

Farrell Law Group

Franchise FAQ Booklet

This booklet has been arranged in a convenient question and answer format, and is intended to provide basic information about franchising to people presently involved in existing businesses who are considering franchising as a means of expanding. This publication is a companion to an expanded book published by The Farrell Law Group entitled Franchise It! A Guide to Franchising Your Business. If you decide to pursue the franchising of your business it is very important that you obtain professional counsel knowledgeable in the field of franchising to assist you in selecting your franchising methods, and in implementing and carrying on the franchise business as well.

1. What is a Franchise?

In its simplest terms, franchising is a method for the **sale of products or services**, or a combination of both, under a **trademark or trade name**, using a **marketing plan or system** which has been developed by the franchisor. The **franchisor** is the one who has developed the product or service, the trademark and trade name, and the marketing system through which the product or service will be sold. The **franchisee** is the party who has bought the franchise, and the one who makes the sales of the products or services to the public, using the franchisor's trademark or trade name and marketing plan.

2. Are some franchises more complex than others?

Definitely. Some of the simpler franchises consist of little more than a sales relationship between a supplier of a product and a dealer or distributor. The dealer concentrates on the supplier's product line and, through the use of the supplier's trademark or trade name, identifies itself with the supplier's product. The supplier generally places some type of requirements on the dealer concerning the sale of the supplier's products. Approximately 60% of all franchises are this type of dealer-supplier franchise.

Another type of franchise is known as the "Business Format Franchise." The Business Format Franchise is an on-going relationship between a franchisor and a franchisee that includes not only the product, service and trademark, but also the entire business concept itself in a complete system. This will generally include a marketing strategy and plan that the franchisor has developed, an operating manual, and standards/quality control obligations covering the service and/or products to be sold, and a continuing process of assistance, advertising and guidance to be provided by the franchisor to the franchisee and to the network of franchisees. Approximately 40% of all franchises are of the "Business Format" type.

3. How big is franchising in the United States?

In 1972 it was estimated that franchising generated approximately \$29 billion worth of sales from approximately 190,000 franchise locations in the

United States. In 2000 it was estimated that franchising generated approximately \$300 billion worth of sales from approximately 350,000 franchise locations. In 2000, franchising generated **one out of every three dollars of retail sales in the United States.**

4. Is franchising growing in the United States?

Yes. The present indication is that franchising will continue to expand rapidly in the future for several reasons. The general trends toward rising personal income, fairly stable wholesale and retail prices, increased competition for market share, and difficulty in raising sufficient funds to finance company expansions internally, are resulting in many companies, both small and large, turning to franchising as a way to expand the distribution of their services and products. Approximately 400-500 companies start franchising networks each year.

5. How do I know if my business is suitable for franchising?

Many different types of businesses can be developed as franchises. Any type of business which has a unique product, service or business style, or which can be "formatted" (e.g. Subway) is suitable to franchising. Businesses that generate a high sales volume through sales of small product units, with large inventory turnover, are particularly suitable for franchising. This is especially the case if the business has certain well-defined procedures which can be explained in a easily understood step-by-step manner to franchisees.

Almost every kind of business has been franchised, including virtually all types of retail services, accounting services, hotels, employment agencies, real estate services, travel services, lawn care, carpet cleaning, health services, delis, photographers, printing services and educational businesses. The list is virtually endless.

If your business has a unique product, service or business style which can be taught to franchisees through well-defined procedures, and requires some degree of special know-how that you can provide to franchisees, then franchising may be an appropriate way for you to expand your business.

6. What benefits can I get by franchising?

Although franchising offers many benefits to potential franchisors, the most important of these can be summarized as follows:

A) You can expand your business, and your market penetration, more rapidly through franchising than by using internal, non-franchised, expansion methods. By using franchises, you do not have to personally develop and manage the franchised business locations in a day-to-day basis; you have the franchisee **on-site** doing that for you, incentivized by his/her own profit motive.

