UNDERSTANDING FRANCHISING: A PRIMER

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BASICS

What is franchising?

Franchising is an extremely adaptable method of distributing products and services. It allows for rapid expansion, but spreads the risks and costs of expansion. A franchisor typically provides the franchisee with training and support for setting up and running a business that uses the franchisor's business system and trademark or service mark. A franchisee typically supplies the capital for staring the business at a new location, and the day-to-day operation and management of the new unit. The franchisee usually pays the franchisor an initial fee and an ongoing royalty for the right to use the franchisor's marks and business system, and for ongoing support.

What kinds of businesses can be franchised?

Franchising is an extremely flexible way of doing business. According to the International Franchise Association, there are more than 100 different industries that use the franchising format, ranging from accounting services to weight loss clinics. Just about any type of business can be franchised – whether selling products *or* services, at retail *or* wholesale, from a storefront *or* from home, or anything in between. But just because franchising might be suitable for your business does not mean that your business would be right for franchising.

How can we tell if our business would be right for franchising?

Keep in mind that, to be successful, a franchisor has to sell franchises, and then the franchisees have to sell the products or services. So, the business has to be right for franchising on 2 different levels. First, it must be attractive to prospective franchisees who are considering buying a franchise (and who might be considering other franchises too). And second, it must be supportable in the marketplace among consumers.

Before starting a new franchise system, you should carefully consider whether your franchise "package" will be something that other people will want to buy in to, and whether you have the time, energy and money needed to get a new franchise system started.

Here are some specific factors you should consider:

- whether you have a proprietary concept/system that others would be willing to pay to learn;
- whether your business concept can easily be replicated by and taught to others;
- whether any unusual skill sets are required for successful operation of the franchised business;
- whether your business concept is easily adaptable to other markets;
- whether the market for your products or services is growing;
- whether your business has a profit margin sufficient to allow a franchisee a reasonable return on investment (even after paying royalties);
- whether there is any value in the franchise system to your franchisees after they have learned how to operate the business (e.g., marketing efforts, continued training and development);
- whether franchising could divert customers away from your existing business;
- whether you can fund the launch of a new franchise system; and

- whether your existing business will survive if you devote substantial time and energy to starting a franchise

Are there people who can help us decide whether to franchise?

Franchise consultants, franchise attorneys, and franchise development companies can help you reach a decision about franchising. If you want, you can spend several months and thousands of dollars on a feasibility study. But here are a few things to keep in mind:

- because franchising is so flexible, the result of a feasibility study is almost always that the business can be successfully franchised;
- the person performing the feasibility study almost always has a conflict of interest because they want you to hire them to do more work if you do decide to franchise; and
- the result of a feasibility study is someone's opinion – not a guaranty.

How do we make the decision whether to start a franchise system?

There is no easy answer. The decision to franchise is serious. Franchising involves a substantial commitment to your business and to your franchisees, and it involves risks.

Starting a new franchise will require you to spend time and money to do it right the first time. It may take a few months or a few years for you to recover these costs. You may have to work nights and weekends to keep your existing business going while you are starting a new franchise. And, this is the easy part.

The hard part is selling your first franchise. Once you start to sell franchises, your franchisees will be depending on *you* to help them start and run their business. These people will be looking to you as the expert on how to run a successful business. Some franchisees will invest their life savings or retirement funds into a franchise. They will have a lot to lose if their franchise is not successful.

Like all businesses, franchising involves certain legal risks. If you do not comply with all of your obligations in the franchise agreement, you could be liable to your franchisees. There is also some risk of liability to a franchisee's customers and employees in the certain circumstances, as well as, exposure to state and federal regulations if you do not properly follow all of the applicable regulations.

Here are some things you could do to help yourself make the decision whether to franchise:

- Learn all you can about franchising. Search the internet and read books and/or articles on franchising. A good starting point is the International Franchise Association's website – www.franchise.org
- Consider alternatives to franchising.
- Learn what successful franchisors do. Study FDDs from other franchisors in your industry. Study their operations. Talk to other franchisors about their experiences.
- Prepare a business plan for franchising. See if it makes financial sense for you to franchise.

GETTING STARTED

What are the key components we need to start a new franchise?

