

Counseling a Start-up Franchisor American Bar Association Forum on Franchising

PART I: FROM THE BUSINESS CONSULTANT'S POINT OF VIEW

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1. INTRODUCTION

Frequently the first problem we face when counseling a start-up franchisor is removing the "myths" about franchising.

Clients, new to franchising, have read in the popular franchise and business opportunity magazines about the unbridled success of franchising. They anticipate that since all the franchisors they read about have had accelerated growth that they will also have rapid growth and can even go international in a few years.

Many times they do not understand the costs in time and money of developing a franchise system properly. They have read the ads of franchise packagers for development services, legal documents and marketing materials which focus on franchising as a vehicle to sell franchises rather than to operate a franchise system. And some of the ads in the back of the magazines talk of becoming a franchisor for between \$1,950 to \$2,950 including legal documents and marketing materials.

Often they have read some of the lay books on the subject or have attended an introductory seminar on franchising and believe they understand the subject better than we do. Some even come to us having already decided that they should not franchise. That is, that the legal difficulties in developing and defending their franchise system are so complex that it is not worth the effort to franchise.

Generally, they have little understanding of what franchising is really about and what it takes to develop and operate a franchise system successfully. Few realize that many franchisors are not successful in the process.

Rarely do they have an understanding of whether their company is franchisable, nor do they understand what the benchmarks of franchisability are or what the true total costs will be.

Clients who are new to franchising need good advice and firm guidance as they make decisions about developing their businesses. But their first and most important decision is from whom they will seek advice. If experienced, reliable professionals do not act as their shepherds through the process, there are a number of inexperienced and unreliable persons who will.

As professionals, it is our first responsibility to these clients to probe their decision on becoming a franchisor and to educate them on the requirements of developing and operating a franchise system.

2. FRANCHISE PACKAGING

For all of the years that I have been involved in franchising, as an executive with franchisors, as a franchisee and as a consultant, there has been a consistent drumming within the professional community that companies that use the services of "franchise packagers" are at risk. Often the most vocal critics have been the members of the franchise legal community.

Lawyers frequently complain that "franchise packagers" take off-the-shelf documents and fit a company into a pre-existing mold with little regard to the realities of the company, or whether the company should have been franchised in the first place. This perception is supported by actual experience: Lawyers often see a franchisor client for the first time only after the company has experienced difficulties with regulators or with their franchisees. In many cases these difficulties result from structural or management problems which should have been addressed at the outset of their franchise program's development.

Each company seeking to become a franchisor is inherently different, even from its direct competitors. The underlying realities of the company need to be thoroughly examined before a determination to franchise is made. Further, the company should be evaluated and its systems quantified, documented and incorporated into an overall franchise system.

Lawyers and other professional advisers who criticize "franchise packagers" realize that the client has expended a significant portion of its available capital in paying fees to the packagers and received little long term value. This problem stems from the process that many "franchise packagers" utilize. Typically, clients are asked to answer lengthy questionnaires on franchise specific questions such as fees, relationship issues, disclosure

issues etc. Strategic planning, if attempted at all, serves only as a motivational exercise, engineered to cement the client's decision to franchise.

The concern with this process is that the client is being called upon to answer questions which have a long term impact on the company, without an adequate understanding of the dynamics of franchise distribution upon which to base its responses. The advice, if any, from the "packager" consultants is based only upon a superficial examination of the company and many times often simply copied from competing systems that appeared to be comparable.

The legal agreements and other franchise documentation often miss significant issues because they are presented as part of a "cookie cutter" "one size fits all" package. Typically, the company is presented with the packagers standard franchise agreement, disclosure document, marketing brochure, and other related documentation and asked to simply fill in the blanks. The emphasis in development is placed on completing the assignment quickly, at a low cost, in order to maximize revenue to the packaging firm.

Unfortunately, franchise packaging is not relegated solely to the consultant. Just as attorneys are rightly critical of the franchise consulting packagers, franchise consultants are rightly critical of those attorneys who practice a similar style with new franchisors in the development of the legal documentation. Some attorneys who work with start-up franchisors seem to believe that the legal documentation, being *necessary* to sell franchises, is also *sufficient* to define the franchise system. In fact, there are far more business issues than legal issues to be addressed in developing a franchise system. The business determinations must define the content of the legal documents, and not the other way around.

3. COUNSELING A START-UP FRANCHISOR

There are five realities for professionals counseling a start-up franchisor.

- First:** Every company that desires to expand by franchising should not necessarily become a franchisor.
- Second:** Each company is unique, and this must be understood prior to developing the system.
- Third:** Franchising is governed by laws and regulations, but it is first a method of conducting business.

- Fourth:** Business decisions should direct the structure and relationships of the franchise system.
- Fifth:** The legal documents should clearly convey the determinations made in developing the business system within the rules, regulations and case laws governing franchising.

Therefore it is essential that, working as a team, consultant and attorney respect their unique skills, integrate their services, and provide start-up franchisor clients with the services they truly require. In summary—

Consultants

THE INITIAL DETERMINATION:

*should practice business
and
Attorneys should practice law.*

The following describes a process for counseling a start-up franchisor which is based on the basic principles and goals described above.

4. Alternative Methods of Distribution; Advantages and Disadvantages of Franchising

The initial determination of both franchisability and the appropriateness of franchising as a distribution method should be established before a client proceeds with any franchise development.

Franchising represents an attractive means of expansion for many manufacturers, retailers and service providers. Franchising permits them to expand without the capital expenditures typically required under other forms of expansion. Franchising is, however, only one of many expansion alternatives available to companies.

The initial portion of the business consultant's relationship with the client is to educate them on the overall requirements of franchisability. The following are the basic areas to be discussed with a client on the issue of franchisability.

The growing perception has been that franchising is a "sure fire", "rapid", "inexpensive" method of company expansion. This is one of the problems facing franchising today. These expectations have been fueled by

the popular press, franchise associations and some franchise advisors. This makes the "leap" to franchising sometimes unrealistic.

Many of the advantages perceived in franchising can also be found in other methods of distribution. While franchising can be an exceptional method of distribution, other methods of expansion may be more beneficial to the client's company.

Franchising is a method to consider when certain critical elements are present. Franchising may be the best choice if the operation of the local unit includes a requirement to provide quality and consistent service and controls; if the unit requires improved and dedicated local management; if there are limitations on finding qualified and motivated staff to maximize local marketing opportunities; and if capital for company-owned unit development is constrained. Franchising is also a method to consider if the company needs to create critical mass (through the development of sufficient number of units to support an adequate distribution system) but lacks the capital necessary to do so within its available resources.

Franchising is not limited, however, to small companies. It is also a method to consider for established retail and service providers. Already experienced in operating and servicing multiple locations, established companies may utilize franchising to enter new core markets (domestic and international), to strengthen their critical mass in existing markets, to enter new tertiary markets (smaller markets which may or may not require modified formats), or to utilize retrofranchising to recapitalize the established or growing business. Established retailers and service providers—with their sophistication, corporate culture and internal resources—have differing requirements from their advisers than less established businesses.

Professionals working with these businesses need to recognize these differences when proposing and providing their services.

For both small and established businesses, franchising should only be considered when acceptable profit and return on investment can be generated, at both the franchisee and franchisor levels. The business consultant should discuss with clients the advantages and disadvantages of franchising for both the franchisor and franchisee including control, motivation, OPM (other people's money), contingent liability, equity dilution, market penetration, trademark enhancement, collective buying power, local management, sources of revenue, sources of capital, program development costs, program maintenance costs, independence and interdependence, franchisee relations and franchise legal requirements among others.

After a discussion with the client on the advantages and disadvantages of franchising, the business consultant should discuss the general

requirements of franchisability. The benchmarks of franchisability include prototype development issues, unit and management conversion issues, product and service, industry segment, trademarks and service marks, operating systems, expansion goals, training requirements, start up-costs, return on investment, operations, marketability and alternatives to franchising.

Following these initial discussions, if the client is still comfortable with the decision to explore franchise development, the business consultant should perform an initial feasibility/diagnostic analysis.

5. FRANCHISE FEASIBILITY/DIAGNOSTIC ANALYSIS

The feasibility analysis explores franchising and other distribution alternatives. This analysis results in a preliminary assessment of the advantages and disadvantages of the company from the available alternatives. Based upon discussions with management, assumptions are developed and used to determine the structure of a base line model for the franchisor and the various levels of franchisees. Financial projections are prepared and thereafter, an assessment of the compatibility of franchising and other alternatives with management's goals and objectives can be made.

The purpose of the feasibility assessment is to provide management with a relatively quick and low cost overview of their options. Because it is primarily based upon discussions with management and the assumptions are not thoroughly tested, it is not intended to be utilized as a strategic plan for the development of a franchise system or the drafting of franchise legal documentation.

While the report provides certain opinions based upon agreed assumptions, it is designed to be a management evaluation tool. Management makes the ultimate determination of which alternative method of distribution to use.

Should it be determined that franchising or an alternative method of distribution should be pursued, then the development of the strategic plan, to accomplish that goal, can proceed.

Appendix I is an outline of the areas reviewed during a franchise feasibility and diagnostic assessment.

