

## **FRANCHISING A BUSINESS**

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Franchising accounts for a growing percentage of the goods and services sold throughout the world. Franchising allows the manufacturer of a product, the provider of a service, or the owner of a retail business to expand using the time, entrepreneurial drive, and financial investment of people who want to own their own businesses. By using the capital and energies of motivated operators, a system can expand more rapidly than it could using the franchisor's own capital and personnel. This allows an entrepreneur to capitalize on his or her window of opportunity to expand, and, hopefully, beat present and future competition to market. As the system grows, the advantages of size should allow the system to enjoy group purchasing, cooperative advertising, growing name recognition and goodwill, and other advantages of scale.

The attraction of purchasing a franchise for the buyer is the prospect of providing a proven product or service, or operating an established and tested business concept using a proven system, in connection with a recognized name. This appeals to those who do not want to start a business from scratch with all the trial and error that entails.

As with any relationship, there are trade offs for both the franchisor and franchisee. The franchisor sacrifices some degree of control since it is not the direct supervisor of the franchised business, as well as limiting its revenues from the operation of the business. For the franchisee, while his or her time and money has been expended in establishing and operating the business, it is the franchisor who controls many aspects of the business and it is the franchisor to whom the franchisee must pay a portion of the proceeds from the business's operations, whether or not the business is profitable.

### **What is a Franchise?**

Franchising is a method of distribution by which goods or services are marketed by parties licensed by the owner of the name or mark under which the goods or services are sold. The franchisor usually dictates many aspects of how the business will be operated, such as the reports that must be provided, sources of supply that must be used, advertising that must be done, daily operating procedures, and so forth. The franchise agreement that governs the relationship is normally for a set period of years, often with renewal options. An initial franchise fee is normally charged and ongoing payments are usually required, often based on a percentage of the franchisee's sales. The franchisor usually provides some degree of continuing assistance to the franchised business and monitors the operation of the business to insure contract compliance and to protect its licensed names and marks.

The legal definition of a franchise differs slightly among the states and under the Federal Trade Commission trade regulation rule covering franchising, discussed below. In California, a "franchise" means a contract or agreement, either express or implied, whether oral or written, by

which: (1) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; (2) the operation of the franchisee's business under such a plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and (3) the franchisee is required to pay, directly or indirectly, a franchise fee. Each of these elements has been the subject of interpretation by the California Department of Business Oversight and by the courts.

It is very important to note that the name given to a relationship has no affect on the legal standing of the arrangement. If it meets the definition of a franchise, it will be a franchise under the law. Calling an arrangement a "license", "joint venture", "partnership", and so forth, will not prevent the relationship from being subject to the franchise laws. Failure to comply with these laws can result in severe civil and criminal penalties as well as liability to those who purchase the franchise.

### **What Makes a Business "Franchisable?"**

Most businesses are capable of being franchised. If it makes business sense for a business owner to consider opening additional outlets as company-owned units, it usually makes business sense to open outlets as franchises. Ideally, before a business is franchised it will have been operating long enough to have proven its commercial attractiveness, worked out most of its kinks, be somewhat unique in the view of the consuming public, be capable of being duplicated, not be dependent on the personality or unique skills of its founders, be capable of being taught to others, and be subject to systemization. The prospective franchisor should have the necessary finances and committed personnel to develop, market, and sell the franchising program and to train and supervise its franchisees. The business must provide the franchisee with the opportunity to make a reasonable return on investment and adequate compensation for the time and effort devoted to the business.

### **Regulation of Franchising**

Franchising is a regulated method of distribution. There are laws and regulations governing the offer and sale franchises in 14 states, including California. Most of these laws require the registration and approval of the franchising documents to be used in the concerned state and the financial condition of the franchisor prior to the offer of a franchise to residents of that state and/or concerning a franchise to be operated in that state.

In addition to the state laws, the Federal Trade Commission has adopted a Trade Regulation Rule that imposes franchise disclosure requirements on franchisors throughout the United States, although there is no separate filing with the FTC. Under the FTC rule, and in most of the states with laws governing the offer and sale of franchises, a franchisor (the seller of

the franchise) must present a Franchise Disclosure Document to each prospective franchisee (the buyer of the franchise) at least 14 calendar days before any binding contract is signed or any money or other consideration changes hands. The Franchise Disclosure Document is a document akin to a public stock offering prospectus which describes the franchisor, its principals, the key terms of the contracts that the franchisee may be required to sign, and other details about the business being franchised. Also described in the Franchise Disclosure Document are the trademark and service mark rights of the franchisor, audited financial statements of the franchisor, and other information of interest to prospective franchisees.

It is essential that a federal trademark or service mark registration, or at least an application for registration, be on file with the United States Patent and Trademark Office when the franchise is offered since the identifying marks and names are an important attribute of a franchise. A current audited financial statement, and in some cases an unaudited interim financial statement, must be included as a part of the Franchise Disclosure Document.