B) Your business expansion can be financed **externally** rather than internally. A "credit crunch" exists today, and will probably exist for the next few years, which especially hurts small businesses that wish to expand. Franchising allows an existing small business to generate a

substantial portion of the financing needed for expansion through the sale of franchises, and the continuing collection of royalties from the franchise network. Therefore, rather than being a financial "drain", a franchise location used for expansion purposes immediately generates cash flow commensurate with the franchise fee charged. The franchise location also continues to generate cash flow through the payment of continuing royalties based upon a percentage of gross income earned by the franchise location.

C) Your expanding business does not need to increase its employee base significantly. Usually, when a small business wants to grow it must considerably expand its employee base, with all of the expenses and headaches that go along with that expansion. If a small business expands through franchising, although it may add a few employees in order to implement the franchise system itself (e.g. training and supervisory personnel), it is the **franchisee** rather than the expanding business that hires and supervises the employees who are going to run the franchise location.

D) The franchisee at each franchise location is an entrepreneur with a personal interest in the success of the business, rather than merely a paid manager. This results in closer attention being paid to the success of the new location with an individual **on-site** who has a **personal interest** in the efficiency and success of the franchised business, as well as the enthusiasm that goes along with that direct personal interest.

7. Where do I start if I want to franchise my business?

First, decide whether or not your business is suitable for franchising. Does it have a product, service or business style that can be reduced to well-defined procedures or methods easily taught to franchisees in a step-by-step fashion? Do you have special knowledge or experience that you can provide to franchisees to assist them to be successful both for you as well as for themselves?

If you believe that your business can be franchised successfully, the next step is for you to prepare responses to questions the Federal Trade Commission requires each franchisor to answer in a document known as a "Uniform Franchise Offering Circular", or "UFOC". The UFOC document must be provided to all prospective franchisees. Answers to these 23 questions can serve as the basis for your "franchising business plan." The information that you will have to provide in response to these questions will require you to actually develop a "business plan" for your franchise.

The FTC requires that you answer questions such as what the franchise fee will be, what the franchisee's initial investment will be, what obligations the franchisee will have to purchase from designated sources, what your obligations to the franchisee will be, etc. You will find that when you have completed your own internal written responses to these questions you will have developed a significantly detailed business plan for your franchise concept. Additionally, you will have assembled a major portion of the legal documents that you will need in order to actually bring your franchise into existence.

We at The Farrell Law Group would be pleased to provide you with an outline of these questions.

8. What laws will I have to comply with if I franchise my business?

The laws that apply to business operations generally apply to franchising as well. However, there are special laws that apply to franchising only. Many of these laws exist because of past abuses in the franchise industry.

First, in conjunction with an attorney knowledgeable in franchising, you will have to properly complete the responses to the FTC questions mentioned above. Those responses, along with certain other information, will comprise what is known as your franchise **Uniform Franchise Offering Circular** or "**UFOC.**" The **UFOC** must be provided to each prospective franchisee at the time any significant discussions occur regarding the possibility of that person becoming a franchisee, and not less than 10 days before any money is paid by the prospective franchisee. Additionally, approximately one-half of the states in the country require that you **register** your franchise with that state before you offer a franchise for sale within that state. It is **extremely important** that you comply with these various state registration requirements before seeking to sell franchises in that state.

When you speak with anyone who is interested in buying a franchise from you, you must provide that person with a copy of your **UFOC**, and wait for a prescribed period of time before signing a franchise agreement or accepting any money from the person. This is to allow the interested person an opportunity to become fully and properly informed about your franchise before making a decision to become a franchisee.

Many states also have laws that apply specifically to franchising. In many cases those laws set standards for the termination or non-renewal of franchises or otherwise regulate the franchise relationship.

Many states also have franchise laws that apply to specific industries, e.g. beer and wine distribution franchisees, farm equipment distribution franchisees, etc. Your attorney should be familiar with the individual state registration requirements, as well as the individual laws that apply to each state in which you do business.