6. FRANCHISE SYSTEM DEVELOPMENT

If the feasibility analysis is positive (that is, if franchising, on balance, appears to be a good alternative for the company), the next step is to develop

a strategic plan. The strategic plan describes the basis for the development and continuing management of any franchise system.

The development of any franchise material, including the legal documentation, prior to making the analysis included in a strategic plan potentially places the start-up or established company at risk. Also, should the client's advisors make structural recommendations which are included in the system (fees, etc), without basing these on a thorough examination of the entity, they may be placing themselves at some risk of malpractice or other claims should the company or its franchisees fail.

All segments of the strategic plan in a franchise system are integrated and dependent on each other. The ultimate purpose of the strategic plan in a start-up situation is to define the relationship between the parties, identify their responsibility, establish the initial and ongoing services provided and determine the costs and revenues anticipated for both the franchisor and the franchisee.

Ultimately, this will enable the company's franchise counsel to begin the development of the legal documents and for management to begin the creation of the internal components necessary to operate the franchise system.

This process of system modeling, while time consuming and tedious, provides the franchisor with a realistic assessment of the operational, training, marketing, legal and financial requirements of franchising. It also assesses the existing resources of the company and whether they are sufficient to properly implement those requirements.

Without a careful organizational analysis and realistic financial projections created through the strategic planning process, the franchise system, both operationally and legally, can be no more than an off-the-shelf package. For example, the determination of fee structure without a complete understanding of the system could potentially place fees too high or too low. Neither alternative is acceptable.

When working with a client in the development of their franchise system, the business consultant should approach the project as a team effort. First, we recognize that, as consultants, we do not have the resources to offer all of the services required by a client. We therefore introduce into the strategic planning process, at an early stage, outside professionals. Our purpose, as project leader, is to understand the role and responsibilities of every member of the team, coordinate their responsibilities and bring the project to a successful completion.

Depending on the internal resources of the client and their needs, the following constitute the principal elements of the strategic planning and development team:

- The consultant as project leader
- The client's management and staff
- Legal counsel
- Accounting, tax and MIS professionals
- Retail marketing strategists
- Public relations/advertising and marketing professionals
- Other outside professionals as required

Second, it should be recognized that each outside professional will have a long term, independent relationship with the client following the initial development of their franchise system. Therefore the role of the consultant as project leader is to manage the overall effort so that each team member fulfills distinct responsibilities. This will enable them to function independently as long term advisors to the client after the initial franchise development process is concluded.

Franchise system development consists of two elements:

*The Strategic Plan
and
The Action/Implementation Plan*

The **Strategic Plan** defines and integrates the operational, training, marketing, legal and financial features of the franchise system and begins the development of the franchise program by focusing on these five main elements. Taken together these areas form the necessary components of the franchise system. An outline of some of the project consideration areas appears in Appendix II.

The **Action/Implementation Plan** organizes and schedules the tasks to be completed in implementing and developing the franchise system as determined in the Strategic Plan. It provides for controls and feedback to ensure a clear direction for the programs development.

The primary difference between the feasibility/diagnostic study and the strategic plan is the depth and detail involved, the testing of the assumptions and beginning the development of the components required to manage the system.

7. THE STRATEGIC PLAN

This section describes and discusses the basic elements of the Strategic Plan.

7.1 Executive summary and business overview

This is the first major section of the strategic plan and summarizes all that follows. Its purpose is to communicate an overview of the strategic plan in a concise manner as well as accurately describing the current status of the company.

7.2 Industry analysis and background

Next to the Executive Summary, the industry analysis and background and the sections on product and service are critical to provide the client with a clear direction.

A franchisor has two products, that supplied to the end user customer and the rights granted to its franchisees. The latter "product," the franchise, is offered within a complex system of competition. While franchising is not an industry, it is a unique distribution and marketing system. In that context the client has two categories of franchisor competitors, one being their own industry segment (e.g., automotive services) and the other being franchisees within their investment range (e.g., initial investment above \$250,000).

The industry analysis is prepared for:

Industry 1: The product and service — focus on end-user/customer

Industry 2: The franchisor — who are the competitors for franchisees and how do they operate and attract potential franchisees.

7.3 Operations - Training - Management and Organization:

7.3.1 The Franchise Operation

The ultimate goal of every franchise is to have each unit operate as a mirror image of the franchisor's program. This requires two basic assessments:

1. What is the substance of the existing operations and how does the franchisor want the franchisees to operate?

2. What types of support programs and corporate organization must the franchisor develop to meet the requirements identified in assessment 1 above?

The operations section of the strategic plan focuses on all levels of the franchisor's organization. While typically this refers only to the franchisor and franchisee level, depending on other methods of expansion utilized (e.g., master franchising, area development and international expansion), each level will have its own unique requirements which the system must recognize and provide for.

Operating systems and support, besides needing to be established at each level, must also be established for each period in the franchise relationship: start-up, early development and continuing operations.

Obviously, the franchisor will need to create standards and procedure manuals for franchisee operations. In addition, the franchisor must define the services it will provide to the franchisees and establish procedures to deliver these services together with training programs crafted to educate the system, at all levels. These will include both home office and field support as well as support services that address the differing needs of the franchisees as they mature in the system. The realization that franchisees require a differing level of service depending on their time in the system and performance in the system is one of the keys for franchise success.

Modern franchising is a complex business. Franchisees require access to information on a real time basis, and the franchisor needs to create mechanisms to collect this information, analyze the results and communicate it effectively. The use of Point of Sales (POS) systems and Management Information Services (MIS) is no longer uncommon in franchising. Modern franchisors use innovative systems of communications with franchisees. These include not only monthly newsletters but also trained field personnel able to assist franchisees based upon system-wide and local information created on a timely basis. Franchisors are even using voice mail systems and facsimile transmittance which give the franchisor the ability to communicate with their franchisees on a daily basis. In the strategic planning process, various possible programs for franchisee support are identified and their costs and benefits are calculated.

7.3.2 Organizational Structure: *Determine the most appropriate organizational structure to accommodate the present organization and anticipated growth.*

Once the critical operations questions are answered, the proper organizational structure to implement the franchisor's strategy can then be

created and developed. If every franchise organization were identical, this process would be simple.

Even though similar titles are used in most companies, job descriptions and staff qualifications will vary, depending on the focus of the franchise organization. An organizational chart detailing function and reporting responsibilities is required. Individuals must be recruited to fill their responsibilities, not just their titles. It is absolutely critical to match the skills and temperament of each individual to the requirements and responsibilities of each job.

The decision to add organizational staff is not simply a function of time and money. In a properly designed system, staff members are added over time as the system can afford them **and** make the best use of their skills.

Organizational structures should be developed for the franchisor headquarters staff, field staff, international operations and franchisee operations necessary to operate the system. The organizational structure is predicated on job descriptions, roles and responsibilities, but more importantly, it is developed against measurable norms. For example, the organizational structure in a mature company will be measured against the accomplishments determined through the MBO (Management By Objectives) program in each department.

Two factors determine the appropriate size of the field organization: (1) the specific services, roles and responsibilities that field staff will fulfill; and (2) the financial cost of servicing the system. The cost is determined through critical mass determinations for both the franchisee and company-owned units. The performance criteria will drive the visitation schedules as well as types of support for all locations. Factors affecting support costs include salaries, travel budgets, regional office determinations, physical location of each field person, training facilities locations, etc.

One of the goals of the strategic plan is to measure the company's performance and plan for improvements, at all levels. For each organizational level of the company, the organizational structure is developed on a zero-based system. The purpose of a zero-based system is to improve performance and maintain an acceptable balance between revenue (current and future) and cost of operations. This assures that staff is adequate and positioned to achieve the goals of the company.

7.3.3 Operational Format: *Define the operational relationship between the corporate, company-owned and the franchise distribution system.*

The operational format of the system includes communications and training functions. In the strategic planning stage, this involves a determination of the correct structure and language for the field staff manuals and the training programs required for the field staff to manage their responsibilities effectively.

Different types of system-wide communications techniques should be evaluated for effectiveness. This includes not only newsletters, faxes, field visit reports, etc., but encompasses the advisory councils, co-ops (marketing, buying groups etc.), 800-number hot lines, methods for updating manuals, training programs and all other methods of system-wide communication and direction.

It is important not to view communications in only one direction. Unit managers and franchisees become very frustrated when they are unable to effectively communicate with the system. Information originating at the unit level is also critical to system-wide direction. Therefore the ability to accumulate data from the POS, MIS and financial and operational information systems on each unit needs to be assessed and incorporated into the plan.

7.3.4 Manuals and Training: *Determine the correct structure and language for procedural and operational manuals and training programs.*

The operations manual serves several functions within a properly developed franchise system. It guides the franchisees and unit managers on the operation of their business in accordance with standards and procedures defined by management. It also enables management to change and improve the system through updates and revisions. This allows the system to meet competition and respond to new opportunities and challenges in the market.

The operations manual is incorporated by reference into the franchise agreement and therefore is an essential part of the legal agreement between the franchisor and franchisee. The manual affects the relationship between the parties throughout the entire term of the franchise agreement.

Unlike the franchise agreement, which is basically a static document, the operations manual changes throughout the relationship. The operations manual and training programs are dynamic and need to be constantly evaluated and updated as well as communicated and controlled throughout the system.

