

SO YOU WANT TO FRANCHISE YOUR BUSINESS?

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In my 30 years of marketing many different franchises and having consulted with 1000's of franchisors and developing over 750 separate franchise businesses, I have come to the conclusion that most consultants and marketing people try to complicate franchising way too much.

FACTS ABOUT FRANCHISING

More than 8 million people are employed by franchise businesses, with an average of 8 to 14 employees per business. From 1975 to 1988, the total number of people employed in franchising nearly doubled, from 3.5 million to 7 million, and the number of persons employed per business increased 80% from 8 to 14. Franchised businesses create more than 170,000 new jobs each year.

According to the U.S. Commerce Department, fewer than 5% of franchises was terminated on an annual basis. In a study by Arthur Anderson & Company of 366 franchise companies, nearly 97% were still in business after 5 years. In contrast, a study by the U.S. Small Business Administration revealed that 62.2% of all new businesses failed within their first 6 years of business.

There are an estimated 8,000 franchise companies operating in the U.S. doing business through more than 600,000 retail units.

75 industries use franchising to distribute goods and services to consumers. Average initial investment level for nearly 8 out of 10 franchises, excluding real estate, is less than \$250,000.

More than \$1 trillion in annual sales is produced from franchise businesses and the 49% of all retail sales in the United States is from franchising.

THE HISTORY OF FRANCHISING

The origins of franchising can be traced back to the middle ages (400 A.D. – 1500 A.D.). At that time, it was an accepted practice for local governments to offer important persons, even high-church officials, a license granting them the right to maintain civic order and to make special tax assessments. Courts or lords could also grants rights to others to operate ferries, hold markets, and perform the business activities today carry out by professionals and craft guilds. The licensee (or franchisee) would pay the licensor (franchisor) a specific fund from the tax revenues collected or assessments made and in return receive military or other forms of protection.

Queen Isabella of Spain probably used (invented) a franchising system when she awarded Christopher Columbus a “franchise” in 1492 to develop travel and trade with the new world. It is fascinating that from the new world franchising would be introduced and re-established in the 20th Century.

Additional progress was made during the early 19th century in England when tavern and pub owners, while experiencing financial hardship, turned to brewing companies for financial assistance. The tavern and pub owners in return for financial assistance were required to purchase all of their beer from that specific brewer.

In the United State, franchising developed in the 1850’s when the Singer Sewing Machine Company formed a franchise in 1851. Agents were commissioned to demo, sell, and repair the Singer line.

In the late 1889, Robert Metzger was the first franchisee of Ford...before him; Fords were sold directly from the manufacturing plant. Ford began establishing dealers.

Rexall Drug stores – 1902
Western Auto – 1909
Howard Johnson – 1925
McDonalds – 1955
Kentucky Fried Chicken – 1955
International House of Pancakes – 1959 IHOP
And many more today...over 8,000 franchisors.

THE FEDERAL TRADE COMMISSION RULE ON FRANCHISING

As of October 21, 1979, FTC Rule 436 governs the offering of a franchise within the United States. Any company developing itself as a franchisor MUST comply with this rule. In addition to the FTC Rule, there are 15 States that require strict compliance to their State Laws governing the offering of a franchise.

In brief summary, a franchise is defined by the Rule as any business offering a contract or agreement whereby there is the licensing of a trade mark, logo, commercial symbol, in the body of the agreement there are significant controls or assistance being offered and the franchisor is being paid \$500 or more during the first six months of the business being opened. Since that nearly covers most business opportunities, the franchisor must provide 10 business days prior to the required signing of the contract or agreement or the receipt of any money a full disclosure address specific items required by the Federal Trade Commission Rule 436.

Listed before are the 23 Items that must be addressed using the Uniform Franchise Offering Circular document:

Item 1. FRANCHISOR, ITS PREDECESSORS AND AFFILIATES

Some of the information that a franchisor is required to reveal in a UFOC, such as disclosure of bankruptcies and lawsuits in the franchisor's past, may be embarrassing and detrimental to the sale of franchises. If a franchisor were to transfer its franchise operations to a related company with a clean bill of health, it could evade these disclosure requirements. To make this impossible, numerous disclosures about "predecessors" and "affiliates" are required in Item 1.

Item 2. BUSINESS EXPERIENCE

In some UFOC's, biographies of the franchisor's key people only cover the last five years and do not mention educational background. This is because some franchise examiners will not approve an offering circular unless the franchisor deletes all non-required information from its Item 2 biographies, not because all franchise executives have a maximum career span of five years and no education.

Item 3. LITIGATION

Franchisors and their personnel must tell prospective franchisees about lawsuits and arbitration proceedings brought against them. But they do not have to tell prospective franchisees about actions they have brought to collect debts owed to them by franchisees who have lost money trying to follow their franchised systems.