If the franchisor will offer or sell franchises to residents of California, or if the franchise will be located in California, the Franchise Disclosure Document and its exhibits must be submitted to the California Department of Business Oversight for review and approval prior to the offer of the franchise in California. Similar disclosures, but not necessarily prior registration and approval, must be made in all other states, either under the Federal Trade Commission rule or under franchise registration laws similar to those in California. Filing fees are required to be paid to each state where filing is undertaken. No filing is made, nor fee paid, to the Federal Trade Commission. State initial filing fees run from \$250.00 to \$750.00. In California, the fee for the initial franchise registration application is \$675.00.

The Franchise Disclosure Document must contain copies of all agreements the franchisee may be required to sign. The basic contract is usually called a Franchise Agreement. This agreement sets forth the rights and obligations of the parties in connection with the franchise. Depending on the complexity of the business involved, a Franchise Agreement may run to over 50 pages in length. Additional agreements may be appropriate, such as an area development agreement, an area representation agreement, a deposit agreement, leases, subleases, confidentiality agreements, releases, condition lease assignments, security agreements, and so forth.

Legal expenses will be incurred by the franchisor for the preparation of the Franchise Disclosure Document, the Franchise Agreement, and the other contracts that the franchisor and its attorneys decide are advisable, for searching a trademark or service mark and filing an application for trademark or service mark registration applications with the U. S. Patent and Trademark Office, and for preparing franchise registration applications, and for dealing with the appropriate state agencies in connection with the franchise registration process. In addition, if audited financial statements have not been prepared by the franchisor in the past, accountants

will have to be employed to audit the franchisor's financial statements. In many cases added to those expenses are costs for the formation of a new entity to serve as the franchisor, any required license agreements allowing the franchisor to use the necessary names and marks, the preparation of marketing materials for use in connection with the solicitation of franchisees, the cost of preparing operating and other manuals to be provided to franchisees, the design of training programs, and any incremental costs required in connection with the franchising business, such as hiring staff and working capital. It is likely that the total start up costs for initiating a new franchising program can run up to \$50,000.00 or higher. The good news is that once the initial work is done, the cost of maintaining a franchising program from a legal standpoint is relatively minor.

If the business will be franchised in more than one registration state, there will be additional franchise registration work to be done but that work utilizes the existing franchising documents and, with a couple of exceptions, the cost is moderate for revising those documents for most specific state franchise law compliance. Franchise registrations must be renewed, or annual reports must be filed in some states, annually. Audited financial statements must be prepared annually as long as the franchisor continues to franchise, and must be included with the franchisor's registration renewal or annual report applications. Once a federal trademark or service mark registration is obtained, only periodic filings are required to maintain those registrations. Amendment applications must be filed in states in which the franchise is registered if there is a material changes in the information contained in a registered Franchise Disclosure Document.

Certain states have Seller Assisted Marketing Plan or Business Opportunity laws that, by their definitions, include franchises. However, these laws exempt franchises that have complied with the FTC rule, state franchise laws, or, in some cases, that operate in connection with a registered trademark. In 5 states, a one-time, or annual, filing must be done to obtain the desired exemption.

The timetable for the preparation of franchising documents and their registration with the California Department of Business Oversight runs about 3 months; one month for the legal work, one month for the prospective franchisor to review and revise the documents, and one month for the California Department of Business Oversight to review the papers. Of course, if any of those tasks are completed sooner, approval will be obtained more rapidly.

If the California Department of Business Oversight does not feel that the franchisor's financial condition is adequate to perform the initial services it promises to provide to its new franchisees, the Department will require the opening of an impound account as a condition of its approval of the franchise registration. This requires the franchisor to open an account similar to an escrow account with a bank into which all initial franchise fees must be deposited. The bank cannot release those funds to the franchisor until the franchisee certifies to the Department of

Business Oversight that the franchisor has performed all of its initial services as promised in the Franchise Agreement. The Department then authorizes the bank to release the funds to the franchisor. If the Department of Business Oversight decides that the franchisor is inadequately capitalized, various alternatives to the imposition of an impound condition can be explored, such as the posting of a bond, deferral of franchise fees, and other, less frequently used alternatives.

There are various exemptions and exclusions from compliance with the some of the registration requirements of the California Franchise Investment Law and under the FTC rule dealing with franchising. These provide limited exemptions and exclusions based on various circumstances, such as franchising by large, well financed franchisors, sales to experienced franchisees, and sales of fractional franchises, those for whom the franchise is only a small part of their overall business. These can be explored in appropriate circumstances. Not all franchise registration states have similar exemption rules.

### **Conclusion**

Franchising can be an excellent way to expand a business more rapidly than could otherwise be done. However, it is essential that a prospective franchisor understand the demands, challenges, costs, and intricacies of franchising. Franchising involves not only complex legal rights and relationships, it also demands an awareness of the human element in this unique relationship. Experienced counseling and guidance in the development of the franchising program and throughout the life of the system is essential to minimize legal exposure and to maintain a healthy relationship between a franchisor and its franchisees.