

# NEW ENTERPRISE FORUM

## FRANCHISING 101

May 16, 2002

---

### THE SOCIETAL IMPACT OF FRANCHISING

For better or for worse, franchising has created a totally new retail landscape of shopping malls, strip centers and miles of highways all displaying the competing signage of hundreds of national franchisors.

During the past 40 years, franchising has grown to such an extent that it now has a significant effect on, and even shapes, American tastes, values and life styles and is seen as a symbol of American culture in all corners of the world.

### THE ECONOMIC IMPACT OF FRANCHISING

Franchising is now said to account for more than 40% of all retail sales in the United States. In 2000, it was estimated that there were some 1,500 franchisors operating in the United States doing business through more than 500,000 retail units and accounting for over \$1 trillion in annual retail sales. Industry analysts estimate that franchising employs more than 8 million people, that a new franchise outlet opens in the United States every 8 minutes and approximately one out of every 10 retail business establishments is a franchise business.

### WHAT IS FRANCHISING?

Franchising is simply a method of distributing products or services identified by the franchisor's trademark or servicemark in accordance with the franchisor's prescribed business methods.

### TYPES OF FRANCHISE ARRANGEMENTS

#### A. PRODUCTS DISTRIBUTION FRANCHISE

The product distribution franchisor is typically a manufacturer selling finished or semi-finished products to a franchised dealer. The franchisees or dealers generally furnish pre-sale and post sale service to customers, concentrate on the sale of the franchisor's products and refrain from selling competitive products.

Examples: car dealerships, gasoline service stations, and soft drink bottlers.

## B. BUSINESS FORMAT FRANCHISE

- The business format franchise is the one most familiar to the general public. The franchisor licenses a business format, operating system and trademark or servicemark to its franchisees and also often sells products to them for use in their franchise operations.

Examples: food service outlets, lodging facilities, automobile maintenance shops, convenience stores, automobile and truck rental operations, business services such as bookkeeping and temporary employment services and a multitude of other consumer services such as home cleaning and repair, lawn care, day care, educational classes, tax return preparation and real estate brokers.

## C. TRADEMARK AND SERVICEMARKS

- A franchisor must own a protectable trademark or servicemark which has been registered with the United States Patent and Trademark Office which it licenses to its franchisees for use in their business operations. The franchisor's trademark is often described as the "heart and soul" of any franchise system. It is the trademark which identifies the products and/or services of the entire franchise system and assures the public of the consistent quality, reliability and standards of these products and services. The entire franchise system is the beneficiary of the goodwill created by the use of the trademark by its franchisees.

## FRANCHISING AS A METHOD OF RAISING CAPITAL

- Franchising offers a number of benefits to the entrepreneur who has conceived an idea for a business enterprise and which the entrepreneur has then developed into a profitable commercial operation through one or more prototypes. The entrepreneur now has the opportunity, by means of franchising, to expand the business into a regional, national or even international network of similar business outlets operated by independent owners.

### A. RAPID EXPANSION OF FRANCHISING SYSTEM

- Franchising enables an entrepreneur to establish a large number of franchise outlets in a relatively short period of time using the capital and other resources of its franchisees. A start-up franchisor often does not have a sufficient asset base to raise the amount of capital that its franchisees collectively can provide to expand the franchise system. Once a number of profitable franchisees are in operation, a franchisor can then more readily raise additional capital to finance expansions. (Note: Capital is often more readily available when the immediate need is not critical). Rapid expansion is often a key to the success of a new franchise system - consumer recognition, acquisition of locations,

availability of financing to franchisees from outside sources, and trademark or servicemark promotion.

#### B. FRANCHISEES SHARE RISK OF EXPANSION.

The franchisees furnish the equity and borrowed capital to pay for real estate, leasehold improvements, equipment, fixtures, inventory and working capital necessary to establish the franchise outlets, all of which advertise and promote the trademark of the franchisor. In addition, the franchisees also pay the franchisor a royalty fee which normally will offset the cost of franchisee selection, training and pre-opening assistance.

#### C. FRANCHISORS CAN USUALLY REALIZE A HIGHER RETURN ON INVESTED CAPITAL

A franchisor can often operate with few fixed assets other than the outlets it owns itself. Accordingly, a high percentage of the revenue it receives from its franchisees is profit and that profit is generated with a much lower capital investment than that which would be required to construct company owned outlets.

#### D. CAPITAL REQUIREMENTS OF THE FRANCHISOR

Although much of the capital to develop a franchising system is contributed by the franchisees, a franchisor must still have sufficient capital to develop and implement its franchising system and to support its initial business operations. A franchisor must have sufficient capital for the following purposes:

- (a) developing, operating and modifying prototype franchise outlets.
- (b) developing and improving operating systems, training programs, products and services.
- (c) developing the franchising system identity and intellectual property attributes. (trademarks, trade dress, unique operating systems, etc.)
- (d) providing for the administrative, legal, accounting, marketing and operations services necessary to launch the franchise system.

A franchisor cannot rely solely upon the initial fees paid by its franchisees to cover these operating costs or it will be under too much pressure to sell franchises as quickly as possible without proper regard to the qualifications of the franchisees or their geographical locations or facilities.

