International Franchise Association
49th Annual Legal Symposium
May15-17, 2016
JW Marriott
Washington, DC

ADVISING NEW AND EMERGING FRANCHISORS ON THEIR JOURNEY TO THE NEXT LEVEL (Legal Hurdles and Opportunities)

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ADVISING NEW AND EMERGING FRANCHISORS ON THEIR JOURNEY TO THE NEXT LEVEL[1]

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Moving from operator to franchisor or from a handful of friends and family franchisees to a legitimate and thriving franchise system requires not-so-equal doses of financial and human resources, tenacity, courage, knowledge and careful planning to avoid the potholes, clear the hurdles, and grab the opportunities that are presented along the way. The list of hurdles and opportunities is limitless. This paper explores some of the major factors that should be taken into account, whether taking the first step or continuing the journey into the next phase of growth as a franchisor.

1. STRATEGIES FOR SUCCESSFULLY GETTING INTO AND STAYING IN THE FRANCHISE WORLD

A. Clearly Define Motives and Both Short-Term and Long-Term Objectives

Franchising initially appeals to many entrepreneurs because of the unparalleled opportunities to expand rapidly while using other people's capital and allocating some of the risks (particularly, start-up risks) connected with the expansion and direct operation of the business. These benefits, however, carry the burden of heavy regulation and the associated costs. Federal and state franchise laws and other regulatory hurdles can be discouraging to would-be franchisors, especially those that are only franchising to generate short-term improvements to the balance sheet. Before taking the step to begin franchising or to expand on what might have already been done, franchisors and would-be franchisors must clearly define their motives for doing so and set both short-term and long-term objectives that will be instrumental in determining everything from how the program is structured to how it's taken to market.

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A number of quality papers, articles and books have been written on this subject. The following is a list of some of them that the authors reviewed in the process of compiling this paper: Kenneth F. Darrow, Mark Siebert and Phyllis Alden Truby, The Structural Elements of a Franchise System and Their Economic and Legal Implications for Start-Up and Existing Systems, A.B.A. 30th Annual Forum on Franchising, Tab W2 (2007); Jim Meaney and Max Schott,II, Starting a Franchise System: Practical Considerations, Planning and Development, A.B.A. 33rd Annual Forum on Franchising, Tab W24 (2010); James R. Conohan, Kevin P. Hein and Cheryl L. Mullin, Starting a Franchise System: Special Issues and Considerations, A.B.A. 23rd Annual Forum on Franchising, Tab W11 (2000); Rocco Fiorentino, Marisa Faunce and Michael Seid, Helping Franchise Systems Succeed: Avoiding the Pitfalls Encountered in the Early Stages of Franchising, Int'l Franchise Ass'n 41st Annual Legal Symposium, Ch. 7 (2008); Kim I. McCullough and Kenneth J. Purvis, Developing a Franchise Program for a Franchisor, CLE International Conference on Franchise Law (2000); DLA Piper US LLP, Expanding a Business by Franchising, (2007); Covenants Against Competition in Franchise Agreements, (Michael R. Gray and Natalma M. McKnew eds., 3d ed. 2012).

First and foremost long-term planning must be driven by the understanding that being a successful franchisor is completely different than being a successful operator. The decision to franchise triggers a fundamental switch in businesses—not only a shift from operator to salesperson and service provider, but also a shift in the customer base of the business. While franchisors draw on the successes created by the units that operate under the brand, the business of franchising requires different skills, different marketing strategies and brand positioning, and different infrastructures. A key business goal must be to add franchise sales and franchisee support as primary business departments.

Second, new franchisors, particularly those that are still aggressively developing company-owned units, often make the mistake of using the existing development and operations teams to do double duty to also support franchisees. With aggressive development on both fronts, that structure typically results in neither side of the development aisle being adequately served. A new franchisor can easily underestimate the added pressures on its current employees. While leveraging existing infrastructure might be the most pragmatic starting place, long-term franchisors should plan to implement changes in the training, marketing, accounting, real estate, construction, and operations departments and their employees. Perhaps new departments will need to be added. Perhaps some tasks will be outsourced. Regardless this must all factor in to the long-term plan.

