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Franchising Your Business

Why Franchising?

Since gaining popularity in the 1960s, franchising has been employed by more than a thousand U.S. businesses as a means of business expansion. According to a recent study performed by PRICE WATERHOUSE COOPERS, franchised businesses (which, for purposes of the study, included all businesses operating as part of a franchised system, whether the individual businesses were company-owned or franchised) operated 767,483 establishments in the United States in 2001. They provided 9,797,117 jobs, met a $229.1 billion payroll, and produced $624.6 billion of output. Hence, franchised businesses accounted for 7.4 percent of all private-sector jobs, 5.0 percent of all private-sector payrolls, and 3.9% of all private-sector output.[1]

By comparison, franchised businesses employed about the same number of people in 2001 as did all manufacturers of durable goods, such as computers, cars, trucks, planes, communications equipment, primary metals, wood products and instruments.[2] They provided more jobs in 2001 than the financial activities industry (including banks, insurance carriers and real estate), construction industry, or information industry (including software and print publishing, motion picture and videos, radio and television broadcasting, and telecommunications carriers and resellers).[3]

Advantages of Franchising Over Other Distribution Channels

Many companies choose franchising to expand their businesses for the simple reason that it enables them to leverage other people's money and labor to meet aggressive expansion goals. In a franchise relationship, 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. The franchisee also typically pays an initial franchise fee (typically $25,000 to $35,000) to cover the franchisor's costs in connection with selling and establishing the franchised business (e.g., providing initial training, site selection assistance, etc.), and an ongoing royalty fee (typically a percentage of the franchisee's gross revenues) for the continued right to use the franchisor's name and system in connection with operating the franchised business. Because franchisees have a vested interest in the success of the enterprises, they generally are more committed and motivated than their corporate counterparts. They also typically are excited about the concept, and can be a productive source of new products, services, operating methods, and marketing concepts. (In the McDonald's system, for example, franchisees are responsible for inventing the BIG MAC, the FILET-O-FISH, and even RONALD McDONALD, himself!)[4] They also are more effective at grass roots marketing, because they are tied to their communities, and thus are able to develop a loyal customer base.

Finding Franchise Partners

The market currently is ripe for finding franchise partners. Executives, managers and skilled workers are turning to franchising in droves either because they themselves are victims of corporate downsizing or because they believe (although so far successful in dodging the pink slip) that the best weapon for surviving the economic uncertainties of the 21st Century will be themselves – their labor, their knowledge and their own entrepreneurial spirit.[5] In fact, authorities speculate that, at any given time, 70% of Americans are thinking about becoming an entrepreneur; fifteen out of one hundred will actually give it a go in the next 12 months; and at least five will be successful on their first try. [6] These folks are motivated, committed and generally have access to capital through personal savings, severance packages, 401(k) plans, home equity loans or other traditional financing sources.

What is Franchising

The traditional business format franchise is often characterized as a "three-legged stool," with the three legs representing the franchisor, the franchisee and the franchise system's suppliers, each bearing equal weight to support the whole. In the ideal model, the franchisor contributes the goodwill associated with its name and a method for operating a successful business. The franchisee contributes capital and labor to build and operate the franchise; and franchise system suppliers provide proprietary products, distribution systems and favorable pricing

Legal Definition of a Franchise

As far is federal law is concerned, a "franchise" exists whenever there is a continuing commercial relationship between two parties and (1) one party licenses to the other party the right to use a trademark; (2) the licensee of the trademark pays to the licensor $500 or more during the first six months that the business operates; and (3) the licensing party promises to provide "significant assistance" to or has the right to exercise "significant control" over the licensee's entire method of operation. When these three elements are present, the Federal Trade Commission requires the licensing party to provide to the prospective licensee presale disclosures as described in Chapter VII.

More than a dozen states, which also regulate franchising, have adopted their own definitions of a franchise. While some state law definitions almost mirror the federal law definition, there are important differences. In addition, a handful of states use the "community of interest" test to determine whether a franchise relationship exists. In Minnesota, for example, a franchise exists whenever there is a contract or agreement between two or more persons (1) which grants the franchisee the right to operate a business using the franchisor's trade name, (2) in which the franchisor and franchisee have a "community of interest" in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise, and (3) the franchisee pays a franchise fee. Many of these states require that franchisors, in addition to providing presale disclosure, either register the franchise or make a filing before offering the franchise for sale in the state.

See Chapter VII for more information about federal and state franchise sales laws. Although seemingly different, both federal and state definitions have in common three fundamental elements: (1) a trademark license, (2) payment of a fee, and (3) interdependence between the franchisor and franchisee. Therefore, whenever a trademark licensee depends on the licensor to make the business venture successful, a “franchise” (for federal or state purchases) may be found to exist regardless of the name given to it by the parties.

Types of Franchising

The most common form of franchising is direct unit franchising, whereby the franchisor grants a franchisee the right to operate a single business. Some franchisors, however, also offer “area development franchises” (in which the franchisee is granted the right to develop and operate multiple units in a defined territory).