## FUNDAMENTALS OF FRANCHISE REGULATION AND DISCLOSURE

The offering and selling of franchises is one of the most heavily regulated of business activities and it is beyond the scope of this Franchising 101 outline to provide a complete analysis of the various federal and state laws and regulations applicable to franchising. All franchise disclosure documents are further subject to specific state or federal statutory and regulatory definitions, qualifications, policies or exemptions which must be interpreted by a qualified franchise attorney.

### A. FEDERAL TRADE COMMISSION FRANCHISING RULES

The Federal Trade Commission's Franchising Rule (FTC Rule), 16 C.F.R. 436 et seq. requires that every franchisor offering franchises anywhere in the United States deliver an offering circular using a prescribed format to all prospective franchisees. The FTC Rule preempts state franchise laws and regulations only to the extent that they are "inconsistent" with the FTC Rule or provide less protection to the prospective franchisee than that provided by the FTC Rule. Accordingly, franchisors and their agents who are covered by the FTC Rule must also comply with all state franchise registration, disclosure and administrative laws and regulations.

The FTC Rule specifies a disclosure format which is seldom used by national franchisors because there are seven or eight states which do not accept the FTC format whereas the FTC has accepted the Uniform Franchise Offering Circular (UFOC) format as a format which may be used to comply with the FTC's disclosure requirements in all states.

### B. UNIFORM FRANCHISE OFFERING CIRCULAR (UFOC)

The franchise laws of some 15 states prescribe the form and contents and/or advance registration of UFOCs which must be delivered to prospective franchisees. These states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Texas, Virginia, Washington and Wisconsin. Oregon also has specific disclosure requirements but does not require registration.

### C. UFOC CONTENTS

The UFOC format requires that a franchisor provide information about its franchise system to potential franchisees covering a wide variety of diverse subjects. This disclosure document is broken down into 23 different sections and requires the franchisor to disclose and describe, among other things, background of the franchisor; the litigation, criminal and bankruptcy history of the franchisor and its principals; the

investment necessary to establish a franchise outlet; the royalties and other fees due the franchisor; the franchisor's registered trademarks and servicemarks; franchisee training; resolution process regarding disputes with the franchisor; financial information regarding the franchisor; information regarding existing franchisees; the territory or geographical location awarded to the franchisee; and the disclosure of other prescribed information.

### **EVALUATION OF A FRANCHISE OPPORTUNITY - 3 STEP PROCESS**

A detailed outline of the complicated process of successfully evaluating a franchise opportunity is also beyond the scope of this Franchising 101 outline. However, in order to attempt to give some structure to this evaluation process, it is recommended that it be broken down into three primary steps as follows:

1. Investigating the advantages and disadvantages of franchising to determine if the potential franchisee is suited for a franchised business.
2. Researching the business classifications in which franchise opportunities are available and selecting those classifications which are compatible to the aims, objectives and personality of the potential franchisee.
3. Evaluating the particular franchising systems available within that business classification and selecting that franchisor which appears to best offer what the potential franchisee is looking for.

NOTE: BEFORE MAKING ANY DECISION TO PURCHASE A FRANCHISE, A FRANCHISE CANDIDATE MUST, AT A BARE MINIMUM, SPEAK IN CONSIDERABLE DETAIL TO MOST, IF NOT ALL, OF THE EXISTING FRANCHISEES WHO ARE LOCATED IN OR NEAR THE PROSPECTIVE GEOGRAPHICAL AREA OF THE FRANCHISEE. IF A PROSPECTIVE FRANCHISEE IS UNWILLING TO MAKE THIS INVESTIGATION, THEN HE OR SHE IS PROBABLY NOT PREPARED TO PURCHASE A FRANCHISE!!

### **THE FUTURE OF FRANCHISING**

As with many other forms of business enterprise, franchising is undergoing some growing pains after 40 years of unprecedented growth and franchisors must continually monitor and sometimes adjust their franchise systems.

The Internet and e-commerce have had a substantial impact on franchising similar to that which it has had on many other aspects of our business and personal lives.

Instant and constant communications between franchisors and franchisees are becoming the standard rather than the exception. Point-of-Sale information, inventory control, automated bank withdrawals of royalties, and other electronic

processes are now required by most franchisors and further test the relationship between franchisor and franchisee.

During the past few months, a number of franchisees have announced that they will make their franchise disclosure documents available electronically. The FTC has already given its approval to the use of this type of distribution system and the electronic registration of the UFOC documents cannot be far behind.

Obviously, electronic distribution of the lengthy UFOC documents will save printing, postage and production staffing costs. It will, just as obviously, create new concerns regarding proper registration, timely disclosure and questionable sales techniques. The next 40 years of franchising obviously promises to be just as exciting, unpredictable and challenging as the past 40 years.

Michael P. Malley, PLC  
3135 South State Street, Ste 203  
Ann Arbor, MI 48108  
734-996-1083  
email: [Michael@malleylaw.com](mailto:Michael@malleylaw.com)