THE ADVANTAGES AND DISADVANTAGES OF FRANCHISING

by

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This memorandum, produced for a number of our clients considering franchising, brings together a "bullet point list" of the advantages and disadvantages (both business and legal) of moving to a franchised system of operation. I've decided to list the disadvantages first, to in some way attempt to counterbalance my natural tendency to be an advocate for franchising, given my 25-plus years involvement in the field.

Note that my comments relate primarily (but not entirely) to comparing franchising with a dealership program, and do not address the issues of moving entirely to a company-owned units approach, which is not what I understand you're considering.

DISADVANTAGES OF FRANCHISING

- **HIGHER LEGAL EXPENSE**

The necessity of preparing agreements, Uniform Franchise Offering Circulars (UFOCs) and related documents, and filing them in various states (with attached audited financials) represents a significant expense, although the year-to-year expenses are generally less than those initially incurred in setting up the structure and related documents. Basic documents, once prepared, can be filed in many states with generally minor changes.

Additional legal (and possibly accounting) costs will be incurred if a separate legal entity is used for the franchising program.

- **TECHNICAL LEGAL CONSTRAINTS - FRANCHISE AWARD PROCESS**

Franchise laws are particularly technical in their application (for example, if a Franchisor provides only 9 days of pre-sale disclosure rather than the required 10, the Franchisee has an automatic rescission right, even though the missing day was not the cause of any loss.) For these reasons, an education program for franchising personnel (which we provide) and the assistance of an in-house legal compliance person is highly useful.

- **TECHNICAL LEGAL CONSTRAINTS - REGULATION OF THE RELATIONSHIP**

Franchise laws in a number of states regulate the circumstances in which a Franchisor may terminate or refuse to renew a franchise. While generally not preventing Franchisors from achieving termination or non-renewal, these laws do present a number of technical requirements that must be complied with. These requirements make inclusion of provisions for objective standards (for both system compliance and financial performance) for termination (and/or recovery of "exclusive" territories) particularly important.

- **FRANCHISE MARKETING CONSTRAINTS**

Advertisements, brochures, flip charts, video tapes, etc. offering the franchise (but not retail advertisements) must be pre-cleared with state agencies and cannot contain earnings claims. Information regarding possible financial results for operating units can only be presented in a formal document attached to the UFOC.

- **CONTROL ISSUES**

As with dealerships, there may be quality control and related issues, at least as compared to company-owned operations.

- **BUSINESS RELATIONSHIP ISSUES**

Perhaps more than with dealers, Franchisees typically view themselves as, to some degree, partners with the Franchisor in the development and possible success of the system. While most will agree that committee management doesn't work and that there needs to be "one captain for the ship," a wise Franchisor will work with his Franchisees, probably with the help of a franchise advisory council, in charting strategic directions, implementing marketing plans, etc. A Franchisor must be psychologically comfortable working with Franchisees who will understandably take the view that "if we're going to be in on the landing, we'd like to be in on the takeoff too."

- **NEED TO DELIVER PERCEPTION (AND REALITY) OF CONTINUED VALUE**

Franchisees (perhaps more than dealers and particularly if they are being asked to pay royalties and/or marketing fund contributions throughout a long-term contract) can be expected, after some period, to feel that they know as much about running the business (at least on the retail level) as the Franchisor and will ask what their continued payments are buying them ("What have you done for me lately?")

Wise Franchisors anticipate the question by building value in the brand (see below), updating systems and providing continued operational and marketing benefits that give the Franchisee a superior position *vis a vis* the competition, making his or her leaving the system obviously a poor business decision.

- **POTENTIAL FOR LOSS OF FREEDOM**

Unless carefully designed, awards of "exclusive territories" may generate legal and other problems when a Franchisor seeks to expand through alternative channels of distribution (Internet, mail order, etc.), special venues (units in Wal-Mart, K-Mart, etc.), access different markets (non-automotive), co-branding opportunities, mergers with existing competitive chains, etc. Appropriate franchise agreement provisions, and proper education of Franchisees, and management of their expectations, can largely avoid these issues.