In addition, some franchisors elect to offer “Master Franchises” (also known as “Subfranchises”). Master franchising, unlike direct unit franchising or area development franchising typically involves three parties: the franchisor, the master franchisee (also sometimes called the subfranchisor), and the unit franchisee. In a master franchise relationship, the master franchisee is granted the right to recruit and provide services to franchisees within a defined area, and receives a percentage of the initial franchise fee and royalty fees (typically about 50%) paid by unit franchisees located in his or her territory. Master franchising is seen most often in international franchising (where a master franchisee may receive franchise rights for an entire country), but is becoming increasingly popular in domestic franchising as an explosive growth vehicle.

Is the Business Franchiseable?

To determine whether your business is “franchiseable”, you must ask yourself if it meets three important criteria: (1) is the financial model able to support franchising? (2) is there a demand for the product or service? (3) can the system be replicated?

To make this determination, it is critical to have developed a business prototype that you can use to test operational systems and controls, decor, designs, layouts, equipment, training methods, advertising and marketing programs, products and services, job requirements and descriptions, financial models, etc., and ultimately to measure the success of the business system. Think of the prototype as a laboratory in which you can test new ideas, identify and develop solutions to problem areas, and truly evaluate whether your business is franchiseable.

Before franchising, a company should have been operating outlets successfully at least at one, and preferably several, locations to verify the viability of the business and its profitability. A minimum period of time to test the pilot outlet(s) would be one year (to take into consideration seasonal factors) and to ensure that the business is producing attractive results. Two or three years of actual operating experience is ideal.

Analyzing the Financial Model

A franchise must be able to produce a reasonable return on the franchisee’s investment, after deducting the value of the franchisee's time. If a franchisee is merely buying a job, his motivation and loyalty to the network may be short lived. The business also must be able to generate sufficient revenue to the franchisor. A franchisor can capture only a portion of the gross revenue of a franchised outlet through continuing fees and the gross profit realized on sales of goods and services to the franchisee.

If a business cannot generate a sufficient rate of return on the franchisee's investment and sufficient revenue to support essential franchisor services and a sufficient profit to the franchisor, the business is a poor candidate for successful franchising. In today’s economy, if a business cannot generate a 20% return on investment after deducting a royalty (typically between 4% and 8%), it will have difficulty sustaining either the franchisee or the franchisor.

Analyzing the Demand for Your Products and Services

Let's not forget about the product or services your franchisees will be offering to the public. Are they good? Are sales based upon a well-established consumer demand or only a passing fad? How are your products and services different – and hopefully better – than those offered by the competition?

Understanding who your competition is, and what actions they are likely to take in the marketplace not only allows you to make a determination of whether your offering is sufficiently competitive, it enables you to be proactive in responding to the expected market changes. You also will need, in examining your options for expansion, to determine whether consumers will want or need your product or services tomorrow. Understanding their buying patterns and changes in the marketplace is essential in understanding the long-term popularity of your product or services.

What is the competitive landscape like? Will other companies be able to absorb your product and services into their consumer offering? What will changes and improvements in technology do to your consumer offering? Will it make your product or service unnecessary or necessary less often? Understanding your true competitive position, not only against other franchise systems but also against everyone who offers your product or service is essential to the long term viability of your company. Understanding how market conditions will affect your offering, therefore, is a critical factor in determining whether your business is franchiseable.

Determining Whether the Model is Easily Replicated

Today’s consumers have expectations of what their experience will be like in a branded business. Based on their experience at other locations or based on recommendations of others who have shopped at other locations, they have expectations about how you operate. Making their expectations into reality requires that the business operate consistently from location to location.

The key to consistency in operations is a business format built around the K.I.S.S. method. Keep It Simple Stupid, says a lot about a successful franchise. You must be able to replicate the design, the signage, location specifications, décor and building plans. Each of these criteria must be documented and taught to franchisees in the initial training program, operating manuals, and through on-going support in the field locations. Can your methods, designs systems and procedures be taught in a reasonable period of time (e.g., three weeks or less)?

Finally, it is important to know the cost of establishing and operating the franchise, so that (1) you can set your fees at levels that will allow franchisees to operate profitably, and (2) you can pass on this information to your franchisees. Federal and state disclosure laws (discussed in Chapter VII) require franchisors to disclose initial and ongoing fees and to provide an estimate of the franchisee's initial investment costs (which franchisees ultimately use to prepare projections for purposes of evaluating the franchise opportunity and obtaining financing). Undisclosed and understated fees and costs not only negatively impact a franchisee's return on investment, but also serve to erode the franchisee's confidence in you. This is not a good way to begin a business relationship!

Is Franchising the Best (or Only) Option for Me?

Franchising is one method of expanding your business, but need not be the only option. Many franchise companies also distribute products and services directly to consumers through company-owned units, through other methods of distribution (such as supermarkets and the Internet), and through distributorships and commissioned sales agents. These alternate distribution methods have both risks and rewards when used alone and in conjunction with a franchise program.

Company-Owned Units

A company rich in cash or with access to financing may consider establishing company-owned units alone or in conjunction with franchised operations. On the positive side, operating profits generated by a company-owned unit often are higher than the royalty stream income generated by a comparable franchised unit. Company-owned units also are subject to tighter controls, and provide an excellent environment for testing new products and services.

On the negative side, establishing and operating company-owned units requires tremendous cash and labor commitment (sites must be selected, real estate acquired, construction and build-out completed, employees recruited, hired and trained, etc.). Because of this commitment, growth tends to be slower and linear as compared to the exponential growth achievable through franchising (especially area development and master franchising).

