Elements of Building a Successful Franchise Network

a program presented by
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Getting on the Same Page
Types of Franchises

- Product Distribution
- Business Format
- Conversion Franchising
Different Forms of Franchise Relationships
The Single Unit Franchise

- Most common:
- Franchisee owns and operates one franchised outlet.
The Area Development Franchise

• Right to establish a designated number of franchised outlets within a prescribed territory
• Must follow development schedule
• Frequently, separate franchise agreement for each unit
Sub-Franchising

- Franchisor grants certain rights to sub-franchisor.
- Typically:
  - Offer and sell franchises to sub-franchisees
  - Sub-license franchisor’s trademarks
  - Collect fees for franchisor
  - Assist with training
  - Enforce system standards
  - Frequently, permits establishment of units
Area Representative/Development Agent

- One person granted right to recruit prospective franchisees
- Franchisee contracts directly with franchisor
- Representative/agent has no right to contract with franchisee, but may be delegated rights and obligations
WHO IS IN THE DRIVER’S SEAT – FRANCHISOR OR FRANCHISEE?
Recent Trends in Franchising

Systems Starting Franchising by Year

1998 1999 2000 2001 2002 2003 2004 2005

1998 2000 2001 2002 2003 2004
Recent Trends in Franchising

Percent of Systems Each Year by Years of Previous Business Experience

- 0-1 YR
- 2-5 YR
- >5 YR
- Linear (0-1 YR)
- Linear (>5 YR)
- Linear (2-5 YR)
Recent Trends in Franchising

Percent of Systems Starting Franchising with Zero (0) Existing Units

0% 2% 4% 6% 8% 10% 12% 14% 16% 18% 20%

2000 2001 2002 2003 2004 2005 2006
The Changing Nature of Franchisees

- 52% of all franchised units are controlled by multi-unit franchisees.
The Result:

• The Changing Nature of Experience, Resources and Longevity
FRANCHISING – WHERE DOES IT FIT IN A TROUBLED ECONOMY?
MORE GOVERNMENT IS COMING, WHETHER YOU LIKE IT OR NOT
Finding Franchisees

Establish a Franchise Network with the Right People
Leads to Prospective Franchisees

• The Internet
• Existing Franchisees
• Referral Networks/Brokers
  • New FTC Rule changes timing for disclosure
• Bottom line – use everything available
Who is Buyer?

- Existing franchisees (yours and other systems)
- Employees looking for more stability
- Customers
Getting Franchisees Over the Hump

• How do you get to “yes”?
• Eliminate the blockage
Financial Performance Representations (formerly known as “earnings claims”)

Why aren’t you using them?
Financial Performance Representations

- Competitive pressures
- May provide some degree of protection
- FTC excludes costs
Financing and Credit Markets

- Cash is king
- Financing difficult and more expensive
  - Arrange in advance
  - Screen out those with little or no equity
Geographic Expansion
(The “Scientific” Plan)

• Radiating circles
• Hit major markets
Geographic Expansion
(The Reality)

- Where the prospects are
- Outposts
Channel Conflict

- Traditional sites – harder to find and expensive
- Alternative sites
- New channels
Channel Conflict

- New sites/channels a source of conflict
- Need reservation of rights provision
- Need communication
Franchisee Advisory Councils & Associations

- Work with advisory council to:
  - Enhance communication
  - Compensate for communication barriers
  - Resolve network issues
- A strong FAC may eliminate need for an association
FRANCHISORS & FRANCHISEES WORK TOGETHER ON LEGISLATION
Restricted Supply Sources

- Are restrictions necessary?
- Is franchisor involved, directly or indirectly?
Sourcing

• If you sell products to franchisees or receive rebates from vendors, provide disclosure
• Often a source of tension
Franchise Documents

- Agreements and UFOCs only become relevant if there is a problem
Franchise Documents

The key document is the operating manual.
System Standards

- Importance:
- Avoiding causes of noncompliance
- Company outlets
  - Training
  - Communication
  - Follow through
Don’t create system standards and then fail to check on compliance
Don’t ignore your right to audit
Vicarious Liability

• Franchisor may be responsible for acts and omissions of franchisees
• More control may mean more risk
Reducing Risk

- Proper insurance coverage
- References to “independently owned and operated”
Disputes
Due to the current economic environment, disputes are more likely to arise.

