Is Franchising The Right Model For Your Client's Business?

By Barry Kurtz and Bryan H. Clements

Barry Kurtz

Bryan H. Clements

When you think of franchising, what businesses come to mind? McDonalds, Burger King, Taco Bell, or Dunkin' Donuts, maybe? Everyone knows that fast food restaurant concepts are well suited for franchising. If you think about it a bit more, you might think of some of your favorite casual dining chains such as Denny's, Red Lobster or Applebee's. Why not? Casual dining restaurant concepts are also well suited for franchising. What about fine dining restaurants? Many of us enjoy dining at Benihana and Ruth's Chris, but not everyone recognizes that these, too, are successful franchises.

Franchising is a flexible, tried and true method of distributing products and services, and offers business owners an alternative avenue upon which to expand their already successful businesses. While most people have a general sense of the structure of the franchise model, particularly because of their first hand experience dining at a fast food restaurant, few realize the breadth of businesses that successfully employ the model, despite their interaction with these businesses on a daily basis.

Some businesses that are commonly franchised include accounting businesses, insurance and tax preparation businesses, frozen yogurt businesses, children's clothing store businesses, flower shop chains, gasoline stations and weight loss clinics. Some less common, yet innovative examples include custom closet design businesses, 1 800 plumbing related businesses, pool cleaning businesses, pet supply and pet grooming businesses, beer and wine distributorships, golf and tennis training programs, health care clinics and senior care facilities, art stores, pest control businesses and janitorial businesses. The possibilities are endless!

Business lawyers must keep in mind, however, that franchising is not right for all businesses, nor is it right for all of their business owner clients. Franchises are highly regulated, and starting a franchise requires the investment of a lot of heart and soul, as well as a lot of time and money. Keep in mind: selling franchises is a totally new and separate line of business. For example: after selling her first franchise, the owner of a bedbug remediation service is no longer *solely* in the business of pest control; she is now in the business of selling franchises, too. To be successful, she will not only need to be able to sell the concept, but she will need to comply with all applicable laws and regulations relating to the sale of this type of investment, which is likely to be something that is outside of her, and frankly her business attorney's, wheelhouse. For these reasons, attorneys advising business owners must help their clients do their homework before deciding to franchise. This starts with helping them understand what by law constitutes a franchise and what steps must be taken before the business owner may offer the concept for sale. After that, the attorney and business owner should evaluate whether the business owner's particular business would be right for franchising.

Franchising is regulated at the federal level by the Federal Trade Commission (FTC). In addition, many states have enacted franchise specific laws, and 13 states require franchisors to register before offering franchises within their states to provide additional protections to potential franchisees. These "registration states" have taken the position that franchise arrangements provide a greater potential for fraud, noting that franchise agreements are typically drafted by the franchisor's attorneys and usually favor the franchisor substantially. It is true that franchisees have little power to negotiate franchise agreements.

Franchises are broadly defined. Many unsuspecting businesses that have licensed their trademarks and marketing plans to others without providing the required disclosures, or registering as a franchise in one of the "registration states," have been found to be franchisors in violation of federal and state law.

Under California law, a business relationship is a franchise if:

• The business will be substantially associated with the franchisor's trademark;

• The franchisee will pay a fee, directly or indirectly, to the franchisor for the right to engage in the business and use the franchisor's trademark; and

• The franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

Before offering franchises, the franchisor will have to work with his or her attorney to prepare a franchise disclosure document (FDD) that complies with the FTC's Franchise Rule. An FDD is an offering prospectus, written in plain English, that provides prospective franchisees with information pertaining to 23 specific items about the franchisor and the proposed franchise. The FDD must include, among other things, background information about the franchisor and its executives, fee and cost information, samples of the contracts franchisees will sign, and information about the franchisor's trademarks and patents. Franchisors will also need audited financial statements to include in its FDD. The FDD will have to comply with the laws of any of the "registration states" in which the franchisor intends to sell, as well, and the franchisor must register in those states before selling.

In addition to preparing an FDD, the franchisor will have to prepare operations manuals and establish an initial training program before it can sell. The operations manual is a detailed reference tool designed to guide franchisees in implementing the franchisor's "system" on a day to day basis. The manuals typically provide the franchisor's trade secrets, such as recipes and marketing information. The franchisor will then need to set up an initial training program which requires that it have a facility at which it can train new franchisees before they open their doors. The franchisor's system, as laid out in its manuals, the initial training and the right to use the franchisor's trademark are the "meat and potatoes" of what the franchisee is paying for.

Preparing an FDD and registering to sell franchises in the various "registration states" can be a costly and time consuming process. Because of this, attorneys advising business clients interested in licensing and selling their business concepts should be aware that a few alternatives exist. For example, some businesses may qualify for one of a few franchise exemptions, but the availability of any particular exemption varies widely among jurisdictions. Keep in mind, though, that some exemptions relieve the franchisor of both registration and presale disclosure requirements. Others merely relieve the franchisor of registration. Further, many require the franchisor make a notice filing with the state before the franchisor makes an offer or sale. Therefore, exemptions are only useful occasionally.