Other Distribution Channels

In the last decade, several franchise companies began competing with franchisees for sales by offering products and services through supplemental distribution channels such as supermarkets and the Internet. For example, in the early 1990s, CARVEL began offering its ice cream cakes in supermarkets. In the late 1990s, DRUG EMPORIUM began offering products via the company's "full service on-line drug store"; and H&R BLOCK began offering tax preparation assistance via the Internet.

Competing with franchisees for sales dollars, however, can cause disharmony in the franchise system. By way of illustration, all of the cited examples resulted in franchisee-initiated litigation or arbitration against their franchisors, which ended with mixed results.[7] When considering multiple expansion methods, therefore, it is important to keep in mind the emotional and economic needs of your franchisees, who genuinely believe that you are their partner and, as such, have (or are required to have) their best economic interests at heart.

Distributorships and Commissioned Sales Agents

Selling products through distributors and commissioned sales agents also can provide an attractive alternative to employing a sales force because it enables companies to eliminate fixed costs such as payroll, payroll taxes, and advertising expenses. The question of whether to sell through distributors or commissioned sales agents requires careful consideration, and an understanding of the nature of these relationships.

Distributors typically purchase products from a manufacturer or supplier and then resell them to customers. Because a distributor actually purchases the products, he or she holds title to the product, and bears the risk of loss until the product is resold to a consumer. Because title to the product passes to the distributor, federal antitrust laws prohibits manufacturers and suppliers from establishing the price at which the distributor may offer the product to consumers. Sales agents, on the other hand, merely act as the manufacturer's or supplier's agent. Because title to the product passes directly from the manufacturer or supplier to the consumer, the manufacturer or supplier bears all risk of loss until the sale and has the right to establish the ultimate retail price.

Keep in mind, however, that both distributorships and sales agent relationships, in some circumstances, may fall within the definition of a "franchise" under federal and/or state law. This occurs most often when a supplier or manufacturer charges an up front fee for territorial protection or exclusivity, because it creates an arrangement that now includes the three fundamental elements of a franchise: that is, a trademark, a fee and interdependency between the parties. See Chapter II for more information about the legal definition of a franchise.

Business Opportunities

When talking about franchising alternatives, someone always asks about selling "business opportunities" (also known as "biz opps"). A business opportunity, as defined by federal law, is any continuing commercial relationship created by any arrangement or series of arrangements whereby:

1. The seller offers, sells, or distributes to a buyer, goods, commodities, or services which are (i) supplied by the seller, or (ii) supplied by a third person (*e.g.*, a supplier) with whom the purchaser is directly or indirectly required to do business

by the seller, or (iii) supplied by the seller's affiliate with whom the purchaser is directly or indirectly advised to do business by the seller; and

2. The seller (i) secures for the buyer retail outlets or accounts for the goods, commodities or services, or (ii) secures for the buyer locations or sites for vending machines, rack displays, or any other product sales display used by the buyer in the offering, sale, or distribution of the goods, commodities, or services, or (iii) provides to the buyer the services of a person able to secure the retail outlets, accounts, sites or locations described above; and
3. The buyer is required as a condition of obtaining or commencing the business to pay, or commit to pay, to the seller or its affiliate $500 or more within the six-month period following the initial sale.

The market for business opportunities historically has saturated with, at the very least, "questionable" opportunities (ranging from worm farms to pay telephone machines to ATMs) and fraught with fraud. Consequently, the term "biz opps" generally carries a negative connotation, and biz opp sales are heavily regulated and closely watched by both federal and state enforcement agencies. Most business opportunity sellers are required to comply (although they rarely do) with the federal franchise disclosure law and the "business opportunity sales laws" and "seller-assisted marketing plan acts" of approximately 25 states. These state laws require business opportunity sellers to register the business opportunity (which typically requires the posting of a surety bond) and delivery of pre-sale disclosures.

Structuring the Franchise Relationship

Before franchise documents can be prepared the initial franchise fee, royalty, advertising and marketing fee(s) must be determined. In determining these fees, the most important criteria are the initial and on-going costs of operating the franchise system and what your competitors are charging.

Determining the Initial Franchise Fee

Initial franchise fees vary widely, ranging from $0 to more than $100,000. Recent studies indicate that approximately 70% of franchisors charged an initial fee of $30,000 or less, with most charging between $20,000 and $25,000. Determining the initial franchise fee for your franchise requires consideration of various factors. As a rule of thumb, the initial fee should be sufficient to cover all of your costs in performing your pre-opening obligations to your franchisee. This includes the cost of screening the franchisee, and providing to the franchisee site selection assistance, initial training and initial on-site assistance. The initial franchise fee also must cover compensation due to a broker or commissions sales representative (which often is as high as 50% of the initial franchise fee). See Chapter IX.

Because the first sales are always the most difficult, the company may consider waiving or reducing the initial franchise fee for the first few sales. Before undertaking this type of marketing strategy, however, the franchisor must ensure that it has sufficient capital to perform its obligations and to support the franchisee during its initial period of operations, recognizing that it will not receive income until its franchisees begin operating their businesses and generating revenues.

