

METHODS OF BUSINESS EXPANSION

by Darryl A. Hart

This article will briefly explore methods often used to expand successful business concepts. Such methods include franchising, internal expansion, distributorships, dealerships, licensing, Business Opportunities and other techniques. Often these methods are used in combination, such as where a company owns its own units as well as granting franchises to others.

Internal Expansion

Expansion using a business enterprise's own money and personnel allows the most control over growth. However, growth by strictly internal means is usually restricted by limits on resources and staff. Raising more money by means of public or private financing and hiring and training new staff will often answer this problem. Usually, however, especially with businesses that do not have an extended track record or those that want to grow more rapidly than can be done with available capitalization, raising sufficient funds and finding, hiring and training adequate staff, can be a challenge. If the business depends on the unique skills of its principals, their contacts or other such factors, internal growth is dictated.

Franchising

What is Franchising?

Franchising accounts for an ever-growing percentage of the sales of goods and services throughout the world. Franchising is a method of distribution in which goods or services are marketed by parties other than the owner of the name or mark under which they are sold in a manner that gives the public the impression that the providers of the goods or services are part of a chain or system affiliated with the owner of the name or mark. The legal definition of a franchise differs slightly among the states and under the Federal Trade Commission trade regulation rule on franchising. In California, a "franchise" means an oral or written contract or agreement, either express or implied, 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 a 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 (just about any type of payment can be a "franchise fee" no matter what it is called). Each of these elements have been the subject of interpretation by the California Department of Business Oversight and the courts.

It is very important to note that the name given to a relationship has no effect on the legal standing of the arrangement if it meets the franchise definition criteria. Calling an arrangement a “license”, “joint venture”, “partnership” and so forth, will not prevent the relationship from being a franchise under the law. Failure to comply with the laws governing franchises can result in severe civil and criminal penalties.

Various exemptions and exceptions to the franchise laws exist for a limited variety of relationships or certain classes of franchisees. Therefore, even though an enterprise satisfies the franchise definitional requirements, some relief from the franchise laws may exist. However, not all exemptions or exclusions are available nationwide and each franchise registration state’s laws and regulations, as well as the federal requirements, must be consulted to determine their applicability.

Why Franchise?

By using the capital and energies of motivated operators, a system can expand more rapidly than it could using its own capital and personnel. This allows a system to take advantage of a window of opportunity, and, thus, hopefully, beat its present and future competition to the market. As the system grows, the benefits of size allow the system to take advantage of group purchasing, cooperative advertising and promotion, growing name recognition and goodwill and other such advantages. Of course, to be franchised, a business must be “franchisable”. This means that it is subject to duplication. If a business depends on the unique skills, knowledge or other attributes, of the owner and those attributes are not easily taught or take a long time to develop, trying to duplicate the business successfully may be difficult.

Why Not Franchise?

Many business owners fear the loss of quality control if they allow others to operate a business under their name. They fear that not having controls similar to those they have over their employees may jeopardize their goodwill. It is true that a franchisee is not an employee of the franchisor and, as such, is not subject to summary dismissal. However, a well-crafted franchise agreement will give the franchisor significant enforcement rights in the event a franchisee is not complying with his or her obligation to observe the franchisor’s quality and operating requirements. This potential predicament is part of the trade off for using the franchisee’s money and efforts to expand the business: quality and other aspects of the business can be enforced but it is not as simple as if the business were expanded solely by internal means.

Franchising is regulated by federal and state law. Before a franchise can be offered or sold in the United States, a disclosure document, that is in many ways similar to a public stock offering prospectus, must be given to each prospective franchisee. This document, called a Franchise Disclosure Document, describes the business being franchised, the number of units in

the franchised system and those anticipated within the next year, the principals of the franchisor, the franchisor's financial condition, its trademark, service mark, copyright and patent rights, if any and the key provisions of the franchise contract or contracts franchisees may be required to sign and other information. In many states, the Franchise Disclosure Document and all applicable contracts must be registered or filed with a state agency before the franchise can be offered or sold in those states. There are also laws and regulations in many states governing aspects of the franchise relationship once a Franchise Agreement is signed. The degree of regulation and the costs of compliance dictate against a casual entry into franchising. However, franchising should not be avoided if it is clearly the best way for a business to expand.

Trying to avoid being considered a franchise when the elements of a franchise are present is a dangerous enterprise. The costs of having a franchise that has not complied with applicable law can be much greater than the costs of compliance at the outset of the endeavor. In addition, for a franchising program to be successful, sufficient assets and personnel must be devoted to selling and operating the system, since it is, in essence, a business separate and apart from the core business that is the basis for the expansion.