Concept – You need a good business concept – preferably one that is unique, interesting, and with long-term potential. This is what your business is all about. It needs to be appealing to consumers *and* to potential franchisees.

System – You also need systemized standards for operation. These include things like policies, procedures, and other types of standards that will be used at every business location and, therefore, are simple to replicate. The system includes the special know how about how to set up and run the business. Usually, the system is represented by the operations manual.

Transferability – The system needs to be transferable. Most franchise systems do not require new franchisees to have any experience in any particular industry. You must be able to teach your franchisees how to successfully set up and run the business using your system. The transfer of this detailed information takes place through the initial training program, through the operations manual, and through the ongoing support the franchisor provides. If there are parts of the system that require special skills that are not easily transferable (such as business experience, musical ability or artistic talent), it may still be possible to franchise your concept, but the pool of potential franchisees will be limited to those people who already have these special skills.

Identity – Your concept needs distinguishing features to give it a clear identity in the marketplace. This identity includes things like:

- trade dress and image (the way the locations look);
- trademarks (identify the business and/or the products offered); and /or
- service marks (identify the business and/or the services offered).

Protection of Identity – It is critical to take the necessary steps to protect the franchise identity by registering with the U.S. Patent and Trademark Office all important trademarks and service marks. This federal registration will give you important legal rights. Part of this process will be to investigate who else might already be using the same or similar names and logos. A trademark lawyer should be involved in this process for maximum protection of the marks.

Protection of System – You should also protect the system to the extent possible. This involves steps like:

- keeping your propriety information confidential;
- using confidentiality agreements and non-competition agreements with anyone who has access to your confidential information;
- claiming copyright protection for key documents, training videos, recordings, etc.; and
- filing for a patent in appropriate circumstances (using an experienced patent lawyer).

Experience/Proven Track Record – You should have experience in setting up and running the same business that your franchisees will. Actual operating experience is important for several reasons:

- It demonstrates the viability of your concept.
- It helps you refine your concept and system and work out inevitable bugs.
- It gives you more creditability with franchisees.
- If units are managed by someone else, it helps you refine your manuals and training program.
- If units are managed by someone else, it helps you set up the management and support staff and infrastructure you will need for franchising.

All of these factors will help you sell franchises. While experience is strongly recommended, it is not required. It is possible to start a new franchise without experience. But inexperienced franchisors usually have a tough time selling franchises.

Profitability – Operating a franchise is a business, and the primary purpose of businesses is to make money for the owners. Each franchisee will expect to make a reasonable return on initial investment by the end of the initial term. You must make sure that the concept is capable of generating profits sufficient to make money for your franchisees (even after paying you royalties and other fees).

Operations Manual – Your manual needs to be comprehensive. Your franchise agreement will require your franchisees to follow the mandatory system standards in the manual. So, it is important that the manual includes all obligations of the franchisees. It can also include non-mandatory suggestions for other things. Manuals change over time as system standards are added, dropped, or changed. Your franchise agreement should allow you to modify the manual at anytime. See section on operating manual below.

Training Program – Your training program will be a short course on how to set up and run the business. Some training programs last a few days, while others last a few months. The complexity of the business, and your franchisees' previous experience will affect how long your training program will last. Most franchise training programs involve some "classroom" time, and some on-the-job training. Classroom time typically consists of meeting key franchisor personnel, reviewing key parts of the manual, going over the franchisor's forms, learning to use computer software or point-of-sale equipment, and learning things needed for day-to-day operation of the business. Some training programs involve "self-study" time where the franchisees watch power-point presentations or training videos, or fill out worksheets about the business. On-the-job training is usually offered at the franchisor's location, at the location of an existing franchisee, or at the new franchisee's location right before opening.

Management – Your franchisees will need some initial support and additional on-going support. You must have capable management to provide this support, in appropriate categories such as site selection, lease negotiating, staff recruiting, staff training, marketing, customer service, etc. You will also need to inspect your franchised units periodically to make sure that the franchisees are following your system standards.

Capital – You will need money to start a new franchise. Some experts suggest that you will need from US$50,000 to US$250,000 to get started. I have worked with some start-up franchisors with much less than US$50,000. The amount you will need depends on your system, how much of the start-up work has already been done, and how much of the additional start-up work you will do yourself. If your efforts are successful, you could recover your start-up capital quickly.

