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

- Postal Delivery
- Fast Food
- Pets
- Truck/Car Rental
- Travel
- Drug Stores/Vitamins
- Tax & Accounting
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
EXTRA! EXTRA!

SMALL FRANCHISORS PLUS LARGE FRANCHISEES: A NEW PHENOMENON?
Recent Trends in Franchising

Systems Starting Franchising by Year

- 2000: 100
- 2001: 150
- 2002: 200
- 2003: 250
- 2004: 300
- 2005: 300
- 2006: 250
Recent Trends in Franchising

Percent of Systems Each Year by Years of Previous Business Experience

[Line graph showing trends over years]
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
NEW FTC RULE WILL AFFECT THE WAY YOU DO BUSINESS (no later than 7/1/08)
Finding Franchisees

Establish a Franchise Network With The Right People
Finding Franchisees

• Quality of the franchisees will greatly influence network success.

• Granting franchises to the wrong people is a common mistake.
Leads to Prospective Franchisees

- The Internet
- Existing Franchisees
- Referral Networks/Brokers
  - New FTC Rule changes timing for disclosure
Leads to Prospective Franchisees

• If you get leads, respond to them on a timely basis

• Sets the tone for the relationship
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
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 or association to:
  – Enhance communication
  – Compensate for communication barriers
  – Resolve network issues
Communication

- Effective communication
- Franchisee opinion of franchisor
- Intranets
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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
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FRANCHISORS MUST HAVE A TECHNOLOGY PLATFORM
Exploit Technology and the Internet

- Single vs. Multiple Websites
- Advertising Fund Financial Support
- Business-to-Consumer eCommerce
- Management Software
Intranets & Extranets

• Enhance network communications
• Training programs
• Automated ordering from suppliers
• E-mail within network
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”
Dispute Resolution
ADR Programs

- Ombudsman
- Informal ADR
Mediation

- Neutral third party
- Businesspeople directly involved
- Non-binding
- Confidential but . . .
- Deals with interests, not rights
• If you say nothing, you will litigate
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FRANCHISORS DELIBERATE: LITIGATE OR ARBITRATE?
Arbitration

• Third party trier of fact
• Binding decision
• No jury trial
• Limited discovery
• 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
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COURTS HOSTILE TO ARBITRATION CLAUSES IN FRANCHISE AGREEMENTS
• Too One-Sided
• Carve-Outs Not Mutual
• Excessive Arbitration Costs
Disputes Often Arise Due to Changes in the Franchise Network
Managing Change in The Franchise Network
Example Two
Example Three
What Causes Change?
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FRANCHISORS BUY OTHER SYSTEMS: WILL "CONSOLIDATE"
EXTRA! EXTRA!

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
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“SOCIAL” ISSUES EMERGE AS FRANCHISE ISSUES
• Make change more palatable for franchisee.
How to create change most effectively by making franchisees your allies
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OPPORTUNITIES LIE ABROAD FRANCHISORS SAY
What if you’re wrong?
Enforce the legal obligation for a franchisee to make a necessary change.
COSTS OF LEGAL PROCEEDINGS CONTINUE TO INCREASE
Major Costs Involved

- Very expensive
- Electronic discovery
- May take years
- Management time
- Distracting to business
- Disclosure requirement
Maintenance of Documents/Evidence
To Defend Against Disclosure Claims

• Set up detailed file system for each franchisee
  – Receipts
  – Executed agreements
  – Correspondence
  – Miscellaneous
Maintenance of Documents and Evidence to Defend Against Lack of Support Claims

• Create file system to ensure support obligations are fulfilled
Prelitigation Strategy

- Create solid paper record
- Businesspeople should document significant conversations
- Take actions that will appear “reasonable” to court or jury
- Termination is not the only remedy
“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 or jury?
• File emails in “folders”
Checklist Before Suing

✔ 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?
Checklist (cont.)

✔ Do the company-owned units measure up?
✔ What affect will commencing action have on franchise system?
✔ How available is proof needed to establish your case?
Checklist (cont.)

✓ What are projected legal fees, and cost in terms of management time, in pursuing litigation?
✓ Will prevailing party recover attorneys’ fees?
Questions