9. How long will it take me to franchise my business?

Once you assemble the information for your initial written responses to the twenty-three questions discussed above, and have these reviewed by your attorney, you should be able to have your **UFOC** prepared for filing with the Federal Trade Commission within one to two months. You can then begin to register your franchise, as required, in those states where you intend to offer franchises. Different states have different procedures. There is no registration requirement in many states, including North and South Carolina. Those states have no requirement, or only require that the UFOC documentation be filed with the appropriate state agency, e.g. secretary of state. Registration in states such as New York, Wisconsin, Virginia, Maryland, Connecticut, Florida, Minnesota, etc. can be expected to take from two to six months to complete. Other states

generally take from one to two months to complete the registration. Therefore, once you decide to go ahead with the franchising of your business you should expect that it will take anywhere from four to twelve months before you will be able to offer franchises for sale, largely depending on the states where you want to sell your franchise.

Of course, you will also have to put together an **OPERATIONS MANUAL** outlining the business operation and systems to be followed by your franchisees. You will also have to develop the structure for your franchise operation which should include a training program for the franchisees you accept. The time this takes will depend upon your commitment to developing a successful franchise system that is beneficial to not only you as the franchisor, but to your franchisee network as well.

10. How much should I expect to pay to set up a franchise system?

Costs can vary widely. In part, these costs will be based on the type and the complexity of the business you want to franchise, and whether or not you want to proceed with franchising gradually or rapidly. Many of these costs will depend upon the budget that you develop for training, personnel, advertising, accounting, trademark development, market research, and the requirements of the state(s) you want to do business in. Legal expenses relating to the development of the **UFOC** and other franchise documents, registration of the franchise in several states, and rendering of general legal advice concerning the development of your franchise system generally are between \$15,000 to \$30,000. To a considerable degree, legal expenses will depend upon the assistance you provide in creating the legal compliance documents. You should discuss fees candidly, and have a written fee agreement with the attorney handling your franchise matters.

11. Should I have a business plan?

A business plan is **absolutely essential** to every business, whether it intends to become involved in franchising or not. When you are considering franchising, however, you are looking to expand your business, oftentimes at a very rapid rate. Therefore, the development of a full business plan **before** embarking on your franchise venture is **absolutely essential**. Your initial responses to the **UFOC** questions (discussed above) will provide you with an excellent conceptual business plan regarding your franchise system. As a further step, it is essential that you also create a business plan for the intended geographic growth and financing of your franchise system. This plan must include a financial *pro forma*. You may very well find that you depart substantially from this business plan once you begin actual implementation of the franchise, and that modifications are required. However, without an initial plan you will have no direction whatsoever, and the likelihood of your being successful in franchising will be diminished.

12. How do I promote and sell my franchises?

When you initially consider franchising as a method of expanding, you should also consider the group or type of people you will be targeting for your franchised business. Based upon your identification of that prospective franchisee group(s), you should develop a marketing plan for your franchises that will allow you to reach them. For example, if you are putting together an educational franchise system, it is likely that teachers and others involved in education will be a primary "target group" for you. You can then select various educational publications that will give you access to this group for marketing purposes. It is also possible to obtain mailing lists that contain the names and addresses of people involved in your "target group(s)."

There are also numerous trade shows where franchisors exhibit their franchises. These shows occur almost every weekend throughout the nation. Information concerning dates and locations of these franchise shows can be obtained from the International Franchise Association, Washington, D.C. or the Blenheim Franchise Shows, Winter Park, Florida. Prospective franchisees regularly attend these shows looking for business opportunities.

Franchise opportunities are also regularly listed in monthly publications such as "**Success**" and "**Entrepreneur**." Approximately 3,000 to 4,000 franchises are also listed in "**The Franchise Annual**," which is published each year. You should be able to get a copy of that publication at your local library, or directly through the Info Franchise News, Inc., 728 Center Street, Lewiston, New York, 10492, telephone (716) 754-4669. Franchisors list their franchise opportunities, with brief descriptions, within "**The Franchise Annual**."

Finally, you can enlist the services of business sales agents that regularly recruit franchisees as part of their ongoing businesses. The fee charged for these services is generally a percentage of the franchise fee charged to the franchisee.