The goal of the training section of the Strategic Plan is to determine the level and types of training required to operate the system effectively at all levels. Areas which are considered include: requirements needed to develop

a standardized training program; the location of the training program; who should teach each component of the program; who should attend; length of training program required and content of the training programs. The Strategic Plan also analyzes the costs associated with each of these requirements of the training process.

The training program provides the basis for consistent, high quality service by providing franchisees and corporate staff with the tools to operate their businesses as they were designed to be operated. Should the expansion plans for the system include multi-unit ownership and master franchise programs, the franchisor's training programs must recognize that these operators need additional skills.

An often cited criticism of multi-unit ownership is poor performance and lowered operating standards. In reviewing problems in multi-unit systems, many times we find that the multi-unit operator was not trained by the franchisor with the organizational skills required to operate at this level of management.

Similarly, Master Franchisees are often responsible for the training and continuing support of their sub-franchisees, yet the training programs offered by their franchisors, except for training in franchise sales, differ little from the training provided to individual franchisees. The result is that the multi-unit owner or master franchisee is poorly prepared to implement system changes which further damages the program.

Training, support and communications systems and the associated costs are realities that need to be addressed when formulating the Strategic Plan.

7.4 Retailing Issues:

Define the retail operating system.

Critical operating requirements with which the franchisee and managers must abide, will be incorporated into the operations manuals of the company. These include merchandising standards, inventory issues, reporting requirements, MIS and POS requirements, loss prevention, marketing and advertising, catalogue issues, and those other critical aspects to ensure that the local unit operates as a "mirror reality" of the company-owned operations.

Planning decisions in response to these retailing issues may require some additional fine-tuning of the sections of the Strategic Plan relating to manuals, training program and communications vehicles. Some of these

retailing decisions involve contractual requirements, which will affect the legal overlay, discussed below.

7.5 Buying Group, Equipment Programs and Advertising Co-Ops:

Define the relationship between the franchisor and the franchisee in buying groups and other cooperative activities.

One of the advantages franchisors can provide to their franchisees is the development of group buying and cooperative programs to reduce start-up and operating costs and improve their return on investment. These include, but are not limited to discounts on equipment and supplies, equipment financing and leasing programs, inventory acquisition and financing, merchandising programs, marketing and advertising, catalogs etc. These programs and systems must be evaluated in the planning process. The franchisor must determine their actual benefit to both the franchisees and the franchisor, and whether they will help achieve the overall goals of the franchise system.

Programs for franchisor/franchisee partnering should be evaluated. These may include:

Buying cooperatives jointly owned by franchisees and franchisor
Franchisee investment funds to finance equipment purchasing, real estate purchasing, leasing programs etc. (This serves as an investment vehicle for franchisees and a method to share in the growth of the system while diversifying risk.)

7.6 Franchise Development:

Prescribe and prioritize the goals and make specific recommendations for implementing an effective growth program.

This section of the Strategic Plan requires the franchisor to develop a detailed critical path for the development of the franchise and company-owned system, determining responsibility and time frame for each project component. These will include market determinations, critical mass determinations, franchisee selection planning to meet goals, market and retail positioning and all aspects of the company driven by these determinations.

7.7 Franchisee Selection Criteria and Marketing Strategy:

Determine the franchisee recruitment and selection process.

The franchise marketing strategy is essentially an analysis of the company's concepts relative to the franchising arena. The objectives of this analysis are to determine the most effective means of market entry; the markets to be penetrated; critical mass and distribution requirements; and the definition of the franchisee profile. In addition, the franchise marketing strategy involves the creation of the franchise marketing package and marketing methodologies. These include not only advertising but public relations and the proper use of franchise trade shows. Finally franchisor also must develop internal mechanisms to search, screen, approve, select and close the franchise sale.

To determine the most effective means of market entry, both qualitative and quantitative analyses are used. The franchisor should consider various alternative methods of expansion (company-owned locations; individual, master franchises; area development; international franchising), used both singly and in combination.

Once the decisions have been made on the type, or types, of franchising methods to be used, the next step is to develop a geographic market strategy. This involves analysis and determination of critical mass requirements, distribution requirements and territorial rights which may be granted to the franchisees.

Franchising is a critical mass business. Critical mass allows the franchisees to achieve market dominance over the local independents, while it allows the franchisor to have the revenue required to provide a heightened level of service at an affordable cost. When a franchisor focuses on critical mass in its strategic market planning, the franchise system benefits in a host of ways. For example, a system that is geared to critical mass considerations attracts better locations, at more favorable base rents, with more concessions and assistance from landlords. This is because landlords and developers recognize the stability of franchise systems and prefer franchisees over independents. (If nothing else, landlords realize that franchisees advertise more than the local independents, which results in more overall traffic to the center.)

Critical mass requirements must be established in the strategic planning process. Having these requirements in mind allows the franchisor to evaluate the key factors for locations and determine how many locations should be established in the market. Assessments should include a determination of the customer profile (demographic, socio-economic, market characteristics), site criteria profile (size, viability, traffic, parking, signage) and a determination of market or trading areas.

The definition of market areas leads to the issue of whether to grant exclusive territorial rights to franchisees. It is easy to say that each franchisee will be protected within a specified radius of miles. However, this method of defining a franchise territory is inherently flawed. Among other things, natural trade barriers (roads, bridges, rivers, highways) must be taken into account.

Just as each franchise differs from every other, each potential franchise candidate is also different, economically, demographically and philosophically. One of the largest expense areas for franchisors is in marketing their franchise opportunity. Thus it is important that their efforts be targeted to the proper candidates.

Unfortunately, many new franchisors rely upon the "typical" franchisee profile (married, 35-50 years of age, etc.) in developing their marketing material. Multitudes of leads provide a sense of accomplishment to the franchisor's marketing professionals, but it is the selection and closure of the proper candidate which makes the system healthy. Lead generation and follow-up are expensive. The cost per lead is only increased if the marketing program attracts franchise candidates who do not meet the franchise profile. Franchisors need to target their marketing to an identifiable franchisee profile. If this specific franchisee profile is not developed and communicated through the marketing effort, all the franchisor does is create activity, not sales, and certainly not system success.

An identified franchisee profile allows the franchisor to customize the message and target the publications and vehicles seen by qualified potential candidates. It also allows potential franchisees to self-screen. An identified franchisee profile is the most cost-effective approach to recruitment. Marketing efforts—including brochures, advertising, media, public relations, trade shows etc.—must be addressed to the identified franchisee profile as developed in the marketing section of the strategic plan.

With the realities of franchise sales and unit performance realistically projected, a company can begin to project its future revenue streams. A simple but common mistake in the area of income projection is entrepreneurial optimism.

Projecting future revenue is a complicated task. Not only must the franchisor realistically estimate how many franchises will be sold, but also when they will be sold and when they will open for business and begin paying royalties. Seasonal factors may affect both franchise sales and retail sales in the system. In addition, the franchisor must make a realistic estimate of the rate of growth of retail sales for franchisees at various stages of their business (new, growing, mature). Another complicating factor is advertising:

Advertising fees are usually calculated as a percentage of gross sales, and the level of advertising expenditures may have a direct effect on the growth of both retail sales and franchise sales.

Franchise system revenue is also correlated to store openings, which are subject to a variety of external, uncontrollable conditions. With quality real estate becoming harder to locate and zoning restriction impacting more and more on site selection, average time for unit openings is often longer than franchisors would desire. If overly optimistic, franchise system revenue projections, and the timing of these cash inflows, may not be attain. Failure to meet revenue projections can result in severe disruption to, and possible failure of, the system.

Corporate overhead requirements must be tightly projected against system size and revenue availability. Without realistic income projection, the size of the organization, both in staff and overhead, may outstrip corporate resources.

It is essential that the recruitment process be structured to efficiently attract the best suited franchisees. The selection process, in turn, must be geared to accept only those candidates who will succeed and contribute to the success of the system.

The strategic plan should include a profile of the potential franchisee and an evaluation of methods for recruiting such franchisees. Franchisors have several alternative strategies available to them in the granting of franchise rights including: individual, area development, master franchising, conversion, etc. Increasingly, franchisors are also re-evaluating the "owner-operator" model, and they are considering financial investors to finance the opening of multiple locations, which are then operated by affiliates of the franchisor or the investor, or by independent management companies. In addition, joint venture relationships and strategic partnerships have become common as a growth strategy.

The strategic plan should examine alternative ways of structuring the franchise sales process. This includes a review and comparison of various types of sales organizations (such as the use of employed salespersons versus outside brokerage services). Additionally, in those systems with company-owned units, a decision on retrofranchising as an asset management and restructuring tool should be made.

Finally, the strategic plan must evaluate franchise sales marketing methods. Both personnel costs and advertising costs (creative, production, media placement, public relations) should be factored into the cost per lead, cost of completed sale, and other indicators of marketing effectiveness. The

franchisor also must develop criteria for selecting and evaluating the individual(s) who will be responsible for the recruiting/sales process.

7.8 Evaluating the Roll Out Fees:

7.8.1 Determine the projected rate of growth for the franchise and company-owned system.

The rate of growth, when coupled with the financial projections and start-up and operating costs at all levels, will enable the company to make the determination of the franchise fee, continuing royalty fee, advertising contribution and other income for the franchisor and expenses for the franchisee.