Item 4. BANKRUPTCY

Among other things, any franchise executive who has filed bankruptcy within the past ten years has to tell all in Item 4. Often, however, the requirement catches some poor man who is an employee of a franchisor and is just trying to quietly live down a personal bankruptcy.

Item 5. INITIAL FRANCHISE FEE

In Item 5 the franchisor has to disclose whether the initial franchise fee is uniform. Supposedly, this lets a prospective franchisee know that he is getting as good a deal as everyone else. In reality, the required disclosure is not effective. This is because it is only applicable to franchisees currently buying franchises. If the price was different in the past or changes in the future, these facts do not have to be revealed. The exception is California, which obliges franchisors fill out a form each time it sells a negotiated franchise and attaches these forms to the back of its offering circular. Virtually every UFOC says that the initial franchise fee is nonrefundable. This means that the franchisor does not have to give a franchisee's money back if he gets cold feet, fails to locate financing, or, as is often the case, cannot find a satisfactory site. It does not

mean that franchisors never refund these “nonrefundable” fees (because they often do), but only that a franchisee should not rely on it. If the franchise agreement does not require the franchisee to pay the initial fee until the franchise is ready to open for business, or if the initial fee will be paid into escrow, this means that the state is worried about the franchisor's ability to survive. No franchisor sets its agreement up this way voluntarily. The state must have required it to defer or escrow the fee as a condition of registration. Just because the state is concerned, however, does not mean the State is correct.

Item 6. OTHER FEES

These fees are listed in this section.

Item 7. INITIAL INVESTMENT

This chart is supposed to give a franchisee a realistic notion of how much money he needs to get up and running with the franchisor's system. Although the chart is supposed to be based on actual data, many franchisors base it on their "experience" instead (in other words, they guess). Franchise litigation histories show that the figures in Item 7 are often highly optimistic. Prospective franchisees should test the reality of these figures by pricing key expenses, such as rental of office space.

Item 8. RESTRICTION ON SOURCES OF PRODUCTS AND SERVICES

The franchisor is supposed to disclose, in Item 8, whether it takes kickbacks from suppliers in return for requiring franchisees to buy from those suppliers. The franchisor is also supposed to disclose whether it makes money on the franchisee's purchases from vendors the franchisor designates or recommends. However, the UFOC guidelines on this subject are phrased so confusingly that many franchisors are not sure what is required and therefore the responses may be inaccurate.

Item 9. FRANCHISEE'S OBLIGATIONS

These obligations are listed here.

Item 10. FINANCING

In this Item, the franchisor is supposed to tell the franchisee all about the financing it provides or arranges for the franchisee to obtain from someone else. Franchisors hate to answer all the detailed questions in Item 10 because of the work required and require knowledge of esoteric matters such as how to calculate APR. So they answer Item 10 by saying they don't offer or arrange financing. The fact that the same financial source has funded 9 out of every ten franchised store build-outs in their systems is apparently just a coincidence. If a

franchisee expects to need financing and no information about it appears in Item 10, he should get the information in writing, even if it is just a letter from the franchisor's bank.

Item 11. FRANCHISOR'S OBLIGATIONS

This is the part of the offering circular where the franchisor is supposed to describe in detail everything it is going to do for its franchisees. However, the disclosures are primarily directed toward revealing what the franchisee has to do, instead. This isn't the franchisors' fault. The Guidelines for preparing a UFOC are set up this way. Part of this section concerns computer equipment. The franchisor is required to disclose whether it can "independently" access a franchisee's computer data via modem and examine the franchisee's data without contractual restriction. In the section on advertising, the franchisor is required to reveal how much of the advertising money paid by franchisees it can use to reimburse itself for operating the advertising fund. Many franchisors take no compensation at all, contributing more to the advertising fund than the franchisees do. Even though many franchisors promise franchisees to use their expertise to help the franchisees find good business locations, careful reading of Item 11 of most offering circulars reveals that the franchisor has no responsibility at all for site selection. Instead, the franchisee has to get the franchisor's permission to develop a given site, but cannot hold the franchisor responsible if the site turns out to be bad.

Item 12. TERRITORY

If the franchisor can build a competing outlet or grant a franchise right on top of another franchisee's location, it is supposed to be disclosed in Item 12. If a franchisor can compete with its own franchisee by selling its branded product in supermarkets or other outlets at a lower price than its nearby franchisee can afford to charge, Item 12 should say so.

