclosed of which senior management was unaware. Former franchisor employees who become witnesses may recall the facts differently than current management and may reveal damaging information that current management did not anticipate. An insignificant case can become significant if the franchisor loses. Litigation with franchisees generally must be reported in the UFOC and a significant number of reported cases can detract from the appeal of a franchise. In light of the cost and delays of the government sanctioned dispute resolution systems (litigation and arbitration), and the inherent risks, the value of systems for early resolution of disputes is compelling.

## **2. Preparation For Litigation**

### **a. Documentary Evidence**

Being prepared for litigation will help a franchisor avoid it in many cases and be in a better position to prevail when avoidance is not possible. A well documented, unambiguous relationship is extremely important to the successful resolution of litigation. If a franchisor has the right documents readily accessible in its files, it may be able to demonstrate to opposing counsel the weakness of the franchisee's claims (e.g., a signed receipt for the UFOC the franchisee claims he did not receive). Such documents are also critical for adjudication. To avoid liability to its franchisees, a franchisor must comply with the law and it must also be able to prove that it has done so. Documentary evidence includes a broad range of paper and electronic documents that are created in the course of offering a franchise, establishing a franchise relationship, site selection, business facility development, training and on-going support and supervision of the franchisee — relating to a specific franchisee or franchisees generally. Such documents include: (1) re-sale and post-sale communications, including e-mails; (2) UFOCs and UFOC receipts; (3) franchise and other agreements and all amendments to those documents; (4) promotional materials given to the franchisee; (5) records of the site selection and business facility development process, any representations and disclaimers made in connection therewith and the respective roles of the franchisor and franchisee therein; (6) hard copies of each version of the franchisor's website to establish what was stated on the website at the time a franchise relationship was established (the franchisee may have a hard copy); (7) records of the factual basis for statements in UFOCs, promotional materials and the websites, particularly investment parameters, earnings claims, revenue generated from suppliers to franchisees and item 20 information, which are frequently the subject of franchisee claims;

(8) records of the franchisee's training; (9) inspection reports and records of reinspections after deficiencies have been observed and of the franchisor's efforts to retrain and otherwise assist the franchisee to correct deficiencies; (10) documents relating to support and assistance furnished to franchisees (e.g., continuing training, changes in standards, specifications and operating procedures communicated to franchisees, field service assistance, marketing programs and materials furnished to franchisees and national and regional advertising and marketing programs); and (11) any internal or external memoranda and notes relating to the offer and grant of the franchise, establishment of the franchise relationship, development and operation of the franchisee's business and any decisions made with respect to the franchisee that may relate to a claim that the franchisor exercised bad faith in implementing the relationship (e.g., a decision to reject a request to relocate the franchise, add or delete a product or service or modify hours of operation) or tortiously interfered with the franchisee's prospective economic advantage (e.g., a refusal to approve a transfer of the franchise).

**b. Document Retrieval**

A franchisor should develop a filing system that facilitates efficient retrieval of all such documents. In litigation, document subpoenas are typically very broad. If documents are not readily available, the cost of assembling and producing them can be very high in terms of management time, disruption of other business activities and judicial sparring over documents that cannot be located. This is particularly true with respect to e-mails. Employees should be encouraged to file e-mails in "folders" to ease review later and a document retention policy should include e-mails.

**c. Monitoring Communications**

A franchisor should monitor communication with a franchisee if there is a potential for litigation. Management should review with counsel the communications that are — and are not — privileged (nondiscoverable) communications to in-house and outside counsel and what is — and is not — protectable “attorney work product.” Policies and procedures should be implemented to control casual e-mail and other communication that may compromise the franchisor’s legal position. Settlement offers may be admissible in arbitration, but not judicial proceedings (but even if the arbitration clause bars them from consideration, the arbitrator may see them and, in a nonjury trial, the judge may be aware of and influenced by them).

**d. Arbitration And Other Litigation Considerations**

Many franchise agreements require all or most disputes to be resolved by arbitration, which is frequently, though not invariably, quicker and less expensive than litigation and gives the franchisor greater control over the selection of the location of dispute resolution. Franchisors also seek to improve the arbitration process by expressly requiring arbitrators to apply the law restricting the permitted discovery (i.e., the number of depositions and interrogatories) and authorizing arbitrators to rule on pre-hearing dispositive motions and provide that offers of settlement are not admissible. Most franchise agreements contain a waiver of jury trial; a waiver of claims for punitive damages; a time limit for asserting claims and prohibit consolidation of claims of different franchisees.