- With franchisees
- With suppliers
- With consumers
Look out for financially-stressed franchisees

Watch for:

• Delinquency in royalty payments
• Complaints from landlords or suppliers regarding payments due from franchisees
• Business partner disputes
• Tax problems (liens)
• Lawsuits against franchisee
• Any other sign of financial distress
Be pro-active

Consider ways to assist:

- Temporary royalty abatements
- Promissory note for past-due receivables
- Extensions on development rights
- Added training and assistance
If bankruptcy looks imminent, get lawyers involved.

• Termination procedures
• Comply strictly with contractual and statutory notice requirements

Timing is crucial.
Resolving Disputes
ADR Programs

• Ombudsman

• Informal ADR
Mediation

- Neutral third party
- Businesspeople directly involved
- Non-binding
Arbitration

- Third party trier of fact
- Binding decision
- No jury trial
- Virtually no appeal
- Class actions
Commonly Held Beliefs – Arbitration v. Litigation

- Litigation more costly and time consuming
- Arbitrators “split the baby”
- Avoid massive discovery in arbitration
- Arbitrators favor equities over the law
- Arbitration less public
Selecting Arbitration v. Litigation

- Reasonable views on both sides
- Decide what is best for your system
COSTS OF LEGAL PROCEEDINGS CONTINUE TO INCREASE
Major Costs Involved

- Very expensive
- Electronic discovery
- May take years
- Management time
- Distracting to business
- Disclosure requirement
Disputes Often Arise Due to Changes in the Franchise Network
Managing Change in the Franchise Network
Example One
Example Two
Example Three
EXAMPLE FOUR: Retail Sales & Sales of Franchise
Brands Starting to Franchise 2000 - 2008

- 2000: 127
- 2001: 128
- 2002: 180
- 2003: 244
- 2004: 272
- 2005: 269
- 2006*: 260
- 2007*: 149
- 2008**: 158

*Estimate
**Forecast
Bleak Outlook In 2009: Resilience Will Be Tested
What Causes Change?
FRANCHISORS BUY OTHER SYSTEMS: WILL “CONSOLIDATE”
NEW INVESTORS: TWO-EDGED SWORD?
How To Anticipate Change in the Franchise Network
Plan contract carefully.
Do not promise what you may not be able to deliver at a later date.
Programs or rights not included at outset will prove difficult to initiate later.
... but how much is too much?
Don’t box yourself in economically.
All your documents are **NOT** equal.

Make maximum use of ancillary documents.
Establish objective criteria, or self-executing mechanisms or events that eliminate need to take confrontational position with franchisees.
If certain changes are anticipated during the term of the agreement, make it clear to the franchisee at the outset of the relationship.
Limit change that may be required.
Don’t impose on franchisee what is not uniformly imposed.
Term of Agreement: How to balance?
Use appropriate occasions to require franchisee to update or improve.
Preserve right at renewal to require franchisee to –

- Sign a current franchise agreement
- Upgrade its facility to current standards
“SOCIAL" ISSUES EMERGE AS FRANCHISE ISSUES
Make change more palatable for franchisee.
How to create change most effectively by making franchisees your allies
OPPORTUNITIES LIE ABROAD FRANCHISORS SAY
What if you’re wrong?
Enforce the legal obligation for a franchisee to make a necessary change.
Change Can Lead to Disputes

• Be Prepared
Monitoring Communications When Considering Changes to the System

• Reasons for decision
• Timing of decision
• Involve lawyers on legal issues for privilege protection
Maintenance of Documents Generally

- Legal Department: Agreements, Amendments and FDD Receipts
- Retain records of communications with prospective franchisees
- Retain hard copies of each version of website
- Retain copies of promotional material
  - Keep record of dates used
- Retain all backup used to create FDD
Pre-Dispute Resolution Strategy

- Create solid paper record
- Businesspeople should document significant conversations
- Termination is not the only remedy
- Take actions that will appear “reasonable” to court, jury or arbitrator
“SMOKING GUN” EMAIL PUTS BULLET IN FRANCHISOR
E-Mails and Electronic Data

- Sensitize employees
- Re-read before sending
- Ask: How will this appear to a judge, jury or arbitrator?
Checklist Before Filing Action

✓ What is your goal?
✓ Have efforts been made to resolve dispute?
✓ Are there potential counter-claims?
✓ How has franchisor treated other franchisees in similar situations?
Do the company-owned units measure up?

What are projected legal fees, and cost in terms of management time, in pursuing the action?
Questions