- **FINDING QUALIFIED FRANCHISEES**

As may be true with dealerships, but more importantly where the franchise relationship is long term, finding and educating (not just training) good Franchisees is vital. The ideal Franchisee combines entrepreneurial energy with the willingness to follow systems and act as a "team player."

Psychological testing and a detailed interview and training process are tools which many Franchisors use to select the right individuals. The question to be asked should be "Is this the best candidate in Rochester?" rather than "Can this man fog a mirror held under his nose and produce a warm checkbook?"

- **UNMANAGED GROWTH**

Given franchising's demonstrated potential for rapid expansion (financed primarily by Franchisees), the potential downside is too rapid expansion, with the needs of the Franchisees outstripping the support capabilities of the Franchisor.

ADVANTAGES OF FRANCHISING

- **OWNERSHIP MENTALITY**

Similar to a dealership, but with more emphasis in franchising, particularly where the franchise agreement is long-term, the Franchisee will have an attitude of being a business owner (not merely dealing with one product line among many) and is more likely to devote time, attention and capital to growing the business, following the approved system and not walking away from occasional business challenges.

As one observer put it: "The best fertilizer for growing a business is the owner's foot firmly planted on the premises."

- **BUILDING THE VALUE OF THE BRAND**

Critical to retail success of each unit in a distribution scheme, as well as the overall competitive strength of the distribution system, is the presence of strong brand identification covering both the products offered and the retail businesses operated.

Assuming that a significant brand recognition factor can be established and maintained in the minds of consumers and Franchisees, the following benefits will flow for the Franchisor and its Franchisees. [Note that realization of these advantages has two primary drivers: (1) prominent identification of each retail business (not just the product) with the trademark and (2) a strong retail marketing campaign building brand identity in the consumer's mind.]

- Easier franchise sales (both individual units and area development arrangements).
- Clustering units to achieve dominant local presence.
- Easier retail sales for franchised and company-owned units.
- Higher initial franchise fees.
- Higher royalty levels.
- Ability to leverage brand identity and require Franchisees to finance marketing campaigns.
- Higher wholesale and retail prices for product.
- Fewer "breakaways" from the system.
- Regional and national market penetration, with establishment of dominant market share
- Greater value when the Franchisor goes public or otherwise realizes the value attached to the brand.
- Greater value for Franchisees when they resell their units or otherwise "cash out."
- Greater value for franchised units irrespective of the owner's personal involvement or skills (A McDonald's has a relatively constant value, due to the brand, independent of who the owner or manager of a particular unit is).
- Easier access to lenders and other financing sources.
- Easier access to desirable locations and favorable lease terms.
- Increased barriers to entry by competitive concepts.

- **IMAGE**

Both among prospective owners and with the consuming public, franchise systems generally have a superior image over other distribution approaches, particularly if there is uniformity as to retail presentation, marketing methodology, operational compliance, etc., precisely the things which are easier to achieve within a franchise framework.

- **FRANCHISEE PARTICIPATION AND SUPPORT**

Although not unique to franchising, the franchise model (when well managed) often incorporates valuable Franchisee input and creative participation by Franchisees. Since all of the participants are part of a single "system" with a common identity, Franchisees are more likely to participate in initiatives for the expansion and proper operation of the entire enterprise, sometimes producing new ideas as well as alerting the Franchisor to operational non-compliance problems created by other Franchisees in the systems.

Allied to this advantage is a psychology that can develop among Franchisees, given many people's need to belong to a group. If properly managed, a sense of team participation can benefit the entire system.

- **SYSTEM-WIDE MARKETING SUPPORT PAID FOR BY FRANCHISEES**

Franchise systems typically include arrangements where Franchisees are required to contribute to a national marketing fund, and participate in local marketing co-operatives, supporting retail marketing, advertisements, promotions and public relations.

