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Franchising and Licensing  
Two Ways to Build Your Business  
2nd Edition

Andrew J. Sherman

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*This book is dedicated with love  
to my first franchisee,  
Matthew Harris Sherman,  
and to my wife,  
Judy Joffe Sherman.*

*I thank them for their never-ending  
support and patience.*

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## PREFACE TO THE SECOND EDITION

Much has changed since the first publication of this book in 1991.

*Franchising & Licensing: Two Ways to Build Your Business*, now in its fourth printing, has become one of the leading resources for the franchising community. It has been reviewed or referenced in dozens of business publications, used by thousands of franchising executives, referred to by hundreds of business students studying franchising, and read by many professional advisers, both in the United States and abroad.

Despite its many successes, the book needed an overhaul. The Uniform Franchise Offering Circular regulations were significantly changed in 1995, and the regulation of franchising abroad has become more common. The advent of technology has created new challenges and opportunities for franchisors of all sizes and in many different industries. Today's prospective franchisee is wealthier, more sophisticated, and better educated than ever before, thereby leveling the playing field, and has more franchise offerings to choose from than ever before. In fact, strong multiunit franchisees are acquiring franchisors; witness, for example, the purchase of Pollo Tropical by Burger King franchises Carrols Corp, and the acquisition of Bertucci's by N. E. Restaurant Company. Clearly, the rules of the game have changed.

The impact of technology has also been very significant on franchise communications, especially as many franchisor executive teams shift their strategic focus from sales to support (e.g., getting units open versus keeping them open). In many cases, these management teams have shifted from entrepreneurial to executive leadership and are taking a much more systems-driven approach than previously. In addition, Wall Street has stood up and taken notice of the dynamics of franchising, leading to more initial public offerings and mergers and acquisitions within the franchising community than ever before; that, in turn, has led to the advent of the multiconcept franchisor conglomerates such as Starwood Lodging, The Dwyer Group, Yogen Früz

International, Servicemaster, Grow Biz International, the International Center for Entrepreneurial Development, and HFS (now Cendant).

Trends in the domestic and international franchising community are moving so fast that by the time this second edition is published, it will probably be time to start working on the third edition. I have had the honor of working with hundreds of franchisors at many different stages of growth and operating in dozens of different industries. This book is dedicated to their continued success and daily commitment to building the strongest possible strategic and mutually beneficial working relationships with their franchisees.

## PREFACE TO THE FIRST EDITION: CURRENT TRENDS IN FRANCHISING

It would be difficult to imagine a day going by in either our personal or business lives during which we did not interact with a franchised business.

On a personal level, we can buy our homes, cars, food, and clothing from franchised stores and offices. We drop off our vehicles in the morning to franchised automobile service centers and our clothing for laundering at franchised dry cleaners. We plan our vacations with franchised travel agencies and enjoy our vacations and recreation at franchised entertainment facilities and health clubs. We can have our children tutored and our pets groomed at franchised offices nationwide.

At the business level, we can contract for temporary help, cleaning services, printing, accounting, computers, automobile rental, corporate travel, video productions, interior design, coffee and tea, catering, courier services, and even rented mailboxes from franchised companies across the country. We can buy our business forms and business supplies from franchised companies and even have our businesses sold by franchisors and franchisees.

The diversity of products and services offered by franchised businesses has enabled the contractual method of marketing and distribution known as franchising to become a powerful force in the U.S. economy. Franchised sales of goods and services at well over 700,000 locations across the country reached nearly \$850 billion in 1998.

Franchised businesses now account for well over 8 million jobs in nearly 100 different industries. From a global perspective, nearly 800 franchisors have sold franchises abroad, accounting for over 50,000 overseas locations in markets as diverse as Africa, Japan, Israel, France, and the Caribbean. Clearly, the men and women who make up the franchising community have a lot to be proud of.

How does all of this impact on you, the prospective franchisor, key staff member, adviser, investor, or lender of prospective franchisors and currently growing franchise companies? Maybe your thriving small business should think about franchising as a method of growth and expansion. Or perhaps you should consider life as a subfranchisor, master licensee, or single-unit franchisee as a way to satisfy your entrepreneurial appetite. Or perhaps your role as a service provider or product supplier to franchisors and franchisees qualifies you for membership. But each requires a fundamental understanding of the business and legal issues affecting the franchise relationship. This knowledge is crucial if you are to prosper in today's competitive marketplace. As you can see, there are many ways to become a member of this dynamic community.

What has made franchising so popular in the United States? From the perspective of the franchisor, franchising represents an efficient method of rapid market penetration and product distribution without the typical capital costs associated with internal expansion. From the perspective of the franchisee, franchising is a method of owning a business but with a mitigated chance of failure because of initial and ongoing training and support services offered by the franchisor. From the perspective of the consumer, franchised outlets offer a wide range of products and services at a consistent level of quality and at affordable prices.

There are several trends, some good and some not so good, that will affect the growth of franchising in our economy as we approach the new millennium. Among the more positive developments in franchising are:

The typical franchisee and multiunit developer is smarter and wealthier than ever before, thereby leveling the playing field in both negotiation and enforcement. Franchising has gotten more competitive than ever before. There are an estimated 4,000-plus franchisors in the United States alone. A prospective franchisee may have twenty or more different franchisors to choose from in a given industry. Also, more sophisticated companies have looked at franchising.