To encourage the sale of multiple units, many franchisors also offer a reduction in the amount of the initial franchise fee when more than one unit is franchised. Franchisor costs to support a franchisee are considerably higher for the first unit opening, with the costs decreasing as the franchise becomes familiar with operating the business. Franchisors will sometimes develop programs designed to teach the franchisee's employees to provide new unit opening assistance. This can provide considerable savings to both the franchisee and franchisor as the territory is developed.

Determining Ongoing Royalty Fees

Royalty fees typically are paid on a monthly or bi-monthly basis, and typically are expressed as a percentage of the franchisee's gross revenues, which results in higher-performing units contributing more to the franchise organization as a whole. Many franchisors, however, charge a flat royalty fee (to avoid having to rely on accurate reporting by franchisees), and some royalty fees are built in to the price of products required for use in operating the franchised business.

Determining the amount of the royalty fee requires good business judgment and a balancing of economic interests. Royalty fee rates under most franchise agreements currently range from four to eight percent of gross revenues. The royalty fee for any particular business, however, should be a number that is sufficient to compensate the franchisor for the services that it provides during the term of the franchise, yet low enough for franchisees to realize a reasonable profit.

Determining Territorial Protection

Many franchisors (approximately 70%) grant franchisees some degree of territorial protection. If you grant franchisees protection, the franchise agreement should clearly define the territory. The territory can be identified on a map or as a radius (which must be measured from a specific point). It also can be defined by geographic boundaries (recognizing that roads and rivers have two sides) or expressed in terms of counties, zip codes or telephone exchanges (keeping in mind that county lines can be redrawn, and zip codes and telephone exchanges can be changed, reassigned and/or supplemented).

Structuring Advertising Funds and Cooperatives

Most franchisors will require franchisees to pay a monthly advertising fee. This fee generally ranges from .5% to 4% of gross sales. In many systems this fee is split into two pieces, which often are characterized as "local advertising requirements" and "national" or "regional" "advertising and promotion fund contributions."

A typical local advertising provision states that the franchisee must spend a designated amount of money each year (or each quarter) on local advertising of the type prescribed by the franchisor in the operations manual. Acceptable local advertising may include yellow pages and other directory advertising, local media advertising and grass roots marketing such as school or sports team sponsorships. The franchise agreement also may give the franchisor the right to establish "local advertising cooperatives," comprised of franchisees who pool their local advertising resources and coordinate advertising efforts in a particular geographic market.

The advertising and promotion fund, however, is a separate fund maintained and administered by the franchisor, which the franchisor uses for general promotion purposes. A typical advertising and promotion fund provision states that the franchisor may use fund contributions, in its sole discretion, for general marketing and advertising purposes, including market studies, sponsorships and endorsements, contests and prize promotions, web site development and administrative fees.

Relationship Between Franchise Agreement and Operations Manual

The franchise agreement creates the legal framework between the parties, and provides the strength for enforcing the parties' contractual obligations to each other. In order to maintain flexibility in the system, however, most franchise agreements require franchisees to comply with standards and specifications contained in an operations manual (discussed in Chapter V), which the franchisor can revise unilaterally. If the franchise agreement is considered the skeleton and muscle of the franchise relationship, the operations manual can best be described as the features that distinguish one system from another. See Chapter V for more information about the operations manual.

Preparing to Franchise

Rather than thinking about franchising as an event ("I shall franchise my business"), we suggest that you think of it as a process – a series of steps leading to the development and expansion of your franchise company. Keep in mind that franchising is a business that is wholly different from your underlying business. It will have its own identity, its own assets and its own processes. You also need to think about the intellectual property that you will license to your franchisees. Do you own it? Is it protected? Finally, you need to begin documenting the standards and procedures that you would like your franchisees to follow. When these essentials are in place, then you are ready to prepare the licensing documents and begin your search for franchise partners.

Structuring the Franchise Entity

To begin the franchise process, you need to think about the franchise entity. Will it be a corporation, limited liability company, or limited partnership? Will it be a department, a subsidiary, or an affiliate of your existing company?

Whether the company is a corporation, a limited liability company or a limited partnership is a tax driven decision that depends on state tax law and the particular needs of your organization.

Whether to franchise your business through your existing company or to form a new entity, however, turns on legal and business considerations. When making this

determination, be aware that franchise companies need to include in their disclosure documents three years of audited financial statements. This means (i) if you franchise through your existing company, you will be paying a CPA to audit the operations of your company-owned units, and (ii) the financial performance of your company-owned units will be public information. Combining your operating and franchise companies also consolidates the risk of liability in a single entity. This means that the assets of your company-owned operations and, potentially, your intellectual property will be exposed to liability from franchisee claims, and your franchise company will be exposed to liability from claims involving the operation of your company-owned units.
For these reasons, it often makes sense to segregate operations into separate entities.

Initial Capitalization and Financial Statement Requirements

Once you determine the appropriate franchising entity, you must decide how much money to put into the entity (either in the form of a loan or a capital contribution). From an accounting perspective (i.e., to avoid insolvency), the franchise company's liquid assets should be sufficient to carry it to its break-even point. From a marketing perspective (keeping in mind that the franchisor's audited financial statements will be in the company's disclosure document), the franchisor's capital contribution should demonstrate that it has enough money to perform its obligations to its franchisees.
These rules change somewhat if you anticipate registering the franchise in any state requiring registration. In most of these states, the state franchise examiner (if he or she determines that the franchise company is too thinly capitalized) has the power to condition registration of the franchise on your agreement to: (1) defer payment of the initial franchise fee until the franchisee is open for business, (2) place the initial franchise fee in a trust account established in the state where the franchise is registered, or (3) post a surety bond in the amount of the initial franchise fee. Therefore, it is important to discuss your franchise growth strategy with your franchise attorney and accountant before audited financial statements are prepared.

