



An Overview Of Key U.S. Trends And Regulatory Issues For Prospective Franchisors

The Foundation of Franchising

Over the last three decades, franchising has emerged as a popular expansion strategy for a variety of product and service companies. Recent International Franchise Association ("IFA") statistics demonstrate that retail sales from franchised outlets comprise nearly 50 percent of all retail sales in the United States, estimated at over \$900 billion and employing nearly ten million people in 2003. Notwithstanding these impressive figures, franchising as a method of marketing and distributing products and services is really only appropriate for certain kinds of companies. Despite the favorable media attention that franchising has received over the past few years as a method of business growth, it is not for everyone. There are a host of legal and business prerequisites that must be satisfied before any company can seriously consider franchising as an alternative for rapid expansion.

Many companies prematurely select franchising as a growth alternative and then haphazardly assemble and launch the program. Other companies are urged to franchise by unqualified consultants or advisors who may be more interested in professional fees than in the long-term success of the franchising program. This has caused financial distress and failure at both the franchisor and franchisee level and usually results in litigation. Current and future members of the franchising community must be urged to take a responsible view toward the creation and development of their franchising programs.

Responsible franchising starts with an understanding of the strategic essence of the business structure. There are three critical components of the franchise system -- the brand, the operating system and the ongoing support provided by the franchisor to the franchisee. The brand creates the demand, allowing the franchisee to initially obtain customers. The brand includes the franchisor's trademarks and service marks, its trade dress and decor and all of the intangible factors which create customer loyalty and build brand equity. The operating system essentially "delivers the promise," thereby allowing the franchisee to maintain customer relationships and build loyalty. The ongoing support and training provide the impetus for growth, providing the franchisee with the tools and tips to expand its customer base and build its market share. The responsibly-built franchise system is one which provides value to its franchisees by teaching them how to get and keep as many customers as possible, who consume as many products and services as possible, as often as possible. In fact, most litigation in franchising revolves around the gap between the actual needs of the franchisees to remain competitive in the marketplace and the reality of what support the franchisor is capable of providing. The genesis of the disappointment begins during the recruitment phase of the relationship and continues beyond the start-up as the franchisee struggles



to remain competitive unless the franchisor delivers on its promises and is committed to providing excellent initial and ongoing training and support.

Reasons for Franchising

There are a wide variety of reasons cited by successful franchisors as to why franchising has been selected as a method of growth and distribution. Through franchising, they are able to:

- * Increase market share and build brand equity
- * Use the power of franchising as a system to get and keep more and more customers – building customer loyalty
- * Achieve more rapid market penetration at a lower capital cost
- * Reach the targeted consumer more effectively through cooperative advertising and promotion
- * Sell products and services to a dedicated distributor network
- * Replace the need for internal personnel with motivated owner/operators
- * Shift the primary responsibility for site selection, employee training and personnel management, local advertising, and other administrative concerns to the franchisee, licensee, or joint venture partner with the guidance or assistance of the franchisor

In the typical franchising relationship, the franchisee shares the risk of expanding the market share of the franchisor by committing its capital and resources to the development of satellite locations modeled after the proprietary business format of the franchisor. The risk of business failure of the franchisor is further reduced by the improvement in competitive position, reduced vulnerability to cyclical fluctuations, the existence of a captive market for the franchisor's proprietary products and services (due to the network of franchisees), and the reduced administrative and overhead costs enjoyed by a franchisor.

Responsible franchising is the *only* way that franchisors and franchisees will be able to harmoniously co-exist in the twenty-first century. Responsible franchising requires a secure foundation from which the franchising program is launched. Any company considering franchising as a method of growth and distribution or any individual considering franchising as a method of getting into business must understand the key components of this foundation:

- * *A proven prototype* location (or chain of stores) that will serve as a basis for the franchising program. The store or stores must have been tested, refined, and operated successfully and



be consistently profitable. The success of the prototype should not be too dependent on the physical presence or specific expertise of the founders of the system.

- * *A strong management team* made up of internal officers and directors (as well as qualified consultants) who understand both the particular industry in which the company operates and the legal and business aspects of franchising as a method of expansion.
- * *Sufficient capitalization* to launch and sustain the franchising program to ensure that capital is available for the franchisor to provide both initial as well as ongoing support and assistance to franchisees (a lack of well-written business plan and adequate capital structure is often the principal cause of demise of many franchisors).
- * *A distinctive and protected trade identity* that includes federal and state registered trademarks as well as a uniform trade appearance, signage, slogans, trade dress, and overall image.
- * *Proprietary and proven methods of operation and management* that can be reduced to writing in a comprehensive operations manual, not be too easily duplicated by competitors, maintain their value to the franchisees over an extended period of time, and be enforced through clearly drafted and objective quality control standards.
- * *Comprehensive training programs for franchisees* which integrates all of the latest education and training technologies and which takes place both at the company's headquarters and on-site at the franchisee's proposed location at the outset of the relationship and on an ongoing basis.
- * *Field support staff* who are skilled trainers and communicators and must be available to visit and periodically assist franchisees as well as monitor quality control standards.
- * *A set of comprehensive legal documents* that reflect the company's business strategies and operating policies. Offering documents must be prepared in accordance with applicable federal and state disclosure laws, and franchise agreements should strike a delicate balance between the rights and obligations of franchisor and franchisee.
- * *A demonstrated market demand* for the products and services developed by the franchisor which will be distributed through the franchisees. The franchisor's products and services should meet certain minimum quality standards, not be subject to rapid shifts in consumer preferences (e.g., fads), and be proprietary in nature. Market research and analysis should be sensitive to trends in the economy and specific industry, the plans of direct and indirect competitors, and shifts in consumer preferences. It is also important to understand what business you are *really* in. For example, many of the major oil company franchisors *thought* that they were in the gasoline business until they realized that they were in the



convenience business and quickly jumped into mini-marts, fast-food and quick-service restaurants either directly or via co-branding.

- * *A set of carefully developed uniform site selection criteria and architectural standards* that can be readily and affordably secured in today's competitive real estate market.
- * *A genuine understanding of the competition* (both direct and indirect) that the franchisor will face in marketing and selling franchises to prospective franchisees as well as the competition the franchisee will face when marketing products and services.
- * *Relationships* with suppliers, lenders, real estate developers, and related key resources as part of the operations manual and system.
- * *A franchisee profile and screening system* in order to identify the minimum financial qualifications, business acumen, and understanding of the industry that will be required by a successful franchisee.
- * *An effective system of reporting and record keeping* to maintain the performance of the franchisees and ensure that royalties are reported accurately and paid promptly.
- * *Research and development capabilities* for the introduction of new products and services on an ongoing basis to consumers through the franchised network.
- * *A communication system* that facilitates a continuing and open dialogue with the franchisees and as a result reduces the chances for conflict and litigation within the franchise network.
- * *National, regional, and local advertising, marketing, and public relations programs* designed to recruit prospective franchisees as well as consumers to the sites operated by franchisees.

ABOUT THE PRESENTER

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