The Federal Trade Commission (FTC), which regulates franchising at the federal level, has gotten more active in enforcement actions. It brought two times as many actions against noncomplying franchisors in 1995 as it did in all the years since the FTC Rule passed in 1979.

Franchising is being adopted by a series of nontraditional industries; it's not just about fast food and auto services anymore. Growing companies in energy services, healthcare, financial services, and other



regulated industries are turning to franchising, raising a host of new legal issues and challenges.

A focus on alternative distribution channels, such as carts, kiosks, satellite unit seasonal units, and in-store units, has raised many structural issues and triggered territorial encroachment issues as franchisors fight for market share.

The International Franchise Association (IFA) opened its doors to membership franchisees in 1994.

Two new franchisee associations, whose members include franchisees from multiple systems, launched various lobbying efforts at the grassroots levels nationwide.

Franchising has been globalized, with more U.S.-based franchisors than ever launching franchising programs overseas and foreign franchisors penetrating the elusive and competitive U.S. market.

The wide-reaching and controversial Iowa Franchise Practices Act was passed subsequently partially repealed because of its unconstitutionality.

Amendments to existing business opportunity laws in states such as Florida, Kentucky, Nebraska, and Utah have enabled states to more closely monitor franchising activities within the states' borders.

There has been an increase in the number of initial public offerings, private placements, and mergers and acquisitions by and among domestic and international franchisors.

There is a new emphasis on the role of the franchisee in the franchisor's decision making and planning processes through advisory councils, board seats, and the use of telecommunications and computer technologies.

Fortune 500 and multinational conglomerate corporations have entered franchising.

In order to take advantage of the positive aspects of franchising and to reverse negative trends, current and prospective members of the franchising community need to be aware of and respect the key elements of the foundation of a successful franchising program.

A commitment to quality, fairness, and effective communication among franchisors and franchisees should go a long way in reducing disputes among franchisors and franchisees. Current and prospective franchisors must be committed to support and servicing the franchises they sell. Franchisors who develop strategic plans that focus on quantity of franchisees and expansion, rather than on quality of franchisees and training, are surely headed for



disaster. These franchising management philosophies are emphasized throughout the course of this book.

*Franchising & Licensing* has been written for two primary audiences: growing businesses considering franchising and companies already engaged in franchising. For the former, this book explains the key management, operational, and legal issues that are involved in building a franchising program. For the latter, this book examines certain issues that are of continuing concern for franchisors at all stages of development, including such topics as protection of intellectual property, litigation, international expansion, executive compensation, mergers and acquisitions, regulatory compliance, and field support.

This book, however, is not limited to these two audiences. Prospective franchisees and area developers should find it helpful not only in gaining insight into the inner workings of a successful franchisor but also in the evaluation of franchise offerings. Professional advisers of all types who work with franchisors and franchisees should find the material contained here useful and helpful in advising their clients.

*Franchising & Licensing* is divided into five primary parts. Each of the first four addresses the core management and legal issues that are critical in building and maintaining successful franchising programs. Part One, "Management Systems," focuses on the human resources, operations, and quality control concerns that are at the heart of a franchised business. Part Two, "Legal and Strategic Issues," focuses on regulatory and contractual issues, which are of concern to the early-stage and growing franchisor, as well as protection of intellectual property, compliance systems, and dispute management, which are of special concern to the mature and established franchisor. Part Three, "Sales and Marketing Strategies," focuses on domestic and international sales and marketing strategies. And Part Four, "Financial Strategies," focuses on key issues for franchisors at all growth levels, such as capital formation and mergers and acquisitions.

Part Five, "Alternatives to Franchising," explores licensing, joint ventures, distributorships, and multilevel marketing structures, with special focus on the two primary types of licensing: technology licensing and merchandise licensing. Part Five is useful not only for licensing professionals but also for prospective franchisors, who are considering all of the alternative growth-oriented distribution strategies prior to jumping into franchising.



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# PART ONE MANAGEMENT SYSTEMS

## Chapter 1

### The Foundation of Franchising

Over the last three decades, franchising has emerged as a popular expansion strategy for a variety of product and service companies. Recent International Franchise Association (IFA) statistics demonstrate that retail sales from franchised outlets make up nearly 50 percent of all retail sales in the United States, estimated at over \$850 billion and employing some 9 million people in 1997. Notwithstanding these impressive figures, franchising as a method of marketing and distributing products and services is really appropriate only for certain kinds of companies. Despite the favorable media attention that franchising has received over the past few years as a method of business growth, it is not for everyone. There are a host of legal and business prerequisites that must be satisfied before any company can seriously consider franchising as an alternative for rapid expansion.

Many companies prematurely select franchising as a growth alternative and then haphazardly assemble and launch the program. Other companies are urged to franchise by unqualified consultants or advisers who may be more interested in professional fees than in the long-term success of the franchising program. This has caused financial distress and failure at both the franchisor and franchisee level and usually results in litigation. Current and future members of the franchising community must be urged to take a responsible view toward the creation and development of their franchising programs.

Responsible franchising starts with an understanding of the strategic essence of the business structure. As Bob Gappe of Management 2000 has always taught, there are three critical components of the franchise system: (1) the brand, (2) the operating system, and (3) the ongoing support provided by the franchisor to the franchisee. The brand creates the demand, allowing the franchisee to initially *obtain* customers. The brand includes the franchisor's trademarks and service marks, its trade dress and decor, and all of the intangible factors that create customer loyalty and build brand equity. The operating