Protecting Intellectual Property

Before licensing your trademark or other intellectual property, you should ensure, first, that you own it (or at least that you have the right to license it), second, that it is protected, and third, that you can preclude others from using it. All of this can be accomplished by registering the mark with the Patent and Trademark Office, preferably on the Principal Register, which provides the following benefits:

- Registration of a mark on the Principal Register serves as constructive notice to the world that you claim to own the mark;
- A Certificate of Registration of a mark on the Principal Register provides prima facie evidence that your mark is valid and that you have the exclusive right to use the registered mark in commerce on or in connection with the goods or services specified in the Certificate, subject to any conditions or limitations stated in the Certificate;
- After your mark has been registered for five years, your registration cannot be challenged except on limited grounds; and

- Registration of the mark on the Principal Register provides a basis for registering your mark in foreign countries.

Trademark registration is particularly important to franchisors for two additional reasons.First, a federal registration provides franchisors a basis for exemption from certain state business opportunity laws (franchisors without federally registered marks must either comply with a handful of state business opportunity laws – which typically including registration and bonding requirements – or refrain from franchising in those states). More importantly, however, federal registration provides priority rights throughout the United States from the date of registration. This means (with some caveats) that, once a Certificate of Registration issues for a mark, no other person may begin using the mark in the United States on or in conjunction with the goods or services described in the Certificate of Registration.

This is not true in the absence of a federal registration. Without a federal registration, the owner of a trademark acquires priority rights only in the trading area of the business, leaving others free to adopt use of the mark elsewhere in the United States. This means, for example, that a Texas business that begins selling franchises nationally may not stop others from adopting use of the same trademark in areas in which the franchisor has neither operated nor licensed the operation of the business. After a mark is registered, however, the franchisor generally will have the power to stop any use of the mark that began after the Certificate of Registration issued.

Developing an Operations Manual

When preparing to franchise your business, you should begin assembling an operations manual that you ultimately will use to communicate to your franchisees your standards, specifications, policies and procedures. An effective operations manual should contain easy-to-follow instructions for operating the franchised business. It may contain a summary of pre-opening requirements, including a description of site selection criteria and approval processes, lease requirements, and requirements or advice for construction or build-out. It may contain a list of required equipment, inventory and fixtures, description of supplier restrictions and/or lists of approved or designated suppliers for certain items. It also may contain operating suggestions or requirements, including prescribed hours of operation, customer service requirements and/or marketing advice. Although an operations manual should be comprehensive, its development (like the franchise process itself) is evolutionary. For example, the first McDonald’s operations manual, produced in 1957, consisted only of 15 mimeographed pages. A year later it expanded to 75 pages, and was printed and bound. A 200-page work was produced in 1961; and, today, the current operations manual is a four pound, 750 page affair.[i] Therefore, don’t be discouraged if your operations manual doesn’t quite measure up to the heavy hitters – you will have the flexibility to revise the operations manual as your franchise system develops and matures.

Developing a Franchise Operations Team

As a potential franchisor, it is imperative that you have a business operations team in place prepared to handle the day-to-day needs of potential and existing franchisees. In simplest terms, this group ensures that the ability and knowledge needed to build the brand is passed on to the franchisees and that the royalties are brought back to the franchisor.

Assuming that the company has an existing structure necessary to run its current operations, franchise operations generally can be integrated into the existing management structure. Here is a reporting structure that captures the key elements of an operations team designed to fully support both a corporate and franchise structure. This example has three key areas reporting directly to the CEO at headquarters.

1. Operations
    a. Field Operations – personnel required to provide ongoing assistance on improving operations and monitoring compliance for quality, service and proper reporting of revenues.
    b. Real Estate – Responsible for assistance in site selection and site approval.
    c. Maintenance – Responsible for providing training and technical support for proper maintenance of fixtures and equipment that may be of a proprietary nature to the business. Manage outsourced maintenance vendors where applicable.
    d. Strategic Planning – Responsible for developing long term growth strategies and tactics. Conducts market research to determine future areas of opportunity and potential markets to meet company growth objectives.
    e. Logistics – Responsible for managing the supply chain of proprietary products, ensuring efficient, on-time delivery of all essential items.
    f. HR – Responsible for all aspects of human resource management for the company.
        1. Training – provides initial training for corporate employees and administers new franchisee training programs. Oversees the development and updating of the operations manual for use in franchise areas. Also develops proper reporting formats for franchise operations.
        2. Compliance – Responsible for maintaining proper franchise legal documents including agreements, disclosure documents, state and federal registrations, trademark protection and franchise files with performance (or non-performance) documentation. Manages outsourced legal teams involving the items above as well as litigation and real estate transactions. If the company has in-house legal counsel, this group may report to that office.
        3. Franchise Sales – Manages the internal or outsourced team responsible for selling franchises. Provides training on how to sell system benefits and ensures proper adherence to all franchise sales regulations. Works with Compliance to ensure all franchise sales documentation is properly maintained.
2. Controller
    a. Corporate Accounting – Manages the finances of the corporation and any corporate operations in the field.
    b. Franchise Accounting – Manages the finances derived from franchise revenues. Ensures proper franchise revenue stream and advises on

compliance issues with field operations. Maintains proper accounting and expenditures in any advertising fund to which the franchisees may contribute. Provides financial updates for proper franchise registrations.