Third, long-term objectives should be crafted with the franchisor's industry in mind. Will franchising give the business a leg up on competitors? How? There are a number of industries where the risks and rewards of franchising simply do not make sense as the owner can be more profitable distributing through other channels. Consider looking at competitors that are already franchising. Competitors' Franchise Disclosure Documents ("FDDs") provide significant assistance here. Several states (currently California, Wisconsin and Minnesota) make filings available at no charge via the state's website. Where a competing franchise system has either not applied to register or is exempt in those states, past and current FDDs are available from private vendors like FRANdata or UFOCs.com. Looking at historical data from other franchised businesses can help emerging companies clearly define what they want to accomplish and how.

Finally, the long-term objectives for franchising should be driven by the variables inherent in the business itself—how it is currently structured, how it has expanded and wants to grow, how it is using and wants to use the trademarks, how it has built teams, how it has sourced products, and how it has developed proprietary material (like operations manuals). Good franchisors have success in these areas as business owners / operators and their key driver in entering the world of franchising is to share the business and systems that they have already developed and proven with others.

B. Budget for the Initial and Ongoing Costs of Creating and Maintaining a Franchise Program

Commencing a franchise program requires the prospective franchisor to invest in a few key areas. The costs of developing a franchise business plan, preparing an FDD and franchise specific agreements, marketing, and recruiting and paying new personnel (for example, sales people) are likely to be significant. There are certainly ways to cut corners—like having the FDD prepared on the cheap—but these "cost saving" moves can be very expensive in the long run. Early bad decisions such as failure to vet the concept or protect the intellectual property can hamstring a franchisor and its franchisees for years. Thus, in most cases, it is advisable to expend the often significant sums to launch a franchise program the right way.

Fortunately, new franchisors have access to numerous resources in getting their programs off the ground. Lawyers, business consultants, and financial advisors often collaborate in the initial formulation of the program and in the documentation and adaptation of system standards and processes (including, for example, the operations manual). It is essential that new franchisors frankly assess the professional service fees these groups will charge and establish an overall budget. This is important not only for determining how much capital is needed, but also for the ultimate decision of whether or not franchising makes sense.

A good place to start is in assessing the current relationships of the business. Who are the current professional advisors and their experience and expertise in franchising? What are the skills of the management? What relationships does the company have with vendors and suppliers? Look for ways to leverage existing relationships and expertise to assist in the process. For example, if outside counsel is experienced in franchising, he or she can often provide insight on some of the business decisions that new franchisors must make.

As the budget will be determined in part by what is already in place, it also makes sense to review the current business plan, the current operational structure, and the status of all intellectual property licenses and registrations. In particular, if the intellectual property is not protected, there will be a significant outlay of cash to do so prior to franchising the business.

It is also worthwhile to do an early assessment of the current financial statements. If additional statements are needed to franchise or if the financial statements need to be audited, the cost of disclosure will rise. Likewise, the current state of the financial statements might affect the analysis of whether a new entity should be formed to act as the franchisor or to deal exclusively with franchise operations. A franchisor must have sufficient funds to protect its proprietary system and to prepare the documents necessary to allow it to offer and sell franchises.

i. Legal Advisors

Budgeting for good legal advice early on is key to avoiding huge compliance problems and costs down the road. As franchising is heavily regulated, there are several components of legal advice for which every new and emerging franchisor should be prepared to pay.

Perhaps most significantly, legal advisors must be retained to ensure compliance with the state and federal laws applicable to the offer and sale of franchises. Generally, these costs include the preparation of the Franchise Disclosure Document and an evaluation of the availability of exemptions from the FTC Rule and the various state franchise registration laws. Ensuring legal compliance can be costly because the attorney must evaluate the exemptions available in each state and review state business opportunity laws. And the actual filings with each state require funds for state filing fees, copies, delivery, and possibly responding to comment letters from state examiners.

Notably a portion of these costs is reoccurring, as franchisors will need to revise their FDDs as material events happen (as is often the case with new or less mature franchisors and franchise systems) and to renew their FDDs and state registrations annually for as long as they continue to offer and sell franchises.