These economic determinations should be based upon an acceptable return on investment for both the franchisor and the franchisees. These should then be compared with investment data for franchise systems in the same industry and franchise systems in the same investment range.

Comparison with other franchise systems should not be the determining factor for establishing franchise fees. Each franchise system is different. Ultimately, if the franchisor cannot develop a financial structure that allows both the franchisor and the franchisees to earn an acceptable return, the franchisor should not sell franchises.

One of the most significant criticisms of franchise packagers is their view that franchising is a sales-driven event. Franchising is a business like other businesses. Unlike other businesses, however, franchising is highly inelastic. Other businesses can adjust revenue by changing the selling price of their product or changing their product mix. Once franchise fees, royalty and other sources of continuing income to the franchisor are established, the franchisor seldom can adjust them, except with respect to future franchisees or renewals.

Fees need to be kept at competitive rates, but pity the poor franchisor that is so similar to its competition that its only distinguishing feature is lower fees. It can be argued that excessively high fees are a barrier to the sale of franchises. The reality, though, is that if the fees are too low, the franchisor will not be able to provide the support and guidance that franchisees need. Without adequate income, the franchise system will not survive.

Setting fees based on what the competition charges can be very detrimental to a franchise system. Two of the most common problem areas occur in the initial franchise training and ongoing support programs promised to franchisees.

Every franchisor I have ever met desired, when the system was established, to provide their franchisees with the finest training programs and ongoing field support in the "industry." These goals often become translated into statements in the franchisor's sales literature and franchise agreements.

It is very difficult to predict the level of service that might be required in the future, and the future costs, to meet these types of goals. It is an inherently flawed and dangerous step to adopt a competitor's existing fee structure without analyzing the new franchisor's own goals and requirements.

The analysis underlying the determination of a proper fee structure for a new franchisor is very complex. Those who advise start-up franchisors should discourage any client who is a neophyte in franchising from making those determinations alone without competent advice. In most cases, if the fee structure is inadequate, the franchisor, and perhaps the system, eventually will fail.

7.8.2 System growth projections

Success in franchising has historically been measured in number of units sold. The logical reader of the "pop" literature could surmise that a system in rapid expansion, or a system that is high in one of the publisher's rankings, is a financially healthy company worthy of consideration for their franchise investment. Often this is not the case.

Every company, whether franchised or vertically integrated, has periods of time in which the company has a negative cash flow. This should be a short-term, temporary situation in the early period of a company's existence. Thereafter, ongoing revenue from continuing operations should exceed ongoing expenses.

In the case of a franchise system, the franchisor may rely, for a period of time in its early days, on income from initial franchise fees to meet its ongoing expenses. But, like any other company, the franchisor should reach a point at which ongoing revenue from operations (*i.e.*, royalties) covers the company's operating expenses. Unless its revenue stream is structured to accomplish this, the franchisor, for all its publicity and quick sales, is at financial risk. In the case of the vertically integrated companies this risk (except for debt) is primarily born by the stockholders or owners. In franchising, the risk is also shared by the franchisees.

Properly developed, a franchisor's income stream is carefully crafted after all of the strategic and other operational components of the system have been determined and their revenue and cost effects have been determined.

In 1988 I authored the "Growth Decisions Study on Franchise Expansion" which analyzed the growth of the franchise industry from 1978 to 1987 by examining 2141 franchisors. The key results of the study are quite interesting for new franchisors estimating their future growth.

1. Franchisors which had begun the sale of franchises after 1977 represented 69.6 percent of the total population studied, even though they represented only 29 percent of the franchises sold during the ten year period. The majority of franchise sales were made by established companies established prior to 1977.
2. Of those franchisors established since 1977 annual franchises sold in years one through three as an "industry" average were between 2.4 and 5.9 per year.
3. During the ten year period following their establishment as a franchise the average franchisor sold a total of 9.6 franchises per year.
4. The average size of all franchisors regardless of when they were established, was 106.9 franchisees. The industry median was only 13.

The essential lesson to be learned is that growth rate, while often higher for franchisors than for company-owned operations, must be projected realistically. Relying on media-induced perceptions, entrepreneurial enthusiasm and the rapid-growth sales strategies of franchise "packaging" companies can cause significant cash flow and financial problems when the true realities set in.

The same results which traditional retailers felt after absorbing high debt in the 1970's and 1980's are felt by franchisors whose growth is driven by unrealistic growth projections. Unrealistic growth projections, whether measured in square foot sales or franchise unit sales, can be disastrous.

7.9 Market Analysis and Strategy:

Define the target markets and market penetration strategies for the company.

This part of the strategic plan examines markets targeted for expansion, whether by franchised or company-owned operations, and including both existing markets and those designated for future penetration.

The franchisor needs a market penetration strategy in order to determine timing for entry into new markets and critical mass requirements.

Many franchisors allow the telephone to drive expansion decisions. An unfocused expansion strategy is dangerous to a franchise company. It costs money to service distant, isolated locations, and the entire system may suffer for lack of attention to quality standards and other aspects of performance. Failure to establish and stick with a rational expansion strategy also wastes marketing resources. "Shotgun" marketing may not be as effective as targeted development.

In addition, an unfocused market development strategy requires the company to be reactive rather than proactive, at all levels. For example, without a market development plan, the company may miss sales opportunities because of failure to register its franchise in key states, or incur unnecessary expense to register in states where it is not prudent to expand yet.

The decision to enter new markets should be made based on several considerations and criteria. For example, the franchisor should evaluate various methods of expansion (including company-owned, individual and multi-unit strategies) in different areas. Management should also review critical site selection criteria, lease negotiation issues, master/head lease decisions required for site control, construction specifications, trade dress issues etc. These criteria not only are analyzed in the strategic plan but later are incorporated, as appropriate, in the system operating manuals, policies and legal agreements.

When forming its market development plan, a franchisor should include critical mass reviews of existing markets. This serves to determine the optimum level of additional penetration in existing markets. Critical mass review of existing markets helps a franchisor reduce its field service cost per unit, distribution costs per unit and make the most effective use of marketing opportunities.

In addition, prior to entering new markets, the lessons learned from analyzing existing markets should be applied in key expansion markets. The goal is not merely to enter new markets, but to enter them successfully. Therefore franchisors must distinguish their core market strategy from their tertiary market strategies. (Core markets being major and secondary urban areas, tertiary being all others).

Core markets may demand a larger and more rapid expansion than tertiary markets. Therefore, core markets may be attractive for multi-unit expansion, and should be reserved for that purpose rather than sold first

come-first served to individual unit franchisees. (The section of the strategic plan dealing with franchisee selection criteria also should address the core market/tertiary market dichotomy.)

A lack of strategic market determinations is one of the significant weaknesses in many franchise programs. A review of the timing required to open and begin operations of new units should be made. Companies are often surprised when conducting this review that what was assumed to be a short cycle from franchise sales to opening is indeed a much longer cycle. This review often reveals the cause of underlying financial and cash flow problems, even where franchise sales have met target.

The section on strategic market plans should also include a review of the physical conditions of the retail locations. This helps the franchisor to determine what capital will be required, both for company-owned units and franchisees, to maintain or modernize the local system. While franchisors typically rely upon franchisees to provide the capital to maintain their own facilities, a review of possible system-wide capital requirements is critical in determining the ability of the system to keep pace with the competition. It also enables the system to review possible opportunities with lenders to establish capital programs for their franchisees.

7.10 Other Evaluations

There are other considerations which may need to be considered in the plan including: information systems diagnostic, internal financial controls, and the effect of the plan on the company's taxes and employee benefits—to name just a few. These other critical evaluations should be incorporated into the overall review of the company.

The resultant strategic plan should interface with every other component of franchise and company-owned system. A good strategic plan will enable management to perform their main management functions of planning, organizing, staffing, recruiting, directing, controlling and expansion.

7.11 Development of Financial Models

Financial data accompanying the strategic plan include income statements, balance sheets and cash flow projections, investment analysis and detailed supporting schedules/analysis—all for both the franchisor and the franchisee for a three to five year period (or until unit and system stability is achieved). For the initial period(s), until a positive cash flow is achieved, the income and cash flow statements are prepared on a monthly basis, and

thereafter on a quarterly basis. This allows the projections to be used as benchmarks for future financial measurements. It also determines the working capital required for the franchisor and the franchisee.

The assumptions are detailed and referenced to the appropriate sections of the strategic plan. The goal of the financial models is to break down each component of the system (and other items identified in the plan) into its realistic economic elements, both expense and revenue. It is also the basis for determining which areas, in a zero-based system, are essential and which, unfortunately, cannot be included at this time.

7.11.1 Zero-Based Approach

In developing the strategic plan, management is wise to utilize a "zero-based" approach. A zero-based approach requires each major aspect of the business to be reviewed and evaluated for its cost and contribution to the company. Nothing is accepted because of its historic reality. This includes management, markets, franchisee profile, fee structure, relationship structure, asset management, suppliers etc.

In a very real sense, developed properly, a strategic plan, utilizing a zero-based approach, forces management to reassess the business, from its core. The plan also establishes the benchmarks against which to measure future accomplishments. Targets should be designed to be reviewed in short term sequences, with results to be measured against these targets on a frequent basis.

