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# FRANCHISING

## A Business Overview and Some Practical Considerations

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## **An Introduction**

Franchised businesses accounted for \$803.2 billion in sales in the United States in 1992, making up 40.9% of all retail sales and employing in excess of 8 million people. Estimates are that this figure may currently be in excess of 45%. 1 out of every 12-business establishments is a franchise, with 74.1% of all franchises being “business format” franchises such as McDonald’s, Hilton, El Pollo Loco, Round Table Pizza, Century 21 or Uniglobe Travel.<sup>1</sup> It could be fairly said that franchising is “only” the most successful method of product and service distribution developed during the Twentieth Century.

Given the tremendous success of the franchised form of doing business, it’s understandable that a significant number of people consider franchising their businesses or purchasing a franchise. Many of them view it as an almost “automatic” road to success.

The reality is different. No method of business, including franchising, guarantees success, either for the Franchisor or the Franchisee.

For the Franchisor, success will be based not on his or her knowledge of the underlying retail business, or even the quality of the product or service, but on the ability of the Franchisor to learn the skills related to franchising, which is a profession in and of itself.

For the Franchisee, success will be based on the Franchisee’s ability and willingness to work within a pre-existing system, helping to build the value inherent in the brand.

The challenge for this presentation is to summarize some of the more important considerations that both Franchisors and Franchisees should be aware of and which we believe drive the potential success of franchise systems. Let’s begin by discussing some overall business realities as they relate to franchising.

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<sup>1</sup> Figures courtesy International Franchising Association.

## Business Realities

- a. Franchising makes sense at the retail level only if belonging to a franchise system gives the retail units competitive advantages that more than make up for the costs of belonging to the system.
- b. If belonging to the franchise system does not give the Franchisee a competitive advantage, as compared to other participants in the industry, the franchised units will not be successful, since they have to bear the additional costs of royalties, mandatory advertising contributions, etc., may be less nimble in reacting to market changes, etc. And, if the retail units are not successful, the system will not be successful.
- c. The primary factor in increase in value of a franchised retail unit is the component related to the value of the brand. This is why a McDonald's restaurant is more valuable than a David's Diner! If the brand does not increase in value, the franchised units will not increase in value. (\$13,000,000 Taco Bell example.)
- d. The Franchisor and its Franchisees have, therefore, a single, unifying objective: **Building the value of the brand.**

All other business objectives are secondary. Retail chains that do not build the value of their brand — to be blunt — fail.

- e. **Brand value is more important than anything else**, including (perhaps especially) product quality. McDonalds and Century 21 did not become industry leaders based on supplying a superior product.
- f. Successful franchise systems are uniformly characterized by the overall strength of the system and consistent application of standards, operating systems and uniform presentation to the consuming public.

The brand is valuable only to the degree that a strong system, with competitive retail advantages, is present.

There just aren't any examples of successful franchise systems where they have varying standards, a poor record of franchisees following the system, inconsistent presentation of the product or service, etc. (McDonald's triumph over A & W, Foster's Freeze, KFC's triumph over Chicken Delight examples.)

In a successful franchise system, the customer's loyalty is to the brand, **not** to the individual unit, as emotionally difficult as that may be for Franchisees to accept.

- g. What's critical from the retail consumer standpoint is creating a “comfort zone” through consistent operational and marketing systems.

A franchise system does this by doing two things:

Making itself unique as compared to the competition.

Avoiding confusing the customer.

The system does this through building brand identity and providing a consistent presentation of the product/service and the marketing message.

The job for the Franchisor is to think deeply about how the system will articulate its uniqueness in a way that gives the Franchisees a competitive advantage.

The job for the Franchisee is to consistently implement that system and build value in the brand, while providing “real life” input back to the Franchisor as to how the system can be improved from an operating standpoint.

- h. All franchise systems face what we call “centrifugal pressures”: Without strong standards and the Franchisees’ emotional commitment to them, human nature is such that people will go their separate ways and the system will fail due to inconsistent messages to the consumer and a loss of strong brand identity.

## **“Is My Business Right for Franchising?”**

The standard analysis is that a business is “franchiseable” if a number of factors are present:

First of all, the business should be capable of being operated by a new Franchisee with relatively little training or experience in the relevant industry, with occasional input and support from the Franchisor. Simplicity is the key word here.

Second, the business should be capable of being systematized, not only for training purposes but also so that ongoing improvements and competitive opportunities can be taken advantage of and rapidly and effectively put into operation throughout the system.

Third, the business should be able to benefit, at the retail level, from marketing or other competitive advantages offered by franchising, such as common retail identity, mass advertising, pricing advantages in purchases of goods and services, shortened response time and improved quality of response to changes in the competitive environment, etc.

This later point, relating to competitive advantages associated with the franchise format, is one that is often missed, by attorneys and clients, in my experience. A business may very well be adaptable to the franchising format but the more difficult question is whether or not, after that format is in place, the retail business will have a competitive advantage in the marketplace as a result of utilizing the franchise format.