Another integral part of the legal work involved in preparing the FDD is the preparation of the legal agreements needed to launch the franchise system—such as the franchise agreement (which is included as an attachment to the FDD), area development agreements, intercompany agreements (see below), software licenses, and vendor agreements. The budget should at least include the preparation of standard contracts, including the franchise or license agreement, guaranties, confidentiality agreements, leases, and software licenses. In addition, many franchisors have their counsel prepare contracts related to financing, credit cards, and other services required for the operation of the franchised business.

Similarly, if the franchisees will be required to contract with designated third-party vendors or suppliers, the legal budget should include the cost to draft or review those documents. And if the franchisor does not have an in-house legal team, outside counsel may also be called upon to negotiate with those third-parties.

Many startup—and some seasoned—franchisors overlook the legal expenses related to promotion of the franchise system. Franchise counsel should review the franchisor's website and other promotion material. Likewise, sweepstakes, coupons, giveaways, and contests all raise their own legal issues.

Where businesses already have attorneys for issues like trademark protection, employment, and litigation, money can be saved by having franchise counsel work directly with those attorneys to avoid duplication of effort.

Legal costs can vary considerably franchisor to franchisor and attorney to attorney. Best practices dictate that, consistent with the overall budget, the attorneys have leeway to tailor documents to each client and produce quality work. Cost sensitive franchisors may consider tailoring their growth plan to conservative targets or seeking flat or capped fee arrangements.

ii. Financial Advisors

Franchisors should plan to involve their financial advisors early in the franchise process. As an initial mater, it is essential that a franchisor's financial advisors understand franchising or are willing to learn. If not, new advisors should be retained.

In most cases, audited financial statements must be included in the FDD. Franchisors will thus need to budget for the preparation of this initial audit. The FTC Franchise Rule and some states do allow for the phase-in of complete sets of audited financial statements. Even still, this deferral should be discussed with a financial advisor, so that costs that cannot be avoided might be minimized.

Some franchisors-particularly those that are part of a much larger enterprise-might elect not to have stand-alone financials and, instead, rely on the consolidated statements of their parent. While that is permitted under the relevant franchise rules and regulations, those entities will be required to guaranty the obligations of the franchisor, so franchisors should discuss with their financial and legal advisors the risks and rewards of using the audited financial statements of their parent or an affiliate. The lack of stand-alone financials might also complicate the franchisor's ability to take advantage of exemptions that are based on the franchisor's having a certain net worth.

Emerging franchisors might also plan to use their financial advisors for work related to additional FDD disclosures, such as Items 5 (Initial Fees), 6 (Other Fees), 7 (Estimated Initial Investment), 8 (Restrictions on Sources of Products and Services), 10 (Financing), and 19 (Financial Performance Representations).

And, for the founder, there will often be financial services fees associated with long-term financial planning and analysis, such as planning for expansion of services, new employees, and the founder's ultimate exit from the business.

iii. Franchise Experts/Consultants

Franchise consultants offer a variety of services to new franchisors, including such critical tasks as drafting operations manuals, program development, development of marketing strategies, development of training programs, writing software, brokering sales, and structuring advertising programs. Depending on the business to be franchised and experience of the franchisor and its lawyer, some consultants' advice may be essential or some may be redundant. It is important to evaluate what consultants are necessary and build the associated costs into the budget.

Most franchisors should expect to incur costs for the development of various strategic plans and tools that it will use in the franchise system. In particular, franchisors must determine how they will develop and pay for an operations manual, training program, marketing material, and other pre-opening services that must be provided to franchisees.

As an example, the operations manual lays out the system's procedures, standards, and specifications. Item 11 of the FDD requires franchisors to disclose the table of contents of the operations manual (or offer the prospective franchisees the opportunity to review the manual), so it presumes that the franchisor has a manual prepared. Although the process can be daunting, having the franchise system's infrastructure defined is essential to maintaining brand integrity once franchising begins. In the process, it is critical not to oversell in the FDD the condition of the operations manual if it remains in development. Disclose what is there as of the issuance of the FDD and note that it is still being developed if that is the case.