3. Merchandising
   a. Supplier Selection – Responsible for negotiations with and selection of suppliers for system proprietary items. Works with Logistics to ensure efficient on-time delivery to field locations.
   b. Marketing – Responsible for developing the advertising and brand growth strategy for the system. Manages the advertising budget and provides proper documentation to Franchise Accounting where necessary. Negotiates and selects most effective method of advertising (may work in conjunction with a council of franchisees).
   c. New Product Development – Responsible for R&D. Manages both internal and external sources of potential new items to bring a constant flow of innovative products to the system thereby ensuring future brand growth.

This list is somewhat comprehensive and in small organizations one person may wear many hats. The important thing is that all aspects of an operations team be addressed. In addition, outsourcing many of these functions is not only common but it makes sense for many emerging businesses. Initial development of franchise agreements, disclosure documents, training aids and operations manuals are often outsourced by existing franchisors. Start-ups also may consider outsourcing strategic planning and franchise sales as a way to stay focused on their core business.

Developing a Franchise Sales Team

After the company has its franchise agreements and disclosure documents prepared and registered (where appropriate) and the fundamental operating systems and manuals have been designed, the process of marketing the company to potential franchisees can begin.There are two fundamental tactics to keep in mind before developing the franchise sales team.

First, you will need clearly defined statements of (1) features and benefits that your products or services provide to the consumer and (2) features and benefits your company provides to the franchisee. Before McDonald's was known to everyone, for example, they had a concept of portable, value-priced "food to go" for the consumer and a proven system to deliver that concept for their potential franchisees.

Second, you will need marketing materials that are based on the features and benefits described above that can clearly state the advantages of your brand and your system to potential franchisees. You may outsource the marketing concept, but it is critical that they understand those features and benefits. They are the creative team but it is your company that is being described. It is a good idea to have your franchise attorney review marketing documents to make sure they are in compliance with all regulations.

Your next decision is whether to outsource the franchise sales process or to keep it in house. Outsourcing can provide an instant low cost sales force that you simply can not do in house. That is the big advantage. If your concept is particularly attractive, this should provide quick results. However, you may not be the best concept in their portfolio of clients so your concept may not get the attention you think it deserves. In addition, it is more difficult to monitor disclosure compliance with broker systems in which the sale may be more important than legal compliance. An in-house sales force, on the other hand, may ensure you always get top billing and proper disclosure but it is very slow and very costly to develop.In the end, a reputable franchise broker sales network may be more advantageous for a new franchise system that does not have the time or resources to do this in house.

Regardless of how you structure the sales team, you want the sales force to be enthusiastic about the opportunities your company can offer but they must stick to the facts. Well designed marketing documents can help your team deliver your message in a positive, upbeat manner without resorting to overstating the truth about issues like past and future earnings which can later void the sale if legal difficulties arise.

Selling Franchises

Franchises are marketed in the same way that products are marketed. First you should know who your customer is. Whether your sales force is a broker network or in-house, marketing the concept is the same.

As explained in Chapter V, your concept should be clearly defined and a marketing effort should begin around that concept. Sales brochures and other printed materials used in print media should have similar designs and color schemes that immediately identify the brand concept. They should be enthusiastic about the concept and clearly state the features and benefits to the consumer and potential franchisee.

Advertising should be focused in trade specific journals and business/franchise opportunity journals if resources permit these expenditures. In addition, business/franchise opportunity trade shows can put you in front of prospective franchise candidates.

In addition, you can get your concept in front of outplacement services that specialize in finding opportunities for experienced workers that have lost their employment due to downsizing. This can be particularly effective if the skills needed are trade specific. GEEKS ON CALL, a trade specific (outsourced computer and network support) concept, for example, is taking advantage of downsizing in the technology industry to target potential franchisees.

Independent broker networks regularly hold seminars on franchising to educate potential entrepreneurs on the benefits and types of franchises available. In today’s market, the average entrepreneur is between 35 and 55 with 10 to 20 years work experience. These folks generally have some personal savings, severance and retirement benefits that they can use to finance start up costs.

After developing an effective method that delivers a steady flow of applicants, the qualification process begins in earnest. While there are consultants who can research and identify the profile for your ideal franchise candidate, the best franchisee is one who works hard, follows, instruction, will enjoy the business, has a suitable background, and has adequate financial resources and a supportive family.

Finally, a franchisor must have a system that can support new franchisees in their transition phase. A strong operations support network can help with site selection, obtaining financing, proper training, operations manuals and start up support. When you consider how much time, energy and resources are required to qualify a potential franchisee, it makes sense to have a strong business plan in place to help each franchisee thrive in the system.

Franchise Regulatory Compliance

The offer and sale of franchises is governed by federal law and the laws of 15 states.