It can't be overemphasized that what we're talking about, at the end of the analysis, is almost always a retail business. If that retail business will not have an advantage relative to its competitors as a direct result of being part of a franchised system, and bear the increased costs associated with being part of that system (royalties, advertising charges, etc.), then the exercise simply doesn't make sense from a business standpoint. From an economic standpoint, the retail business must be profitable enough to (1) sustain the Franchisee and cause him or her to recommend the purchase to others and (2) support adequate long-term royalty and/or other payments to the Franchisor.

Additionally, the prospective Franchisor should have been actually operating the business at the retail level on a profitable basis, preferably at multiple locations, for a significant period of time. Franchising an untested “concept” is probably rarely successful and I've never seen it succeed in my actual experience.

Also, a business with limited geographic or other market appeal will probably be difficult to franchise, at least on the scale necessary to make it a successful project for the Franchisor.

Finally, the business should generally have some distinctive advantage over its competitors (independent of any advantages accruing from being franchised) or reach some currently underdeveloped “niche” market. To attempt to franchise a new national hamburger or real estate chain in 1998 would surely be an ambitious, if not completely foolhardy, undertaking!

Since the range of businesses which have been successfully franchised runs from formal apparel, automotive services, hair care and accounting through children’s fitness, computer learning centers, maid service, transportation, lawn care, travel agencies, real estate brokers, home inspection, and over a hundred other industries, it’s clear that the actual type of business involved is rarely a determining factor in the question of whether the business is “franchiseable.”

What’s more important is the following: Whether you are suited to be a Franchisor, not whether the business is “franchiseable.”

The prospective Franchisor needs special skills, above and beyond those needed in the substantive underlying business. Franchisees, whose success will be critical to the success of the Franchisor, are neither employees of, nor business partners with, the Franchisor. The Franchisees will bring varying levels of sophistication to the enterprise but all will ultimately reach the point where they believe (perhaps justifiably) that they know as much about operating the retail business as the Franchisor. Successfully managing that relationship, and continuing to deliver value to the Franchisee as the relationship matures, are probably the keys to success in franchising. Frankly, if the Franchisor can’t regularly have a good answer to the Franchisee’s question “Why am I writing this royalty check?”, the enterprise will not be a success for anyone other than the litigators and the bankruptcy trustees.

Conversely, the Franchisor who fails to think of his or her Franchisees as customers, who forgets that the Franchisor constantly needs to find ways to deliver value to the Franchisees and who sinks into an “us vs. them” mentality, is unlikely to find franchising a pleasant or profitable experience.

In the long run, top-down management simply doesn’t work in franchising (even assuming it does anywhere else), and intelligent counsel will find a way to make the prospective Franchisor look within him- or herself to see if the proper psychology is present before beginning the exercise.

## **Getting the New Franchisor Past “Adolescence”**

One of the challenges all new Franchisors face is getting beyond the beginning stage of franchising and maturing into a developed “system” that is both profitable for all concerned, as well as relatively immune to legal exposure. As in much of life, the “adolescence” of a franchise system involves the greatest dangers and opportunities. By the way, most franchise systems never make this transition since the majority never get past a limited number of operating units.

As I see it, three of the most important elements to focus on in making this transition are structure, education and constant legal vigilance. What do I mean by those headings?

Under structure, I'd urge concentration on the basic design of the franchise system. The danger counsel new to franchising may fall into is attempting to draft franchise documents, particularly the franchise agreement, based on “standard” materials available off-the-shelf in the law library. In nearly all cases, these forms are substantially out-of-date and fail to take into account the recent business and legal evolution that franchising is undergoing. Perhaps more seriously, form documents, even those copied from a currently successful Franchisor, will never contain the adaptations unique to each business. For example, the questions of whether or not to offer “exclusive” territories, or to provide for the Franchisor to distribute goods and services through possibly competing channels of distribution, can only be answered after considering the specific features of the business being franchised, as well as the Franchisor's long-range strategic plan.

Education is probably one of the most neglected fields in the entire transition from “baby” Franchisor to mature system. Clearly, it makes sense for a Franchisor to utilize the experiences of others rather than making expensive mistakes “reinventing the wheel.” What's not so clear to new Franchisors is that franchising, as a method of doing business, requires as much professional development and specialized knowledge as is true with the substantive, underlying business being franchised. While the new Franchisor may know everything there is to know about the fish taco business, for instance, we can safely assume that they know nothing about franchise relations, administering an advertising fund, negotiating with a Franchisee association, franchise marketing or franchise sales law compliance. Sophisticated franchise attorneys include training for the Franchisor in the legal aspects of all areas of franchising, along with serving as an appropriate reference to professionals and/or organizations prepared to offer formal training and/or networking/mentoring opportunities.

Finally, legal compliance falls most directly into the area of counsel's responsibilities in assisting the system to mature. A franchise organization that fails to protect itself from challenges by disappointed Franchisees will never make it past the

stage of adolescence and, like a teenager who drinks and drives, will probably crash with horrendous results for everyone involved. After all, on one level, franchising is simply one more method of growing a business using someone else's money.