Qualifying your client's business as a "business opportunity" ("Biz Opp(s).") is another alternative to the burdensome registration and disclosure requirements involved in franchising. Biz Opps. are known as "seller assisted marketing plans" in California, and 26 states have laws regulating Biz Opps. A commercial arrangement is a Biz Opp. under the FTC's Business Opportunity Rule if:

• The seller solicits a purchaser to enter into a new business; **and**

• The purchaser makes a required payment; **and**

• The seller states or implies that the seller or another will:

o Provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled, or paid for by the purchaser; **or**

o Provide outlets, accounts, or customers (i.e. Internet outlets, accounts, or customers) for the purchaser's goods or services; **or**

o Buy back goods or services the purchaser makes, produces, fabricates, grows, breeds, modifies, or provides.

However, like franchise exemptions, Biz Opps. are limited in their usefulness. Many states require Biz Opp. sellers to register in advance of offering or selling Biz Opps. within their states, and the FTC, as well as certain states, including California, require Biz Opp. sellers to provide prospective purchasers with a one page disclosure document and various attachments to give them the information necessary to make an informed purchase decision. In the past, though, Biz Opps. were viewed by many regulators as scams, or fraudulent envelope stuffing schemes. But, the Biz Opp. model is growing in popularity and is now being used by many reputable, and profitable, companies as an efficient means of expanding their businesses.

Once your client is familiar

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with the legal requirements of, and alternatives to, starting a franchise, she should take a good, hard look at her business to decide whether it is right for franchising. Franchisors must be able to sell franchises, so their franchises must be attractive to prospective franchisees. A franchise is attractive if it is based on a concept that is sustainable in the marketplace. Franchises based on fad products or services rarely survive. To be sustainable, the concept must be unique enough to withstand competition and must be one potential franchisees are willing to pay to learn. Explore with your client whether her concept can easily be taught to others. Ask whether the concept is adaptable to varying markets. A chain of exotic dance clubs may struggle due to fierce resistance in many communities and trouble with local zoning laws, whereas a restaurant concept like Hooters may experience greater acceptability from more communities. Other factors you should discuss include laws and regulations that are applicable to your client's particular type of business; whether it is clear the concept will be profitable for both the franchisor and its franchisees; the initial cost of creating the franchise; the length of time it will take to achieve success; the rate at which your client can reasonably expect to expand as a franchisor; and your client's ongoing ability to ensure its franchisees will be supplied with the inventory, supplies and equipment they require to operate.

Consider presenting your client with an example of success, such as Gold's Gym, which started as a local gym catering to bodybuilders in Venice, California and grew to be a fitness franchise giant with over 700 locations worldwide.[1] Gold's Gym's founder saw that bodybuilders in Los Angeles needed a place to work out with advanced, specialized equipment and opened a no frills gymnasium for these serious athletes. He filled his gym with heavy weights and specialized machines that he designed and built himself. Many movie stars, rock stars and other famous Angelinos, including Mr. Universe, Arnold Schwarzenegger, joined the gym, and the company adopted a memorable logo an image of a baldheaded body builder grasping a heavy looking barbell which became its registered trademark. After several years, and several lucky breaks, including having Gold's Gym featured in a famous movie about bodybuilding, Gold's Gym successfully began expanding as a franchise. The Gold's Gym business model works for franchising because it caters to a wealthier clientele and its name and trademark are universally recognized and associated with fitness. The concept has been able to grow and change capturing the latest in fitness trends for over 45 years without impairing its original model. Moreover, its franchise startup costs, operational overhead and inventory costs are likely reasonable so that franchisees, as well as the franchisor, can make money.

Franchising is a proven means for successful businesses to expand, but choosing to franchise one's business is a decision that must be well considered. When your business client seeks your advice regarding franchising, take the time to explain what constitutes a franchise in the various jurisdictions in which she may be interested in offering franchises. Review the costs involved and the steps she must take before offering franchises. Help your client consider whether her business model will be attractive to potential franchisees and sustainable in the face of competition. As a friendly reminder, though, weekend carpenters should not attempt to build skyscrapers. Just the same, business lawyers unfamiliar with the ins and outs of franchising should not try to go it alone when drafting FDDs and franchise agreements. Consider checking with an experienced franchise attorney to help you through the process.

Barry Kurtz, a Certified Specialist in Franchise and Distribution Law by the California State Bar Board of Specialization, is the Chair of the Franchise & Distribution Law Practice Group at Lewitt Hackman in Encino, California. Barry may be reached at 818-907-3006 or at bkurtz@lewitthackman.com.

Bryan H. Clements is an associate attorney at Lewitt Hackman and may be reached at 818-907-3003 or at bclements@lewitthackman.com.

[1] http://www.goldsgym.com/golds/