7.11.2 Management By Objectives

It is advisable that management initiate an MBO (Management By Objectives) program for each critical area of the company. This will serve several purposes:

1. Allow a detailed analysis of anticipated future events prepared by the staff responsible for achieving those plans.
2. Provide for a frequent measuring tool to utilize in evaluating success.
3. Enable frequent reassessments and therefore frequent updates.

7.12 Legal Overlay:

Determine the legal requirements for the franchise system.

The franchise system and the franchisor/franchisee relationship is shaped by strategic planning, policies, procedures, ongoing administrative monitoring and support services designated in the strategic plan. The legal agreement between the franchisor and franchisee spells out the relationship and system. The disclosure document provides prospective clients with at least the minimum information required by law and professional practices.

The legal overlay portion of the strategic plan directs the client's franchise counsel as to the decisions made by management regarding the franchise program. Among other things, the legal overlay establishes: initial and ongoing fees, franchise terms, renewal policies, termination rights, transfer rights, assignment rights, territorial exclusivity, trade, other marks and secrets, lease/sublease policies, site selection and criteria, franchisee's reporting and audit responsibilities, purchasing requirements, retail performance, marketing and advertising.

The legal overlay section provides basic information required for franchise counsel to prepare the disclosure documents. It also directs counsel to which states and countries will be targets for expansion.

The legal overlay is an essential part of the business planning process. Franchise counsel, as a member of the development team, has played a critical role in the determination of the systems structure. Their main role, at this time though, is to review these decisions, provide advice and counsel on all aspects of the program and after agreement is reached, draft documents which both protect the system and convey the reality of the program, as management has determined.

Business is a creative activity. It is also an interactive activity. All of the components of the plan—operations, training, marketing, financial, legal, etc.—are integrated. Actions in one area create reactions in others. Therefore, the final product of the initial strategic plan should be the legal documentation of the franchise system. These should be based on the determinations made in the plan.

8. ESTABLISHED PRODUCT AND SERVICE COMPANY ISSUES

While most of the above discussion applies equally to small and large companies, there are additional issues to be considered when the new franchisor is a more established company. Professional advisers must be sensitive to these issues.

8.1 Organization and Management Philosophy

Established companies have a corporate, field and local organization in place which was designed to operate a direct controlled business. Philosophically, management is used to the premise that they can direct their company by making decisions and instructing the organization on the implementation of the policy. This "employer mentality" is not suitable for a franchise organization. Some companies can make the change to an organization that provides direction through the "moral persuasion" which is required in a franchise. Some need to establish separate organizations (skunk works) to separate the franchise system's management from the traditional management structure. Some, as a cultural matter, cannot make the necessary changes. For the last type of organization, franchising is not an alternative.

8.2 Corporate Organization

Franchisors typically are able to operate with a smaller corporate and field organization than classic retailers. As the burden to directly supervise local operations is eliminated, the franchisor's field organization takes on the responsibility of franchisee compliance and assistance. Often, field organizations which assigned one field supervisor or general manager to five or eight locations can now reduce this level of organization by four to five fold. Without the burden of direct supervision, field operations personnel may be able to work with 25 or more franchise locations as they are no longer burdened with day-to-day responsibilities. They can shift their focus from day-to-day problems to issues of quality and consistency. In addition, depending on the size and structure of the corporation before it began franchising, it may be able to achieve significant savings in financial and administrative areas as payroll and other administrative functions are transferred to the franchisees.

8.3 Local Management

Typically, franchisees are responsible for staffing their locations, setting salary and benefits, and supervising their employees. This is a major shift for the traditional company. The difference in motivation between salaried management and franchisee ownership can be startling to a traditional company. Financial and operational results of franchised locations versus company-owned locations can yield dramatic comparisons.

The motivation of direct ownership enables the franchisee to monitor, more closely than a salaried manager would, the salary structure, staffing levels and other cost areas of the business. As franchisees are motivated by both profit and the intangible pride of ownership, they are in a better position to react to local opportunities. This may increase local profitability as well as customer satisfaction and quality control.

8.4 Price Controls and Direct Sales

Traditionally structured companies are accustomed to setting prices at all of their locations and developing their marketing campaigns and advertising independently. In addition, their locations typically obtain all of their inventory, disposables, equipment, etc., from the company's sources.

Many established companies that begin franchising incorrectly assume that they will be able to maintain similar controls over price and marketing activities by franchisees. Also many such companies believe that they can rely upon income earned through distribution to their local operations. These and other issues (full line, product mix, quotas, dual distribution, etc.) must be addressed in the context of the new method of distribution for the established business.

8.5 Critical Mass and Territorial Rights

Where established companies choose to fill existing markets with franchised locations, the issue of distance between locations, territorial rights, competition for the franchisee from the franchisor locations must be addressed. Often, an analysis of these issues may lead to a decision not to franchise in established markets or to sell off the market to a franchisee or group of franchisees. The sale of the market to franchisees may be a unique event or may be part of a broader "retrofranchising" strategy for the company.

8.6 Retrofranchising

Retrofranchising is a broad based reorganization strategy whereby the company decides to offer for sale a substantial portion of its company-owned locations to new franchisees. This differs from a limited sale of an occasional location as it has a dramatic effect on the entire organizational structure of the company. It also has broad implications in areas such as distribution systems, pension plans and vesting rights, employee benefit programs, stock options, state and federal taxation, etc.

In addition, other issues to be considered include the future use of the capital from the sale of the locations; transfer of some of the underlying local obligations (leases in particular); changes in the allocation of corporate overhead to remaining local operations; possible entry into new financial markets through royalty securitization; and changes required in the corporate organization (especially in support areas such as financial and administration whose roles and scope will dramatically change). Also, in industries whose

operations are subject to environmental regulations (e.g., underground storage tanks in gasoline distributors, waste containment facilities), a determination of the cost of future compliance and cleanup needs to be factored into the franchise relationship.

8.7 The Glass Structure

A psychological evaluation of the management team should be conducted prior to the transfer of established management to the franchise environment. Given the radically different management skills required in the franchise culture, existing executives may not be well suited to manage the franchise process.

"Open management environments" are becoming common today in larger organizations. In an open management environment, local management is involved in providing direction to headquarters. A franchise system is like an open management environment. Decisions made by franchisor management, which may have absolutely no seeming impact on local operations, often become issues for franchisees to focus on. The franchisor company is operating in a glass structure, similar to that of a public company, where every decision is analyzed and commented on by "outsiders." The need to address this reality is commonly recognized in franchising (through the use of advertising and marketing councils, advisory boards, etc.), but it may be a new experience to large privately owned businesses accustomed to making decisions independently. This is more than an educational issue to be addressed by the company's advisers, it is a structural issue for the company.

8.8 Other Issues

An established company entering into franchising must conduct a structural analysis of its existing organization (corporate, field, local) and identify the areas where changes will be required. Management should understand the differences between a vertically integrated single organization and a franchise system, and be comfortable with the changes that will be required. Other issues that may require attention and possibly outside advice include, among other things, tax, licensing, MIS/POS, employee benefits, and union contracts.

Part 6 above describes the core professional development team. Many of these functions may already present in the larger organization. Outside advisers familiar with franchising should interview each of the existing managers or advisers who may play a role in the new franchise system. Outside advisers should evaluate these existing internal or external resources

and make recommendations as to the complement of the professional development team.

9. IMPLEMENTATION

An Action Plan should be developed which will organize and schedule the tasks to be completed in implementing the plan. It should provide for controls and feedback to ensure a clear direction for the company.

Control over the timing of the plan's implementation is critical. The implementation program ensures that something is going to happen.

Many business plans end without an effective implementation strategy. This is one of the major causes of strategic drift. Without a clear implementation plan, the business planning process is fairly useless as a management tool. Each component of the plan should have a detailed action plan with clearly defined timeliness, milestones and responsible individuals delineated.

10. PART I CONCLUSION

Counseling a start-up franchisor requires the skills of several disciplines. While the involvement of professional advisors in the development process may have a definitive ending, the results have an impact on the franchisor and their franchisees long into the future.

A criticism of the above process may be that it is time-consuming and costly. It may limit a company's ability to franchise because the required professional fees limit the capital available to initially operate the system.

Conversely, as the resources required are detailed in the feasibility assessment, before the majority of the professional fees and other costs are expended, the process protects the franchisor and their future franchisees from being undercapitalized, which is a major reason that businesses, whether franchised or traditional, fail.

PART II: FROM THE FRANCHISE LAWYER'S POINT OF VIEW

1. INTRODUCTION

In the context of this part of the paper, the term "start-up franchisor" means a person who is engaged in a new business venture and who has not yet offered or sold franchises for it.

Sometimes lawyers are consulted by new franchisors who have already begun selling franchises. (In most cases, the new franchisor/new client needs legal advice because the previous sales were made without benefit of disclosure or registration.) The specific compliance problems of "start-ups" that have already begun selling franchises are beyond the scope of this paper. The scope of this paper is also limited to the sale of franchises only. It does not address issues associated with the offer and sale of "business opportunities" and other similar kinds of regulated offerings.

Despite these exclusions, the operating definition of a start-up franchisor as first stated above is far from narrow. It includes people who have never engaged in franchising, as well as people who have been involved in franchising other businesses. It includes people who have experience in business, as well as people who are just starting out.