13. How do I decide what my franchise fees and royalty amounts will be?

This is probably the question most asked by people interested in becoming franchisors. There is really no set rule. The initial franchise fee, as well as the continuing royalty amount (a % of gross sales, generally paid monthly or weekly), must be determined by looking at what your competitors, if any, are charging, and by considering "what the market will bear." **Most importantly**, both your franchise fee, and your continuing royalty amount, must be set at levels that are **reasonable** and in good faith, and that will allow the franchisee a reasonable opportunity to develop a successful franchise. **It cannot be overemphasized that your long term interest as a franchisor depends entirely upon your ability to obtain quality franchisees, and to thereby develop a strong franchise network.**

If you look through "**The Franchise Annual**" you will notice that franchise fees and continuing royalty payments vary considerably. You should examine the industry category where your franchise belongs, and review the franchise fees and royalty amounts charged by those you believe will be your competitors. You must take into consideration the fact that you are offering a new franchise and,

as a result, might not be able to charge as much of a franchise fee now as you think you might be able to charge in the future.

Especially when it comes to determining the continuing royalty amounts, you should make your decision very carefully. You can alter the initial franchise fee you charge in the future, but the royalty amount you set now will be the royalty amount that you will be required to live with for a long time. The royalty amount is much more important than the franchise fee since it represents the cash flow you will be receiving from that franchisee for years to come.

14. In developing my franchise, what "pitfalls" must I avoid?

(A) Do not try to "get rich quick" by offering franchises at inflated amounts with inflated royalties. As we said earlier, the **long term** health of your franchise system **as a whole** will determine whether or not your franchise succeeds or fails. If you try to maximize your own profits at the expense of your franchisees, you are doomed to failure.

(B) Provide adequate training and continuing assistance. The training that you provide to your franchisees regarding your franchise system and operational requirements will be absolutely critical to their success. This training cannot simply be a "one shot" affair. Continuing training sessions will be required, along with continued monitoring of the satisfactory performance by franchisees of your operational requirements. You must work as a team with your franchisees. Franchisors who create a "them versus us" mentality will almost certainly fail.

(C) Do not make inaccurate or incomplete disclosures in your **UFOC**. Franchisees **will depend upon** the information they receive from your **UFOC**. If that information is inaccurate, incomplete, or misleading, or if you fail to provide the services or products you tell franchisees at the outset you are going to provide, you will almost certainly face a very unhappy group of franchisees. This will, once again, greatly reduce your opportunity to develop a strong franchise system.

(D) Be sure to maintain standards of quality. Your failure to require that individual franchisees comply with your quality standards will reflect on your entire system, not just on that individual franchisee. Consistency is the hallmark of a good franchise system. Therefore, standards of performance must be fairly and uniformly applied to everyone.

(E) Do not allow non-compliance with monthly/weekly royalty payment obligations. You must have a designated form for royalty reporting, and require that all royalties be reported and paid **on time**. Allowing franchisees to deviate from your royalty reporting requirements will surely spread rapidly, and will result in significant problems for your franchise network.

(F) Do not forget to communicate with your franchisees. Your franchisees must feel that they are part of your franchising "team". You must keep them fully informed regarding your growth and development plans for your system as a whole. If you fail to do this, they will perceive themselves as single entrepreneurs rather than as an integral part of a dynamic franchise system in which they can take pride.

15. What final thoughts do you have about obtaining assistance if I want to get involved in franchising?

While a thorough understanding of the concepts discussed in summary form in this booklet is extremely important, it is equally important to obtain experienced and knowledgeable professional help to assist you in developing the franchise concepts you are considering. Franchising is an area that has its own methods, nuances, and realities. Experienced professional assistance is absolutely imperative to ensure that you will have the best possible opportunity for success in your franchising venture.

We hope this information helps you. It is important to understand that you need the assistance of professionals who are knowledgeable in the field of franchising in order to make the decisions that are necessary to determine if you should proceed with franchising your business. If we can be of further assistance to you, please contact us by phone or e-mail at your convenience to schedule a conference.

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