Federal Law

Federal law, which applies to the offer and sale of franchises in all 50 states: 1. Requires that franchisors and franchise brokers deliver to prospective franchisees a pre-sale disclosure document or UFOC; 2. Requires that franchisors furnish to prospective franchisees execution copies of all franchise agreements, with all blanks filled in, in advance of their execution; and 3. Prohibits franchisors from making “any oral, written or visual representation (either to a prospective franchisee or for general dissemination) which states a specific level of potential sales, income, gross or net profit,” or which states other facts which suggest a specific level, unless the franchisor’s pre-sale disclosure document contains a formal “earnings claim.”

State Franchise Laws

Fourteen states require that franchisors (unless exempt from coverage under the state’s law) register the franchise or make a filing before they engage in any sales activity in or from the applicable state. These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Most of these states require that registrations or filings be renewed on an annual basis; other states require that franchisors submit an annual report within a certain number of days following their fiscal year end. Most states also require that the registration or filing be updated in the event of a “material change” in any information previously provided to the state administrator.

State Business Opportunity Sales Laws

Additional states have “business opportunity laws” or “seller assisted marketing plan acts” which may apply to the offer or sale of a franchise. Most business opportunity laws exempt franchise sales if the franchisor complies with federal franchise laws. A franchise will not qualify for exemption in certain states, however, if the franchisor does not have a federally registered trademark, does not file the appropriate exemption notice, does not comply with FTC Rule requirements in offering or selling a particular franchise, or if the franchisor makes certain promises or representations in connection with the sale of franchises. See Chapter IV.E for more information about these laws.

State Relationship Laws

Once a franchise is sold, a different set of laws and regulations apply. These laws are commonly known as “franchise relationship laws” because they govern important aspects of the franchise relationship, such as the franchisee’s right to sell or transfer the franchise to a third party, and the franchisor’s right to terminate or refuse to renew the franchise relationship. To the extent that these laws provide a franchisee greater protection than the franchise agreement, the terms of the state law will supersede applicable provisions in the franchise agreement. For example, if the franchise agreement provides for termination without notice and the applicable state statute provides for 30 days’ notice, the terms of the statute will prevail.

What Will it Cost to Franchise

As a ballpark figure, you should be prepared to spend at least $50,000 to develop and implement a barebones franchise program. This includes enough capital to assess your business (which may include hiring professional help), protect your intellectual property, structure your franchise and prepare necessary legal documents, prepare an operations manual and sales and promotional material, and market and sell your franchise opportunity.A more realistic estimate would be $60,000 to $100,000+, depending on your various needs and choices.

Sounds overwhelming? Keep in mind, that you have the ability to control your expenses by (1) documenting your concept and system before hiring a professional (this helps the professional to quickly grasp the concept and provides a big jump start in preparing legal documents and promotional material), and (2) hiring reasonably priced professionals with a strong franchising background (this helps to avoid miscommunications and “learning curve” charges).

Also remember that franchising is a process and that you alone control the pace. If you envision yourself franchising your business a year from now, now is the time to set the wheels in motion.

Initial Assessment

Before developing franchise and disclosure documents you must first analyze your business to determine (1) whether operating a franchised business would be profitable for a franchisee, and (2) whether franchising the operation of the business would be profitable to you, and (3) whether franchising is more or less desirable than other methods of expanding your business. A franchise consultant and/or your accountant can help you analyze your business and help you to answer these questions.

Consultants and accountants typically charge on an hourly basis, although some may be willing to complete the assignment on a project fee basis. Hourly rates can range from $100 to more than $300 per hour, and a seasoned consultant typically can help you complete a limited assessment in two to three days.

Structuring the Franchise

Once the final decision is made to franchise your business, an outline or plan must be developed as a guide for structuring your franchise program. The cost of developing the franchise structure can range from $5,000 to $25,000 depending on the level and extent of professional involvement.

UFOC and Franchise Agreement

The costs to prepare a UFOC and franchise agreements (which agreements may include a unit franchise agreement and, if the franchisor grants area development rights or master franchises, and area development agreement and/or master franchise agreement) will differ, depending on the complexity of the franchise documents and the firm engaged to perform the work. For a simple UFOC and unit franchise agreement, a typical cost may range from $15,000 to 25,000.

State Registrations

The costs to register the franchise or make appropriate filings in states that require registration or filing will vary, depending on the state and the firm engaged to perform the work. Some firms charge on an hourly basis; however, the trend in this area is toward flat fee billing. Franchise registration service fees typically range from $250 to $2,500 per state (excluding state filing fees which range from $400 to $750 per state).
To roll out a national franchise program, therefore, you should budget approximately $20,000 to $25,000 to cover professional service fees and costs.

Operations Manuals

The costs to prepare an operations manual depend on several factors, including the amount of material contained in the manual and the amount of work that you do yourself. Templates may be purchased online at prices ranging from several hundred dollars to $2,500. If you engage a consultant to assist in preparing your operations manual, the cost may range anywhere from $5,000 (if you provide the content) to $10,000 to $15,000+ (if the consultant provides the content).

Franchise Sales Programs and Materials

Once you have your franchise systems and documents in place, you are ready to start selling franchises. A detailed discussion of the many methods of prospecting is beyond the scope of this brief description, but there are certain basics most franchisors wish to have.