There is no single description of a "typical" start-up franchisor. Prospective franchisors are as varied as the businesses in which they are involved. Their business experience and financial qualifications range widely.

Any lawyer or consultant who deals with clients who want to franchise their businesses must pay close attention to each client's individual situation. It is tempting, but dangerous, to try to standardize the services or advice that one offers to start-up franchisors. Even companies that are in the same basic business have different objectives and different needs.

Franchising is not an industry, but a method of distributing products and services. There are about as many different kinds of franchisors as there are products and services distributed in the economy. The Winter 1993 edition of the Franchise Opportunities Guide, published by the International Franchise Association, lists 70 industry categories, many of which are composite (e.g., "pet sales, supplies and services").

Experienced franchise consultants and lawyers can attest that there seems to be no limit to the types of businesses that can be franchised. There is a constant stream of new industries (such as the video rental business) and new concepts (such as home barbecue cleaning services) that use franchising to expand.

Franchising is attractive to entrepreneurs because it allows them to expand quickly, using other people's money. Gaining access to other

people's money is not the only reason for choosing franchising. Franchising also can provide a means of increasing sales and profits, as franchisee owner-operators usually work more diligently than employees.

Franchising appeals to many entrepreneurs because it appears to them to be *a game that anyone can play and win*. We all know stories of hugely successful franchise systems that started on a shoestring. We have heard of entrepreneurs who lacked formal education and financial backing, but who—through sheer persistence, personality, and hard work—built large franchise systems.

To a large extent, anybody **can** get into the franchising game, regardless of money or experience. (Of course, doing it successfully is another matter.) The only genuine barrier to entry in franchising is the complicated system of regulation that governs both sales of franchises and aspects of franchise relationships.

As franchising has evolved in the United States, it has become almost more a creature of regulation than a method of distribution. Thus, lawyers play a significant role in the development of new franchise systems. Lawyers who concentrate in franchising, especially those who represent start-up franchisors, quickly acquire "a little knowledge" about the business side of franchising. This can be a dangerous thing for both lawyer and client.

Franchise lawyers must guard against false confidence about their business expertise. At the same time, they must develop the expertise needed to be able to recognize the business (or mixed business/legal) nature of many issues covered by the "legal" documents they prepare. They must be able to evaluate their clients' abilities to make informed business decisions. They also must learn to guide clients toward sources of competent advice in a number of different areas.

2. TYPES OF START-UP FRANCHISORS

Although it is not possible to describe a single "typical" prospective franchisor client, it is possible to make some generalizations about the types of persons or companies who come to a lawyer or business adviser for advice about franchising.

A sophisticated, experienced, well financed company is the most desirable type of start-up franchisor client. Such a company usually has a proven system of chain operations or an established brand of product or service. *A sophisticated company* often has the resources and willingness to study alternative methods of distribution and make reasoned decisions based on research.

Individuals who have specific experience in franchising are another type of frequently encountered start-up client. Often, they are either former employees or former (or current) multi-unit franchisees of an established franchisor. An *experienced individual* may have less financial resources than a sophisticated company, but usually has a very realistic appreciation of the financial and managerial requirements for successful franchising.

Most people who are interested in franchising a business have operated a similar business for some period of time. Occasionally, someone who has only a concept, but no operating prototype, wants professional advice about franchising the concept. Experienced legal and business advisers have learned to avoid this type of client. The *whiz kid with a concept* usually lacks both a prototype and money.

On the other hand, many small business operators who become interested in franchising have experience in operating one or more similar businesses, but lack funding to expand in any manner other than franchising. Before taking on a *small operator* as a franchising client, experienced legal and business advisers evaluate the business with great care. Some small operators that "need" to expand by franchising are merely victims of the credit crunch. Others present substantial risks, which neither banks, investors, or franchisees should be asked to underwrite.

One last type of prospective client is the *non-franchisor*. Many entrepreneurs are well aware of the burdens of franchise regulation. Some try to avoid franchise regulation by styling their businesses as something else, such as a "license" or a "business in a box." Unfortunately, not all non-franchisors seek professional legal advice about their status.

Designing a system to avoid the legal definitions of "franchise" or "business opportunity" is beyond the scope of this paper. Avoiding franchise laws and regulations is a complicated endeavor that requires an experienced, skilled lawyer who concentrates in franchising law.

3. REPRESENTING A START-UP FRANCHISOR

Franchising is highly regulated, yet there are few purely "legal" issues in developing a franchise system. In fact, drafting a UFOC is like nothing else so much as drafting a business plan. This causes some non-lawyers to believe that they can create franchise legal documents without a lawyer.

Some lawyers, on the other hand, seem to believe that they can create franchise legal documents without expert franchise business advice. As

noted in Part I of this paper, many lawyers criticize franchise consultants for using a "cookie-cutter" approach and failing to provide individualized advice to clients. Lawyers often see a franchisor client for the first time only after the client has paid a consultant a lot of money for documents that were poorly prepared and will not serve the client's interests. This kind of experience leads some lawyers to conclude that it is better to use no consultant at all than to risk using one who may turn out to be incompetent, unprofessional, or worse.

The problem is that clients who want to start a franchise often lack the background and experience necessary to make sound business decisions about designing their system. If a lawyer is the first or only outside consultant they have, they tend to consult their lawyer on all kinds of issues, both legal and business.

3.1 Practical Issues

For an experienced franchise lawyer, one factor that is a major influence in the lawyer's decision to represent a start-up franchisor is where the prospective franchisor client is in its "due diligence" process of investigating alternative methods of expanding a business. A quick way to find out where the prospective franchisor stands is to find out whether the lawyer is the first outsider to be consulted.

By simply asking, "Who else have you talked to about this?" a lawyer can determine fairly quickly how much homework a new prospective franchisor client has already done. If the prospective franchisor has done its homework (that is, has performed the analyses and exercises described in Part I of this paper), its principals and staff will have talked with many other outside consultants before turning to a franchise lawyer. In that case, it is not hard for the lawyer to decide to accept the representation. The only remaining issues are the usual ones surrounding any client engagement (such as fees and scope of work).

If the prospective franchisor answers that the lawyer is the first, or nearly the first, outside person to be consulted, the lawyer should be on guard for problems. This situation occurs more often with some kinds of start-up franchisors than with others.

Sophisticated companies seldom start their investigation of franchising by consulting a lawyer. A sophisticated company that is considering franchising usually turns first to its own management and staff, who are given the task of evaluating the company's options for alternative methods of distribution. Sometimes the in-house staff consults outside business and

financial advisers, which may include consultants who specialize in franchising. Unless one of these persons (or perhaps the company's inside counsel) is curious about the legal ramifications of starting a franchise program, no one is likely to call in a lawyer until the company has fully studied the business issues and has tentatively decided to franchise.

Experienced individuals may call in a lawyer at an earlier stage in their planning. Someone who has personal experience in franchising does not need to make the same laborious climb up the learning curve as a neophyte does. Anyone who has personal experience in franchising almost certainly will be aware, at least in a general way, of the legal requirements affecting franchisors. An experienced individual is likely to have, and to have consulted, many contacts in the franchise industry, including franchisors, franchisees, franchise consultants, franchise lawyers, and other franchise business contacts (such as lenders and suppliers).

It is more difficult to characterize the behavior of the *whiz kid*. Some are able to get financial backing, or at least advice and support, from consultants, investors or others. Some call a lawyer early in the process, knowing that the legal documentation will be a key part of the project. Some never contact a lawyer until they run into trouble with regulators or franchisees.

A *small operator* client that is interested in franchising usually concentrates on free or low-cost sources of advice early in the process. Therefore, a small operator client may have talked with franchisors or franchisees, regulators, and academics or authors, or may have attended seminars on franchising before contacting a lawyer. A small operator client sometimes may be referred by a lawyer who does not concentrate in franchising.

When a lawyer is the first outside adviser that a start-up franchisor consults, it does not mean that the lawyer cannot provide **any** advice or assistance to the client. It does mean that the lawyer must proceed carefully, keeping in mind both legal and business requirements, as well as the lawyer's own professional limitations and ethical restrictions.

3.2 Ethical and Malpractice Issues

Most lawyers are strictly trained never to make a business decision for a client and always to insist that the client make business decisions for itself. Lawyers follow these rules not so much because of any requirements of legal ethics, but rather to avoid malpractice liability.

Ethically, lawyers are permitted to offer general advice to clients. Rule 2.1 of the Model Rules of Professional Conduct (as adopted by the ABA House of Delegates on August 2, 1983) expressly permits lawyers, in rendering their advice, to "refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."

Lawyers may be obliged, as a matter of competent representation, to advise clients that they should consult experts in other fields. The comment to Rule 2.1 states:

Where consultation with a professional in another field is itself something a competent lawyer would recommend, the lawyer should make such a recommendation. At the same time, a lawyer's advice at its best often consists of recommending a course of action in the face of conflicting recommendations of experts.

Do lawyers have any responsibility to evaluate the business decisions of their clients? The comment to Rule 2.1 states that

when a lawyer knows that a client proposes a course of action that is likely to result in substantial adverse legal consequences to the client, duty to the client under Rule 1.4 may require that the lawyer act if the client's course of action is related to the representation.