Item 13. TRADEMARKS

If a franchisor's name turns out to belong to someone else, and that someone else sues the franchisee for infringement because the franchisee uses the name, does the franchisor have to defend the franchisee? If the franchisee is forced to change its signs, stationery, advertising, and so on, will the franchisor reimburse the franchisee for the expense? This information is contained in Item 13.

Item 14. PATENTS, COPYRIGHTS AND PROPRIETARY INFORMATION

Patent, copyright and proprietary information is contained here.

Item 15. OBLIGATION TO PARTICIPATE IN THE ACTUAL OPERATION OF THE FRANCHISE BUSINESS

The obligation to participate in the actual operation of the franchise business is contained here.

Item 16. RESTRICTIONS ON WHAT THE FRANCHISEE MAY SELL

The restrictions on what the franchisee may sell is contained here.

Item 17. RENEWAL, TERMINATION, TRANSFER AND DISPUTE RESOLUTION

The renewal, termination, transfer and dispute resolution terms are contained here.

Item 18. PUBLIC FIGURES

If a famous person recommends that franchisees buy a particular franchise, the franchisor is supposed to reveal in Item 18 how much it paid the famous person for making the recommendation.

Item 19. EARNINGS CLAIMS

Does anyone make any money with this franchise? If so, the figures can be presented in Item 19. If the franchisor has something to brag about, this is where it should do it. If the franchisor does not give any information in Item 19, you have to ask yourself, why not? The answer is that franchise lawyers spent years telling franchisors how dangerous it is to provide earnings information in case they are sued, so that some franchisors who should be proud of their franchisees' financial performance are afraid to tell anyone.

Item 20. LIST OF OUTLETS

Item 20 tells prospective franchisees how many franchises a franchisor has sold and how many of the franchised businesses have survived. If this Item shows there have been lots of terminations, a person might conclude that it is hard to stay in business in this business.

Item 21. FINANCIAL STATEMENTS

The last three years of audited financial statements are contained here. Does this franchisor have enough cash to provide the benefits to franchisees that it says it will? The financial statements referenced in Item 21 and attached as an exhibit should provide an answer. If the letter from the auditor at the beginning of the financial statements contains a "going concern" notation--a statement that

continued operation of the franchisor's business is in question, watch out! Read the footnotes to the financial statements.

Item 22. CONTRACTS

All contracts that the franchisee must sign are contained here.

Item 23. RECEIPT

The franchisor will ask you to sign this to prove you received the UFOC.

STEP-BY-STEP PROCEDURES FOR FRANCHISE DEVELOPMENT

Corporate Structure - It is recommended that a new corporation be formed for the purposes of franchising. Since an audit must be prepared, a newly formed corporation can save thousands of dollars in this area. Also, for liability reasons, a new corporation may be advisable.

Trade Name - The cornerstone of a franchise is the trademark, commercial symbol, logo and/or slogan. To achieve the necessary registration from the U.S. Trademark & Patent Office it takes from 12 to 18 months to receive.

Uniform Franchise Offering Circular - The Federal Trade Commission requires that all franchisors provide a prospective buyer with the necessary disclosure documents in compliance with Rule 436 of the FTC. This document is usually 50 to 60 pages and address 23 items of disclosure. The UFOC document must be updated and be current within 90 days at all times.

Audit - The FTC requires a audit of the financial condition of the franchisor corporation annually. Registration States will require updates every 90 days in addition to the annual audit.

Web Site - Instead of the preparation of printed promotional materials which can be extremely costly and often times outdated within months, franchisors are developing websites that contain all the necessary information concerning the franchise opportunity. The Confidential Franchise Application Form is part of the website. Printed materials are optional.

Manuals - Most franchisors provide 2 sets of manuals to their franchisees. Development Manual which is all of the pre-opening things requirements that must be completed by the franchisee before the business can be opened. Then the Operations Manual is the day-to-day procedures, policy, and guidelines of the business.

Training - The training program is always on-going, but the initial franchisee training is usually provided at the national headquarters of the franchisor for 5 days. Then a field representative will usually be available for another 3 days after the business is opened.

Field Support - It is necessary to inspect the operations of a franchisee on a regular basis to ensure quality control standards.

Registration States - There are 15 States that require registration of your UFOC before marketing is allowed within their States. There are fillings required also.

Marketing/Advertising - To find qualified potential franchisees, various methods are employed through the media to reach these individuals.

WHY COMPANIES FRANCHISE?

There are two primary reasons why owners of businesses want to franchise or even a combination of these two reasons: 1) because they want to share their business with others, and 2) because they want to enjoy the financial rewards of franchising.

A company that is only worth \$100,000 to \$250,000 can be valued at over \$100 million dollars within 3 to 5 years after franchising. I will not go into this at this moment, but always explain to all clients of National Franchise Services how this works.

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