What's different about franchising is that the investor actively operates the business and, if it fails, is rarely prepared to blame themselves. What's far easier is to blame the Franchisor (notwithstanding that other Franchisees, with precisely the same system, training and services have succeeded) and to seek legal recourse.

Franchisors should understand that, inevitably, some proportion of Franchisees will not succeed, they will take advantage of any possible means of getting their money back and recovering damages and must design a system of documents (particularly including the dispute resolution provisions) that provide maximum protection to the Franchisor. Equally important is developing a relationship with the Franchisor where counsel is brought in at every important juncture in the developing relationship between the Franchisee and the Franchisor, so that legal mistakes can be avoided.

## **Relations Between the Franchisor and the Franchisees**

One of the things that makes franchising different is that it involves ongoing business and legal relations between independent business entities, where none of the entities is in the role of a passive investor. While this presents innumerable points for the development of possible friction, it also creates the conditions for synergistic co-operation and joint development and exploitation of advantages *vis a vis* the competition. Most failed franchise systems have something in common: the development of an “us vs. them” attitude between the Franchisor and its Franchisees. Similarly, most successful franchise systems have a strong relationship with their Franchisees involving good communications and joint development of the system and building value in the brand on an ongoing basis.

The lesson is clear: Those franchise systems that have succeeded don't always do it because they offer a superior product (is a McDonald's hamburger really better than the one offered by the corner grill? Probably not.) but because they've mastered working together as a system, with both the Franchisor and the Franchisee bringing resources to the table and placing themselves in a superior position relative to the competition. And that's essentially impossible to do without a good relationship between the Franchisor and the Franchisee. Sophisticated franchise counsel find ways to constantly remind their clients of this and will be able to balance the need for legal protection with cooperative relations between the Franchisor and the Franchisee.

## **Important Things a Franchisee Needs to Do Before Purchasing a Franchise**

1. A Franchisee needs to have done “due diligence” in investigating the Franchisor and the satisfaction (or dissatisfaction!) level experienced by current and (any) past Franchisees. At a minimum, the Franchisee should have spoken with each of the existing Franchisees (including anyone who has been in a relationship such as a “license”), and any who have left the system, to ask them a series of questions regarding their satisfaction level, after verifying that the person the Franchisee is speaking with has no connection (family or otherwise) with the Franchisor.

For example, answers to questions such as the following would be very relevant:

- Are the Franchisees satisfied with the performance of the business?
- Are they making the amount of money they expected to? (They may even be willing to share some sales figures with you.)
- Would they recommend the franchise to their best friend or a close relative?
- Do they see any problems with starting this business in this area?
- What would they tell the Franchisee to be concerned and/or careful about?
- Do they plan to expand to additional locations?
- Do they enjoy the daily operation of the business or has it become unpleasant and stressful?
- How would they rate the performance of the Franchisor on a scale of 1 to 10? Did what the Franchisor tell them prior to their purchase turn out to be complete and correct or was anything untrue or was anything important left out? Does the Franchisor honor its commitments? How satisfactory was training, site selection assistance, pre-opening and post-opening support? Is there an advertising program and how is it working? Are fair prices being charged for any items sold to the Franchisee by the Franchisor or any affiliated company?
- Are the estimates of costs to open the business, as set out in the

UFOC, accurate and match their experience? In particular, is the amount shown in Item 7 of the UFOC as “Additional Funds” an adequate capital reserve to reach profitability or were they required to dip into savings to support the business? Have they reached breakeven yet and how long did it take?

- If they had it to do all over again, or if they could push a magic button and get all their money back, what would they do?
  - For Franchisees that have left the system, why did they leave and how relevant were their problems to what a Franchisee might face?
2. The Franchisee needs to think about whether or not he or she will be happy operating this business, day in and day out, for a number of years. I’ve seen situations in which a franchised business may be generating adequate returns for the Franchisee but the actual operation of the business (making submarine sandwiches and supervising 19-year old employees, for example) becomes less and less rewarding as time goes on.
  3. Even if the business is attractive to a Franchisee, he or she should think clearly about whether franchising (or licensing), in general, is right for you. While franchising (or licensing) can have many benefits, it does involve some surrender of freedom to the Franchisor and a Franchisee must be willing to take direction from the Franchisor in a number of areas. There are some businesspeople who may be very effective as independents but who would chafe at the restrictions involved in a franchise or license system and a Franchisee needs to look at themselves carefully in that regard.
  4. In addition, while the Franchisee can, in well-run systems, receive significant benefits from the Franchisor, the Franchisee will have to pay for those, typically through a periodic royalty. Can this business support this “load” and do the advantages of being part of a franchised/licensed system more than compensate for this expense, which will otherwise reduce your net income from the business? Ultimately, this is related to the question of whether the costs of participating in the industry as part of a franchised/licensed system more than overcome the costs and restrictions involved.
  5. Finally, is this the right Franchisor for you, assuming you want to participate in the industry and want to do so in a franchised or licensed mode? Has the Franchisee investigated other Franchisors in the field and made an objective determination that this one is the best franchise or license available for the cost?