Rule 1.4 requires lawyers to keep clients reasonably informed and "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." What is the scope of the "representation" when a lawyer is engaged by a start-up franchisor?

In most cases, start-up franchisors engage lawyers for the purpose of preparing a disclosure document and filing applications for registration to offer franchises in various states. Under Rule 1.4, a lawyer engaged for these purposes must inform the client, at a minimum, of the requirements for disclosure and registration, and the consequences of failure to comply with those requirements.

Must the lawyer also provide information or explanation about non-legal issues that confront the client in connection with developing a franchise system? Rule 1.4 does not require a lawyer to offer franchise business advice, but may require the lawyer to recommend that the client seek such advice.

Suppose that a lawyer informs a start-up franchisor client of the legal requirements applicable to franchising and further recommends that the client seek business and financial advice from experts in other fields. And the client politely declines to spend money on any consultants other than the lawyer. What may, or must, the lawyer do in that case?

May—or Must—the Lawyer Decline the Representation?

This is always an option. It is easiest to decline a representation before it starts. There are complications (even in a non-litigation context) in withdrawing from a representation after work has begun.

Could withdrawal in this case be more than an option—could it be an ethical obligation? Under Rule 1.2(d), a lawyer shall not assist a client

in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

In the context of franchising, many state registration laws (as well as some other types of laws, such as "Little FTC" acts) specifically define instances of conduct by franchisors that may be deemed to be criminal or fraudulent. A lawyer who represents franchisors, therefore, should study all applicable laws very carefully, not only for the benefit of clients but also to avoid possible ethical violations under this rule.

A more difficult question is whether a lawyer should agree to represent a client who is legally qualified to offer and sell franchises, but who the lawyer believes lacks other qualifications to be a good franchisor. Does the lawyer have any ethical restrictions or obligations in this case?

Some experienced franchise lawyers do refuse to represent start-up franchisors who lack the experience, aptitude or financial capacity that the lawyer considers necessary for franchising successfully. Other franchise lawyers will agree to take on such clients, despite their imperfections, for several reasons.

First, the lawyer's "voice of experience" might dissuade an unprepared company from going into franchising. Second, if the client insists on franchising, the lawyer may be able to influence the client to proceed in a responsible and professional manner. Finally, if the lawyer were to turn the client away, the client could easily hire a franchise "packager" or an unqualified lawyer, or simply cobble together a "do-it-yourself" UFOC. In that

case, the lawyer's refusal to represent this client would have no beneficial effect, and on balance might turn out to be a loss to the company, its franchisees, and the public at large.

May—or Must—the Lawyer Offer Business Advice to the Client?

Rule 2.1 clearly permits a lawyer to mix business and legal advice. However, Rule 1.1 requires a lawyer to provide competent representation to a client. A lawyer who offers business advice to a client assumes a serious risk of being exposed to malpractice claims if the advice should prove to be wrong, ineffective, or merely unsatisfactory to the client.

May—or Must—the Lawyer Refuse to Provide any Business Advice to the Client?

A franchise lawyer might conclude that silence is the best policy when dealing with a client's need for business advice. But to refuse to comment in any way about a franchise client's business decisions could violate ethical rules. As noted in the comment to Rule 2.1 quoted above, a lawyer might have a "duty to warn" a client about the potential adverse legal consequences of a bad business decision.

In franchising, bad business decisions commonly lead to legal problems for franchisors. Franchisees have a broad range of legal theories on which to base their claims. One developing theory of law holds that a franchisor has a duty of competence and should be liable to franchisees for the consequences of the franchisor's incompetence, as demonstrated by its bad business decisions.

The "duty to warn" probably does not extend beyond a duty to recommend that the client seek expert business advice. It would not require a lawyer to render substantive advice on non-legal subjects. On the other hand, many lawyers have training or experience in business which would qualify them to offer business advice if they chose to. A lawyer who has such special knowledge can avoid ethical or malpractice problems, while still providing useful help to a client. The lawyer can point out the potential business problems, refer the client to expert business advisers, and give the client some ideas or topics for discussion to be pursued in detail with the business advisers.

4. EVALUATING A PROSPECTIVE FRANCHISOR CLIENT

Part I of this paper describes the ideal circumstances for a lawyer to represent a start-up franchisor: as one member of a team of qualified experts working cooperatively. Even in that situation, however, a lawyer should not abandon all interest in the "business" issues surrounding the development of a new franchise system. The resolution of these business issues will form the core of the client's legal documents. If it is acceptable to the client, the lawyer should participate in the process and contribute comments and advice wherever appropriate. At the very least, the lawyer should stay informed of the client's business decisions and progress and scheduling as the Strategic Plan is developed.

The ideal situation described in Part I is not always realized. Lawyers who work with start-up franchisors must assume that many of their clients will need more than just legal assistance. These are the clients who answer "Well, nobody, really" or "Just some friends and customers" when asked, "Who else have you talked to about this?" To evaluate these clients' needs, lawyers should be prepared to ask them a series of further questions.

4.1 Initial Readiness

The first series of questions to ask a prospective client who wants to offer franchises is comparable to the initial determination process described in Section 4 of Part I. A lawyer who poses these questions is not seeking detailed substantive answers, but instead an indication of how much study and preparation the client has already undertaken. For this purpose, the lawyer should ask the prospective client questions like these:

- Have you looked at various different ways of expanding your business?
- Why have you decided to pursue franchising?
- Have you analyzed the competition in your market?
- Why do you think your business can be franchised?
- What is your personal experience in business? In franchising?

A client who is ready to begin developing a franchise plan and program should be able to answer these basic questions in a way that demonstrates some reasonable depth of understanding. If the client stumbles on any of these questions, the lawyer should recommend that the client do some more

homework and perhaps talk with some business advisers before incurring any major expenses toward developing a franchise system.

A lawyer can assist a prospective client at this stage by recommending people to contact and publications to review. The best source of general information about franchising is the International Franchise Association in Washington, D.C. The IFA can provide lists of franchise consultants who are members of IFA's Council of Franchise Suppliers.

Some lawyers may be well enough acquainted with certain franchise consultants to be able to refer prospective franchisors to (or away from!) those consultants. Unfortunately, there are no developed standards for rating or evaluating franchise business consultants. A prospective franchisor should not engage a consultant (or, for that matter, a lawyer) without asking for and checking franchise client references.

Prospective clients sometimes ask lawyers to recommend useful literature about franchising. Books typically found on the lawyer's shelves (the Business Franchise Guide, ABA Forum outlines, etc.) provide little useful guidance to lay persons. The IFA maintains a library in Washington, D.C., and many business schools and larger public libraries also stock reference books on franchising. Exhibit A is a list of books and periodicals that may be useful to a prospective franchisor.

4.2 Feasibility Assessment

If a prospective client passes the initial readiness test, the lawyer should follow up with a second series of questions. These questions are based on the assumption that the client has made a knowledgeable determination to pursue the development of a franchise program. These questions are a parallel step to the feasibility study described in Section 5 and Appendix I to Part I. With these questions, the lawyer in effect tests a legal model of a possible franchise.

- Have you analyzed exactly how you as the franchisor would make money in franchising? (*E.g.*, from initial fees, royalty fees, product sales, real estate, other.)
- What are you prepared to do for your franchisees? Will these services be sufficient to get them set up in business and help them succeed?
- What will your services cost to provide? Where will the money come from?

- Who will be your service personnel helping franchisees? Do/will these persons have the background and talent to train and assist franchisees?
- Have you already documented your system? If so, will your existing manuals and materials need to be adapted for franchisees? If not, who will document the system, and when, and how?
- Exactly how will your franchisees make money in their businesses? Is buying a franchise for this business a risk that you yourself would take, or that you would recommend to a good friend?
- What do you expect your franchisees to do for you?
- What restrictions will you place on your franchisees? How are these restrictions related to the success of the franchise and the success of their businesses?
- Do you foresee that your business or business strategy may need to change in the future? Do you know what the changes might be and when they might occur?
- Where do you expect to be and what do you expect to be doing 5, 10, 15 or 20 years from now?

Before engaging a lawyer to draft the legal documents for a franchise, a client should have a complete vision of the franchise, the "system" and its life-cycle extending many years into the future. It is not necessary at this stage to have every detail of the system in place. What is necessary is that the central concepts of the system hang together coherently, and that the system has a rationale for smooth forward momentum.

If the client is not able to draw a picture of a franchise system that will work, the lawyer should advise the client to go back to the drawing board and fill in the blanks. This means more study, planning and preparation before turning to the legal documents. An outside business expert is even more valuable at this stage, because the expert can focus attention on specific issues and allow the client to use time more efficiently.

5. LAWYER'S ROLE IN THE STRATEGIC PLANNING PROCESS

Once a client has cleared the hurdles of an initial determination and feasibility analysis, a lawyer can begin to offer useful legal assistance. As indicated in Part I, however, the client must resolve many detailed business and financial issues before it makes sense to draft a UFOC and agreements.

Most business lawyers, especially those who practice in franchise law, do not regard themselves as mere scribes, hired to write down the client's business decisions in the required legal format. Despite the preponderance of business issues (as opposed to pure legal issues) involved in a franchise offering, lawyers have an important role to play in the design of the Strategic Plan.