Likewise, franchisors should plan to invest in developing a training program. Any system that wishes to duplicate itself must be able to train others in how to implement the system's elements. Training programs allow for uniformity—a key element to almost all franchise system. So franchisors should plan to expend resources to organize and prepare this program.

iv. Trademark Registration and Ongoing Maintenance and Protection

Trademark protection should precede a franchise program. A startup budget must include the fees and expenses necessary to protect intellectual property if available protections have not been obtained. Trademarks, service marks, trade names, logos, and symbols or other indicia of origin are the hallmark of a brand, and the success of a franchised system depends on their remaining exclusive to the franchisor and its authorized franchisees.

Before considering franchising, a business should search the United States Patent and Trademark Office website for pending and registered trademarks similar to the marks it is using or intending to use. This searching can be conducted through the Trademark Electronic Search System or TESS, and it is fast and free. What it isn't, though, is the end of the investigation. Because US law bestows ownership of a mark on the first to use it (or the first to file an application indicating its intent to use), franchisors are well served by incurring the costs of a comprehensive search conducted by an outside vendor that will reflect any prior and existing users who might have superior common law rights in and to the mark. Copyrights can also be searched through the United States Copyright Office website.

The franchisor should plan on paying for its attorney to review the search results to determine if its marks are strong and not being used by other parties. After the search and analysis is complete, the attorney may advise to broaden the protection that

the franchisor might have already established by filing additional registration applications in additional classes of goods and services.

Long-term, the franchisor should plan to maintain the registrations of the marks, docket key action dates (for example, dates for filing affidavits of use and incontestability, and filing renewals), and continuously monitor potential infringing uses or attempts to register similar marks. In addition, the franchisor should budget to bring litigation if anyone infringes the trademarks.

v. Risks/Advantages of Using Supply Chain to Help Defray Costs

The supply chain can be a profit center for the franchisor. But, controlling suppliers raises both substantive and disclosure issues. Specifically, designated or approved suppliers must be disclosed in detail in Item 8 of the FDD. The burden is even greater if the supplier is an affiliate of the franchisor, or the franchisor itself.

Substantively, supplier designations have historically raised antitrust issues. Today, if the franchisor can show that its proprietary methods or recipes require a specific supplier, it can most likely avoid liability and justify its designation. Branded merchandise raises concerns regarding if the franchisee is benefiting—for example, through an increase in buying power.

These reasons and others raise serious concerns regarding whether or not a startup franchisor should use supply chain for profit. The better strategy initially may be to control the source of products and services to control quality or for the economic benefit of the franchisees.

vi. Cyber-Security

Another area where franchisors face rising costs is privacy, data, and security compliance. Today, all businesses—franchised or not—face a growing risk of data breach. The instances of breach by hackers and others, such as former employees, are prevalent, and the direct and indirect harm can be substantial. The theft of customer data or confidential and proprietary information can be devastating to a brand by way of reputational harm and public relations costs. Moreover, the economic impact of a breach can be substantial—including liability to customers, defense of regulatory enforcement actions, costs associated with notification requirements, and fines and penalties. In light of this, investing time and money in data security and compliance is critical for all retail businesses.

The risks of data breaches and security non-compliance are complicated in franchise systems as even a simple question like “Who is responsible for the personal information collected, stored, analyzed and shared through the franchise business?” is not easily answered. As with other issues of vicarious liability, customers may seek to hold a franchisor liable for its franchisees’ data-related conduct, particularly when there is significant franchisor involvement or control. As with most risks, insurance against data breaches is available, and franchisors are more and more often requiring their

franchisees include that coverage among the list of required coverages that the franchisee must maintain and under which the franchisor and its affiliates are required to be designated as a named insured.