1. Lead Management System – Presuming that your lead generation system is successful, you will need to have an orderly and thorough system to follow up leads and manage the sales process through its paces. While many firms use Excel spreadsheets to track prospects, there are several new customer relationship management software programs available tailored specifically to the franchise industry. These are very affordable and robust. They allow for tracking, automated follow ups, and synchronization within the sales force and the rest of the organization.
2. A Brochure – This time honored marketing tool is typically used for casual inquiries and handed out at trade shows, etc. where the cost of the hand out is a concern.
3. A Portfolio Kit – This includes a cover with pockets for literature and die cuts for business cards. Pre-printed inserts are often cut as step sheets and cover a wide variety of topics about your franchise. Articles, photos, and other source material also are often included.
4. Website – Some franchisors have two sites: one for consumers, and one for franchisees and prospects. Most have just one site for consumers with a link to franchise information. Some franchisors give very detailed information on the site, and provide a contact for those who are interested. Others require a login after the prospect has filled out a detailed screening form online (the data can be made to load directly into Goldmine or ACT as mentioned earlier) to get access to detailed information.

In addition to these basics, franchisors may also have a formal presentation they give prospects as part of a Discovery Day. This might be done in PowerPoint or some other program as overheads or on a video projector. More advanced franchisors may have a mini-CD or DVD mailer with an automated presentation.

In addition to cold calling, attending franchising fairs, and direct mail, some franchisors advertise in general franchising publications or trade specific publications. As competitive advertising is often quite good, print ads must be designed with care and attention to quality.

So, what does all this cost? Without sounding trite, it depends on what you can afford to spend and how well you want your brand portrayed. The two do not necessary run in synch with each other. You can spend a lot of money and get work that represents your brand poorly, or does not help sell. You can also get great work that effectively sells for a relatively modest budget.

You have to be realistic in your expectations however. Anybody with a computer and software can do brochures today. That does not mean they have the qualifications and skill to help you develop and market your brand. It is best to find someone who has demonstrated experience in the area of developing marketing support materials for franchisors.

For a ballpark, expect to spend $8,000 to $10,000 for creative direction, copy development, art development, account supervision, etc, to the development of camera ready art for the brochure, portfolio cover and stepsheets. This would include stock photography on hand. Custom photography will run $2,000 to $4,000 per day plus travel. Printing 5,000 brochures and 1,500 (covers and step sheets) kits in full color would be about $5,000.

Developing a website could range from $5,000 to $15,000 which would work for consumers and prospects. If you want programming to include a lead form or restricted access, add $1,500 to $8,000 depending on the requirements.

So, for the basics, not including your CRM lead system, you should budget at least $20,000 at the low end for materials. A more realistic budget might range from $40,000 to $50,000. This would include your corporate ID package such as business cards, letterhead, envelopes, shipping labels, etc and perhaps a direct mail piece or trade ads.

You then have to budget the direct costs of direct mail (list acquisition, additional printing, fulfillment, postage) and/or trade ads (space costs), trade shows (booth design, registrations, travel), etc. Keep in mind that most of the upfront investment in your brand materials is non-recurring.

Franchise Sales Options

The costs of hiring in-house franchise sales help can vary greatly and be fairly expensive. In general, experienced franchise salespersons may expect to receive a salary approaching or exceeding the six-figure mark, plus commission (typically 10% of initial franchise fees received on sales). Franchise brokers and lead referral agents, on the other hand, typically work on a flat fee or straight-commission basis (ranging from $13,000 to a 50% commission) and are paid only if a deal closes.

Endnotes

[1] The Economic Impact of Franchised Businesses, (Washington, D.C.: IFA Educational Foundation, Inc. 2004), p. 1.
[2] Ibid.
[3] Ibid.
[4] Love, John F., McDonald’s: Behind the Arches, (New York: Bantam Books 1985, 1995) pp. 217-221.
[5] Farrell, Larry C., Getting Entrepreneurial!, (New York: John Wiley & Sons, Inc. 2003), p. 3.
[6] Farrell, Note 1, p. 3.
[7] See Carvel Corporation v. Noonan, et al, 350 F.3d 6 (2d Cir. 2003) (upholding certification to the New York Court of Appeals questions as to whether a franchisee could sue franchisor for tortious interference with prospective economic relations where the alleged wrongful conduct of the franchisor interfered with a franchisee's relationship with its customers and whether public harm was required for a punitive damages claim by a franchisee against its franchisor for tortious interference with the franchisee's

prospective economic relations with its customers); Franklin v. H&R Block, American Arbitration Association, Case No. 16 114 00540 01 (decided December 31, 2002) (upholding Block's offering of Internet services and computer tax preparation software against a franchisee's claim of encroachment); Emporium Drug Mart Inc. of Shreveport v. Drug Emporium Inc., American Arbitration Association Case No. 71-114-0012600 (decided September 2, 2000) (ordering Drug Emporium, Inc., which operated Drug Emporium.com, not to sell to any customer located within its franchisees' territories and to place a notice on its Web site that products cannot be shipped to any customers in those covered territories).

[8] See Love, Note 1, p. 140.

[9] The Profile of Franchising: Volume III: A Statistical Abstract of 1998 UFOC Data, (Washington, D.C." IFA Educational Foundation, Inc. 2000), p. 6.

[10] Profile, Note 6, p. 7.

[11] Profile, Note 6, p. 7.