The Strategic Plan sets forth the basis and purpose for the rules of the system. Legal training makes lawyers particularly adept at both writing rules and explaining or justifying them. Legal training also enables lawyers to analyze diverse sets of facts. These are useful talents in the preparation of a Strategic Plan. Unless the client for some reason wants to exclude the lawyer from "business" discussions, a lawyer should not automatically stand aside from the process.

In fact, a lawyer should intervene early in the strategic planning process to ensure that the client and the client's consultants are aware of the specific legal requirements for offering franchises. The lawyer should direct the business people toward providing the specific disclosures required for key items such as personnel (UFOC item 2), initial investment (item 7), required purchases (items 8-9), financing arrangements (item 10), and information about franchise marketing plans (item 20).

The business planners also should give early attention to basic issues of the identity and capitalization of the franchisor entity. These business decisions have legal consequences that can delay or disrupt a franchisor's marketing plans.

5.1 Franchisor Entity

To comply with disclosure requirements, a franchisor must provide audited financial statements. Because of the cost of developing audited statements for past years, many start-up franchisors form a new entity to act as the franchisor and submit an audited opening balance for the new entity.

If the franchisor decides to form a new entity, the lawyer will help determine the form of doing business. There are no restrictions or

requirements imposed by franchise laws that would determine that a franchisor must be organized as a corporation. If a new entity is formed, the lawyer must ascertain the ownership of key assets (such as the trademark registration, trade secrets, "company-owned" units) and advise the client about the pros and cons of assigning these assets to the new entity.

5.2 Capitalization; Escrow or Impoundment of Fees

Whether the "franchisor" is a new or existing entity, it must meet certain financial requirements to qualify to offer and sell franchises in registration states. For example, all registration states require franchisors to demonstrate "adequate" financial arrangements to fulfill their obligations to their franchisees. (See Exhibit B for excerpts from state franchise laws on this subject.)

States evaluate the adequacy of a franchisor's capitalization by referring to the financial statements, the "Supplemental Information" sheet submitted with the registration application, and the franchisor's obligations to franchisees as described in the franchise agreement and the disclosure document. A franchisor that fails to demonstrate "adequate" financial resources may be required, as a condition for registration, to agree to an escrow or impound of franchisees' payments, to be released only when the franchisee is open for business.

The financial standards applied to franchisors for this purpose are within the discretion of the state administrators. For planning purposes, one can refer to the Michigan Franchise Investment Law, which requires a franchisor to escrow funds upon the request of a franchisee if the franchisor's most recent financial statements are unaudited and show a net worth of less than \$100,000.00. Other than the Michigan provision, the most straightforward rule is found in the Illinois regulations (see Exhibit B), which describe the general criteria (but not specific dollar limits) for determining whether to require and escrow or impoundment.

Franchisors usually find that it is impractical or uneconomical to furnish a bond or establish escrow accounts as required under the terms of the initial order issued by a state. It is usually possible to negotiate the terms of the order. In this regard, the detailed regulations used in Illinois and Maryland are very helpful in elucidating the purposes of the requirement (see Exhibit B).

A thinly capitalized start-up franchisor, therefore, runs significant risks that it will be denied the right to sell franchises in some or all registration states (which include markets such as New York, California, and Illinois). The

strategic and financial planning process must take these critical legal issues into account at a very early time.

There is no unconditional "right" to offer and sell franchises. Some state franchise laws provide that the administrator "shall" grant registration applications (see Exhibit C). The rights granted to franchisor applicants under these provisions are hollow, at best.

Suppose a registration application was overlooked and "accidentally" became effective through the passage of time. In every state the administrator retains the power to issue a stop order on short notice. This could effectively send the franchisor back to square one of the application process. A lawyer advising start-up franchisors should caution them not to try to take advantage of mistakes or oversights of franchise regulators, but instead to try to deal with the regulators as candidly and fairly as possible.

5.3 Other Corporate Issues

Depending on the type of business involved, other corporate legal issues (e.g., qualification to do business and liability for state taxes) could be very significant. The lawyer who advises the client on franchising compliance should verify that the client's business planners and accounting/tax specialists are aware of these possible complications.

6. LEGAL ISSUES RELATING TO START-UP FRANCHISORS

Despite the preponderance of business issues to be addressed by a start-up franchisor, a few issues remain primarily or even purely within the legal province. Some legal issues should be addressed in connection with the client's initial decision to franchise, while others can be deferred until later.

6.1 Is It a Franchise?

Many clients wish to avoid, if possible, the costs and difficulties of franchise regulation. Most experienced franchise lawyers advise clients not to attempt to design a program to avoid the coverage of these laws. Instead, the client should decide what it wants and needs from a business point of view. If it turns out that the business is or may be a franchise, the client can then evaluate whether it is more cost-effective to change the program or to comply with the legal requirements for franchise disclosure and registration.

Clients are often unaware of the complexity of overlapping federal and state laws and regulations that define a "franchise" or a "business

opportunity." Some are aware that there are exceptions and exemptions under these laws, but they do not appreciate the difficulty of crafting a national program to comply with all applicable laws.

On the other hand, clients often have an exaggerated idea of the costs of regulatory compliance. When they learn the costs of maintaining a balkanized compliance system, and the potential costs and liabilities of noncompliance, they usually accept operating as a "franchise" as the least of all evils.

Another issue is whether to use the FTC or UFOC format for disclosure. Only in rare cases would a start-up franchisor be well advised to use the FTC format rather than the UFOC format. For the sake of completeness, though, a lawyer should explain to a start-up franchisor client the differences between the two formats and the fact that the choice exists.

6.2 Types of Agreements

It is important for the start-up franchisor client to understand at an early stage that the disclosure document must include all agreements to be used between the franchisor and the franchisee in connection with the purchase of the franchise. The following is a non-exhaustive list of agreements that franchisors, including start-ups, frequently use:

- Franchise Agreement
- Area Development Agreement
- Multiple Unit Option Agreement
- Conversion Agreement
- Commitment Agreement
- Reservation Agreement
- Site Development Agreement
- Lease/Sublease (real property)
- Equipment Lease
- Promissory Note
- Security Agreement
- Personal Guaranty
- Confidentiality Agreement
- Advertising Cooperative Agreement

Despite efforts to promote a standard terminology for franchising, franchisors, consultants and lawyers often use different terms for various kinds of franchise arrangements. Do not assume that a client knows the technical differences between subfranchising and the use of area

representatives or regional directors. Instead, ask the client to describe "who does what for whom" under any proposed sales or service arrangements.

Obviously some agreements, such as leases and security instruments, require expertise in areas other than franchise regulation. Lawyers who represent start-up franchisors should make an honest evaluation of their own ability to draft specialized agreements and a critical evaluation of form agreements obtained from public or other sources.

6.3 Trademark Protection

A legally protectable trademark is a basic requirement for any franchise system. The client should be urged to have the trademark applications handled professionally. The lawyer should verify the existence and status of the client's trademarks by obtaining and reviewing copies of all registrations and pending applications.

6.4 Trade Secrets

Many clients need counseling about how to maintain the confidentiality of trade secrets and other confidential information to be disclosed or used in connection with the franchise. Although some of the rules for handling confidential information seem self-evident, it is not enough merely to write them down in an agreement. Clients need to know the importance of having and enforcing procedures and standards if they want to be able to rely on judicial protection for their trade secrets and confidential information.

6.5 Franchise Relationship Laws

Several areas covered in the franchise agreements and the manual may be affected by franchise relationship laws. These include conditions for renewal, transfer and termination of the franchise, as well as various kinds of restrictions on franchisees.

Many of the prohibited practices are abuses that were abandoned by franchisors many years ago. Occasionally, a neophyte franchisor may demand, for example, the right to terminate the franchise at any time without notice. Instead of simply citing the requirements of the franchise relationship laws, a lawyer should probe the client's reasons for wanting provisions that are legally prohibited. Often, the client has a point, but has failed to articulate it well. By learning what the client really wants or needs, the lawyer usually can craft a provision that makes legal and business sense.

6.6 Antitrust and Unfair Competition

A lawyer should review the terms of the proposed franchise programs for potential antitrust and business tort problems. In particular, if the program involves territorial or customer restrictions or restrictions on purchasing or pricing, the lawyer may need to intervene in these "business" decisions. Again, quite often the client's real objective is legitimate, but the concept must be refined to pass legal muster.

Covenants not to compete must be reasonable in order to be enforceable. Drafting a "reasonable" covenant not to compete requires knowledge about the special characteristics of the business and the protectable interests of the franchisor. The ultimate decision whether the covenants will be enforced lies with the courts, which will base their decisions on legal precedents as well as the facts before them. Therefore, when drafting covenants not to compete, a lawyer must consult both the business people and the case law.

6.7 Disputes

Clients and even consultants readily defer to the advice of lawyers on dispute resolution, governing law, choice of forum, and related issues. Their ready acceptance of the lawyer's expertise can be a trap in itself if the lawyer does not have expertise in litigation. This is an instance in which the lawyer, as well as the client, may need expert legal advice from someone else.

7. PART II CONCLUSION

Counseling a start-up franchisor requires broad knowledge and a variety of skills, for both business consultants and lawyers. The best advice that a lawyer or a business consultant can give to a would-be new franchisor is, "Get more advice!"