Entity – You will probably want to form a new legal entity to be the franchisor; however, this is not a requirement. By setting up a new entity, you will help protect other assets (such as company-owned units) from liability that may arise under the franchise system, and you will reduce the cost of getting audited financial statements. The most popular entity choice for franchisors are limited liability companies and corporations. Each entity has advantages and disadvantages, as well as, different tax treatment. All of these, along with your possible exit strategy, need to be weighed in making the correct decision.

Legal Compliance – To be able to sell franchises legally, you must have a Uniform Franchise Disclosure Document (FDD) to deliver to your franchisee prospects, and you will need to register the franchise in certain states. The FDD must comply with certain rules for the content and format of the required information, and it must include copies of the form franchise agreement and other contracts you will use with your franchisees. You will also need to learn about the federal and state laws that regulate franchising *before* you begin talking to franchisee prospects.

Audited Financial Statements – The FDD must also include audited financial statements prepared by an independent certified public accountant. The fastest and least expensive type of audit is one done for a company as of the day of formation (or initial capitalization). Audits for companies with existing business operations will take more time and money. The FTC allows for a phase-in period for new franchisor – meaning that full audited financials are not required until the 3rd year of operations, however, several States require audited financials by the 2nd year.

Business Plan – To help you formulate your plans for your new franchise system, you should develop a business plan. This is not a requirement, and many start-up franchisors do not do this, but it is certainly a best practice.

Marketing Plan – Similarly, you should develop a specific plan for how to sell franchises. There are many different marketing techniques and tools available for selling franchises. You should formulate your plan based on your budget, and the target audience of prospective franchisees. Franchise advertising is regulated in some states, so be sure to consult an experienced franchise lawyer early in this process.

What should be in the franchise operations manual?

The operations manual should include all of the mandatory requirements for operating the franchise according to your quality standards. It should contain all of the details about the franchise's general obligations stated in the franchise agreement.

A typical manual includes the following sections:

- *Introduction* – welcomes the franchisee into the system, and outlines the broad terms of the franchisor-franchisee relationship.
- *Background* – provides background information about the franchise system, such as its history, management, and mission statement.
- *System* – includes a detailed description of the franchise system.
- *Site selection* – explains the physical requirements for the franchise location, and includes factors to consider in searching for appropriate locations.
- *Unit layout and decorating standards* – may include prototype plans for layout of the franchise unit, and specific information about the requirements for any required décor.
- *Required purchases* – lists the furnishings, fixtures, equipment, supplies, signs, and other items and services the franchise must purchase, and includes any relevant specifications or approved suppliers.
- *Equipment operation* – instructs on how to use, maintain and repair equipment relating to the franchise operations.
- *Operating standards* – may include specific operational requirements and suggestions in categories such as: staff training; accounting; fees and reports; customer service; advertising; use of the marks; product preparation; service standards; pricing and purchasing policies; appearance standards; inventory control; and insurance.
- *Contact information* – important contact information for the franchisor's staff, approved suppliers, and emergency contact information.

What should not be in the manual?

You must be careful about the types of things that are specified as mandatory in the manual. If you set system standards for something that results in someone being harmed, you may be liable. For example, if you specify the serving temperature for coffee in a fast food franchise, you might be liable for damages if a customer gets burned when she spills a cup of hot coffee in her lap. An experienced franchise lawyer can help point out provisions in your manual that might cause problems for you.

What kind of support should we provide to franchisees?

The support you should offer depends on the type of franchise involved. It might include the following:

- Site selection
- Lease negotiation
- Unit layout
- Operational training
- Sales training
- Management training
- Accounting training
- Computer training

- Customer service training
- Identification of suppliers
- Negotiation of favorable prices for required products or services
- Sale of certain products or services to your franchisees
- Staff recruiting and training
- Marketing materials and promotions
- General business advice
- Trouble-shooting

Why do we need so much money to get started?

There are 2 reasons.