Partnerships and Joint Ventures

Joining with others to expand a business is a time-honored practice. However, such an arrangement may also be found to be a franchise. To avoid being a franchise, the arrangement must be carefully drawn and the practical aspects of the venture must avoid the franchise-definitional elements indicated above. For example, in an attempt to avoid being a franchise, the owner of names, marks, business system, marketing plan, product line and so forth, may form a venture and call it a partnership or joint venture (a joint venture is, in essence, a partnership that is limited to particular project). However, if one party puts in its marks, product or service, a system that is required to be followed by the venture and the other side puts in the money and manpower for the project, with some share of the profits or gross sales going to the owner of the names, etc., in most cases this arrangement will be found to be a franchise. To avoid franchise status, the arrangement must be a true partnership with each side putting in money or other items of value, in proportion to their share of the profits and exercising equal control over how the venture is conducted. If the venture is required to purchase products or services from the owner of the names, etc., the profit split or gross sales division may be irrelevant in finding a franchise since the "franchise fee" aspect of the arrangement may be satisfied as a result of such purchasing requirements.

Also to be considered from a practical standpoint is that in a general partnership or joint venture each partner/venturer will be responsible for the acts and business liabilities of the other, a risk few are willing to take. For this reason and because it may be found to be a franchise

anyway, the partnership/joint venture route is probably best avoided unless great care is exercised in structuring the arrangement.

Corporations, Limited Liability Companies and Limited Partnerships

These are legal entities formed to protect their owners from personal liability for the liabilities of the entities. However, as with partnerships and joint ventures, if the real purpose of the arrangement is merely to avoid the franchise laws and if the business operates under the name, marks or identifying symbols of one of the owners, danger may lurk. If the party or parties who would otherwise be franchisees put up the lion's share of the money for the business, run the daily operations of the venture, are required to follow the requirements, systems, marketing or other restrictions dictated by the other party, if the owner of the names or marks receives a portion of the gross sales or a share of the profits disproportionate to its investment or if the entity is required to make purchases from the owner of the names or marks it is probable that a franchise will be found despite the use of a legal entity as the business form. It is also possible that a franchise will be found to exist between the owner of the names or marks and the new legal entity itself, which is considered to be a separate person under the law, in addition to or instead of, between the owner of the names or marks and the person or persons putting up the money for the enterprise.

Using other people's money and efforts to expand a business should always raise the question of whether a franchise exists. While arguments can be made about whether a particular arrangement constitutes a franchise, if the arrangement is attacked as violating the franchise laws, the resulting costs can far exceed the costs of complying with those laws in the first place.

Licensing

Licensing is an arrangement in which one party permits another party to sell goods bearing the names, marks or other proprietary property of, the licensor but without the marketing and/or operating controls that are elements of a franchise. Examples would be a cartoon character licensed to a toy maker, a sports team's logo is licensed to a clothing manufacturer or a software developer licensing the use of its product to its customers.

While the licensor can require the licensee to adhere to limited requirements designed to protect the licensor's property rights and can specify certain performance requirements, the licensor does not provide the marketing plan or system to be followed by the licensee. Determining where proprietary protection ends and too much control begins can be tricky and the consequences of error can be significant. On occasion, the constraints placed by a licensor

on a licensee are increased over the course of the association or on the renewal of the relationship. In that way, what starts as a license can evolve into a franchise.

Dealerships

Dealerships are independently-owned outlets selling goods produced by another. Most retail stores are, in essence, dealerships. When we usually think of dealerships, we think of automobile retailers. These, however, while being dealerships, can also be franchises because of their association with the names and marks of the auto makers, the nature of the payments required to be made to the manufacturers and because of operating requirements placed on the dealers by the car companies. Any dealership substantially associated with the identifying names, marks or symbols of the product sold, can be a franchise. For example, if a sporting goods store operating under its own business name sells a wide variety of brands, it is a dealer in those brands. However, if it sells principally one brand and uses the name of that brand as part of its business name or is otherwise substantially associated with the marks or symbols of the manufacturer, it may also be a franchise.

Distributorships and Selling Agents

A distributorship exists where a manufacturer allows a third party to sell its goods to retail outlets. For example, XYZ Distributors may have the exclusive right to sell Acme Widgets to dealers in a specified market area. The distributor may be required to purchase the goods from the manufacturer, may receive them on consignment or may be subject to some other arrangement regarding payment. As in the case of a license, the manufacturer does not require the distributor to follow a system of doing business, other than as may be necessary to protect the manufacturer's goodwill. The distributor usually operates under its own business name and not that of the manufacturer. The distributor normally sets the prices at which it will sell the goods. In addition, the distributor normally does not pay a fee for the privilege of being a distributor, although required purchases of advertising or training material, excess inventory or some such expense, may be considered a franchise fee for purposes of determining whether a franchise exists. As in the case of a license, where the manufacturer dictates the distributor's method of doing business or prescribes a marketing plan, there is substantial association with the manufacturer's names or marks and there are payments over and above the legitimate wholesale price for the merchandise being purchased, the existence of a franchise must be considered.