This ability of the entire system to pool advertising dollars produces obvious competitive advantages (including raising barriers to entry by potential competitors and/or leveraging an already leading position in the industry) and is one of the primary reasons for many systems' survival in down markets (*e.g.* Century 21) and/or ability to maintain market share in the face of competitive challenges irrespective of mediocre quality products (*e.g.* McDonald's).

- **IMPROVED CONTROL OVER OPERATIONS AT THE RETAIL LEVEL**

Franchising provides both a legal and institutional structure allowing detailed control over the individual unit's marketing and operational programs. If you believe that it is critical for each unit's success (as well as that of the system as a whole) that each unit follow recommended marketing and operational guidelines, franchising provides one of the strongest methods of achieving that objective.

- **AVOIDANCE OF LEGAL EXPOSURE**

To the extent that your system is currently a "quasi-franchise," you face exposure to both state and/or federal enforcement activity, as well as claims for rescission, damages and attorney's fees (class action or otherwise) for non-compliance with franchise and/or business opportunity registration and disclosure laws. This exposure exists not only as to current dealers, but also is present (and, in fact, increased) with every new dealership that is awarded. At some point it may be appropriate to ask if a great company is being built on a foundation of sand.

Moving to a franchise template, and complying with the relevant laws, eliminates this exposure (at least for future awards and possibly for past ones, depending on arrangements reached with existing dealers.) It also avoids challenges, not only by unsuccessful dealers (of whom there will always be at least 5% to 10% in any distribution system) but also by potential buyers of the corporation, who may use the potential for exposure to franchise law claims as a basis for reducing the price paid for the company or entirely walking away from the deal.

Registration as a franchise also removes the necessity, in at least some states, to register as a business opportunity. Business opportunity laws often require unfavorable provisions in contracts, allow rescission during a "cooling off" period and place the company in the same category as those offering vending machine deals and worm ranches, a group you may want to distance yourselves from.

Additionally, compliance with disclosure requirements often acts as a type of "insurance," on the basis that if a fact was disclosed to a prospective Franchisee (particularly where the disclosure document was reviewed by a state), it becomes far more difficult for the Franchisee to later claim he or she did not know of the unfavorable fact in question.

Finally, franchising documents typically provide areas of special protection to the Franchisor, including the following (some of which we mentioned in our earlier letter):

- Franchisees are required to purchase designated products and equipment <u>only</u> from approved suppliers, which may be limited to the Franchisor and/or its affiliates.

- If Franchisees purchase items from unauthorized sources, or the above limitation on sources of supply is unenforceable, royalties are imposed, or (if royalties are already part of the system) adjusted upward <u>substantially</u> to make up for lost revenue at the Franchisor/affiliate level.

- If Franchisees do not meet sales/product purchase quotas, they can lose their territorial rights, be terminated and/or ineligible for renewal.

- If you are uncomfortable with the working relationship with a Franchisee you can, at any time, implement a "friendly divorce" by returning the initial franchise fee, the Franchisee returns all equipment and de-identifies, you waive any post-term non-compete (but not confidentiality or indemnity requirements) and you receive a release.

- Franchisees contribute to a national marketing fund and are required to join, and contribute to, local marketing co-ops.

- Releases by the Franchisee of all known and unknown claims against the Franchisor and/or any affiliates are <u>mandatory</u> on assignment, renewal, execution of an agreement for a second territory, etc., thereby periodically "wiping the slate clean."

- Jury trial is waived and all disputes (with minor exceptions) are resolved by mediation/binding arbitration at the Franchisor's headquarters, conducted by persons experienced in franchising. (Let's avoid having your business' future decided by a jury of retired postal clerks and college students.)

• Limitations on damages payable to Franchisees, shortened statutes of limitation, etc.

• The law of the state of incorporation (preferably not a franchise registration/relationship law state - Nevada and Delaware often serve well) of the Franchisor, or the law of the state where the Franchisee is located, applies, avoiding application of California's pro-franchisee laws in many instances.