1. Financial Ability. If you plan to sell franchises in a state where you have to file your FDD for review by the state franchise regulators, you must be able to show that you have the financial ability to perform your obligations under the franchise agreement. The franchise regulators will examine your audited financial statements that are included in the FDD. If these statements do not show sufficient liquid capital, the regulators may refuse to register the franchise unless you:

  - infuse additional capital into the company; or
  - file a surety bond; or
  - file a guaranty of your performance by another company which has audited financial statements showing sufficient liquid capital; or
  - agree to impound all fees collected from each franchisee in that state into a special account until after the franchise regulators approve your withdrawal of funds; or
  - agree to not collect any fees from each franchisee in that state until after the franchise unit is open for business.

Nobody knows for sure how much liquid capital is sufficient. A general rule of thumb was that at least US$25,000 in cash would be sufficient. But new franchisors without any operating history may be required in some states to have liquid assets of at least 2 times the initial franchise fee.

2. Start-Up Costs. Like most businesses, there are certain costs involved in starting a new franchise. You can control these costs to some extent by: deciding which types of start-up service you can do without; by choosing to do some of the start-up work yourself; and by carefully selecting your franchise lawyer and accountant. At one extreme, you can hire a franchise development company to do practically everything for you. At the other extreme, you can do almost all of the start-up work yourself.

Here are some places where you could spend your start-up capital:

- franchise consultant (for feasibility study, strategic planning, franchise counseling, market study, business plan, operations manual, marketing plan, etc.)
- artist (for logo)
- trademark attorney (for registering trademarks or service marks)
- corporate attorney (for forming new entity to serve as franchisor)
- franchise attorney (for franchise counseling, franchise agreement, FDD, state registration, franchise sales compliance training, etc.)
- CPA (for audited financial statements)
- computer consultant (for customized computer systems)
- web site designer (for web site or intranet)
- marketing designer (for marketing materials for franchisees)
- interior designer (for designing trade dress, layout, décor, etc.)

- architect (for prototype plans)
- overhead (such as separate office for franchise operations, management staff, franchise sales staff, travel, etc.)
- state registration fees (ranging from US$0 to US$750 per registration state)
- advertising placement

What types of legal documents are commonly used in franchise systems?

- The Franchise Disclosure Document (FDD) – provides potential franchisees with the disclosures required by law.
- Franchise agreement – outlines the legal relationship between franchisor and franchisee.
- Owners agreement – signed by the owners of the franchisee; includes a confidentiality agreement, non-competition agreement, personal guaranty, and restrictions on transfer.
- Development agreement – for franchisees who buy the right to open multiple franchises in a certain area.
- Subfranchise agreement – for a relationship under which the subfranchisee will grant franchises to third parties.

What are some of the issues we will need to consider in planning our franchise concept?

- What minimum qualifications will you require for new franchisees?
- How will you find qualified prospects?
- How much will the initial franchise fee be?
- Will you offer financing?
- How much will the royalties be?
- Will there be any other fees? If so, how much?
- What kinds of controls will you have to make sure franchisees pay all they owe you? Consider a point of sale (POS) system.
- How long will the franchise term last?
- Can the franchise agreement be renewed for additional terms?
- Will you require franchisees to purchase certain goods or services?
- Will you require franchisees to buy them from designated suppliers?
- What kinds of ongoing value will you provide to franchisees to keep them in the system after you have trained them on how to run the business?

What are some of the steps we can be taking now as we consider franchising?

Here are some concrete steps you can do now that will give you a head start when you are ready to franchise, and that will probably help your business even if you decide not to franchise:

- Make sure your core business is stable and successful (and can serve as a prototype and training facility for franchisees, if appropriate).
- Start the process of obtaining federal registration of your principal trademarks or service marks as soon as possible (this can take 12 to 24 months).
- Begin preparing your operations manual.
- Set aside sufficient capital to meet your anticipated start-up costs.
- Research your competition.
- Plan the management, technology and supply infrastructure needed to support your franchisees.
- Select an experienced franchise lawyer and an accountant.

How can we research competing franchises?

Two service companies collect and sell copies of franchise offering circulars. For a fee, you can obtain your competitors FDDs directly from FRANDATA or FranchiseHelp.

www.frandata.com

www.franchisehelp.com

The state of California also keeps an online database of franchise documents for those franchises present in California. We can assist you in getting *free* copies of these documents if you know that a certain competitor has a location in California.

Please feel free to email or call with any questions you may have about franchising:

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