Akin to Distributors are commissioned selling agents or manufacturer's representatives. These people normally obtain orders for manufacturers with the manufacturers delivering the orders directly. The agents do not purchase the goods from the manufacturer for resale. The manufacturer retains title to the goods until they are sold to the ultimate dealer and sets the prices

at which it will sell the goods. The agents are paid a commission on the orders taken. However, if the agent is required by the manufacturer to operate under the manufacturer's name, conduct its business in a certain way, perform specified services and pays, directly or indirectly, for the privilege of being an agent or representative, a franchise may be found to exist between the manufacturer and the agent.

Many states have laws dealing with the relationship between manufacturers and their dealers, distributors and agents, usually concerning the timing of payments to the dealers, distributors and agents by the manufacturer.

Seller Assisted Market Plan (Business Opportunity)

Many states have laws regulating Seller Assisted Marketing Plans, known in many states as Business Opportunities. These are arrangements under which one party offers or sells products, equipment, supplies or services which are used by the purchaser to begin, maintain or operate a business, when the seller has solicited the purchase of the items by means of a representation that the purchaser can earn an amount in excess of the purchaser's initial payment, that there is a market for the items or services purchased or anything marketed, produced, modified or developed by the purchaser or using the products, supplies, equipment or services that were sold by the seller or that the seller will buy back any product produced by the purchaser using the items sold to the purchaser by the seller. Such arrangements often involve rack sales, home-based businesses, vending machines and other such activities.

Seller Assisted Marketing Plans and Business Opportunities are partially similar to franchises in that they provide a business plan or marketing system to the purchaser in exchange for a one-time or continuing payment. What normally differentiates these plans from franchises is the absence of the trademark aspect discussed above, in that the purchaser of the plan is not permitted to use the seller's names or marks in identifying the business. In some cases, however, these arrangements can be found to be franchises even though the seller sought to avoid that designation, such as where the use of equipment bearing the seller's name was found to satisfy the trademark aspect of the franchise definition.

In states that regulate these arrangements, disclosure documents, bonds, escrows, cooling off periods, specified contractual language and other requirements are imposed by law. In such states, the plan must be filed with and approved by a state agency before it can be offered or sold. While franchises fall within the definition of Seller Assisted Marketing Plans or Business Opportunities since they contain all of the required elements, plus the trademark aspect, the various state laws usually exempt franchises using registered marks and/or those complying with state or federal franchise laws from Seller Assisted Marketing Plan or Business Opportunity law

compliance. The Federal Trade Commission trade regulation rule that governs franchises also covers Business Opportunities, requiring the disclosures set forth for both franchises and Business Opportunities.

Internet Sales

The sale of products and services over the Internet gains momentum yearly. Because this method of distribution is relatively new, existing laws and regulations have not always caught up. Therefore, franchise, Seller Assisted Marketing Plan and Business Opportunity laws may apply to Internet sales activities where the required definitional requirements are met, however inadvertently. Care should be exercised when one party allows sales on its web site to be made by another party. If the web site owner provides restrictions on what the selling party can sell and how sales can be made, under what conditions refunds must be given or other marketing limitations or requirements and payment is made by the selling party to the web site owner, a franchise may exist. While it can be argued that the franchise laws were not designed for this type of arrangement, courts have found that those laws apply because of the broad definitions specified in the franchise laws. Unless and until those laws are changed, each prospective third-party web relationship must be analyzed to determine whether the franchise law or some other, compliance must be undertaken.

Conclusion

While there are many ways to expand a business, the broad scope of the federal and state franchise laws dictate caution whenever one party allows another party to benefit from a trademark, service mark or other identification, there is some degree of control by the trademark owner over the operations of the other's business and any money or other thing of value, changes hands. Failure to comply with the franchise laws, if applicable, can result in costly litigation, government enforcement action, fines, contract rescission and other civil and criminal penalties. If there is doubt whether an arrangement is a franchise, it quite likely is. The risks are too great to take the chance that a court, arbitrator or governmental agency will find, after the fact, that an arrangement is a franchise, with the attendant burdens will result. If the nature of the enterprise dictates that it is a franchise, it is unwise to try to style the business as other than a franchise since the benefits of being a franchise and the attendant controls sought by the franchisor, may be sacrificed for short-term expediency. However, if the elements of a franchise are not necessary to the business plan, one of the other methods of growth can be used to expand the endeavor without the complexities and costs of franchising.