Franchisors should evaluate the pros and cons of directly controlling or involving themselves in franchisees' cyber-security policies and practices. In doing so, some have concluded that the risk associated with a data breach is so significant that they must reconsider the traditional view on this issue. Accordingly, some franchisors are taking a more active role in developing and implementing data security plans and practices for their franchisees. This, of course, includes costs that must be planned for, such as auditing and inspecting for compliance, and developing action plans if risks are discovered in the audit/inspection process or otherwise. A franchisor who discovers a risk of data breach at the franchisee levels but does nothing to mitigate the risk places itself in a much vulnerable position in respect of claims that might be asserted by consumers harmed if a breach occurs.

Similarly, a franchisor should plan its document management and retention policies as soon as possible. It is significantly easier to take steps early on to identify records and implement consistency across departments.

In particular, it is advisable that franchisors implement document destruction procedures and schedules. Each record should only be retained for a pre-determined period unless a valid business reason (such as a litigation hold or other special situation) calls for its continued retention. In today's ever expanding world of electronic data, it can be incredibly expensive to host data that is unnecessary and possibly harmful to the brand. For example, in the event of a data breach, unnecessary, personally identifiable information is nothing but a liability.

C. Plan in Advance for Evolution

i. Evolution of the Brand

Franchise agreements are typically long-term agreements, and they often present little opportunity for the franchisor to change the terms in the absence of a special event like a transfer or the amicable resolution of a default. These long-term contracts enable franchisees to recoup their initial investments but can also limit a franchisor's ability to respond to a changing competitive environment. For example, franchisors may want to change the system's décor, fixtures, furnishings, building design, menus, service offerings, trade dress, technology, or even the trademarks. These sorts of modifications and improvements can be quite costly and time intensive. Because of this, franchisees may push back or refuse to make the changes. Generally, they do so based on the language in the franchise agreement or on state franchise laws. Franchisors who use long-term contracts must incorporate a certain degree of flexibility to allow for the brand to evolve over time in order to remain relevant and competitive for the benefit of all stakeholders.

While it may seem like a long way off, startup franchisors should plan now for how their brand might evolve and how they might require the franchisee to evolve with it. In franchising as an industry, this concern is becoming increasingly prevalent as established brands mature to the point when rebranding or brand transformation becomes essential to keeping the brand attractive and relevant. Several recent cases suggest that modifying key features of a franchisor's brand, such as brand standards, could be difficult. For example in a recent case, Dunkin Donuts Franchising LLC's motion for preliminary injunction based on a franchisee's refusal to remodel was denied because Dunkin could not show that it would suffer irreparable harm as a result of the franchisee's refusal.[2]

This risk can be contained through advanced planning and effective drafting of franchise agreements and disclosure documents.

Indeed, the first thing a franchisor will likely need to do when contemplating a brand evolution is to review all of its franchise agreements to determine its contractual rights to require changes. State-of-the-art agreements contain not only express terms permitting franchisors to modify the system and brand standards, but also mechanisms that permit franchisors to respond to unforeseen developments.

One key mechanism for modifying the brand and implementing changes is through the operations manuals. Thus, new franchisors are well advised to consider including a provision in the franchise agreement that requires the franchisee to comply with the mandatory provisions of the operations manual.

Best practices dictate that items that may change over time are better suited for the operations manual than the franchise agreement, simply because the operations manual is more flexible. Thus, system standards and specification regarding décor, uniforms, vehicles, required branded material, and like are generally included in the manual and not the franchise agreement.

Startup franchisors should consider defining the "operations manual" broadly in their franchise agreement to include more than just one set of material provided by the franchisor. That way a brand update could be implemented as an amendment or supplement to the manual without re-printing or re-distributing the entire operations manual.

Notably, franchisors may not modify the express terms of their franchise agreements through revisions to the operations manual. So, in drafting the franchise agreement, the franchisors should consider issues like timing and cost and address them if necessary. For example, a franchisor may want to answer—or may want to avoid—the following questions through provisions of the franchise agreement:

- Will the franchisor limit the type of upgrades required?

[2] *Dunkin Donuts Franchising LLC v. Claudia III, LLC*, 2014 U.S. Dist. LEXIS 110365 (E.D. Pa. Aug. 11, 2014).

- What types of “upgrades” are allowable? Words like “remodel,” “modernize,” “improve,” “repair,” and “modify” can have very different meanings if a franchisee were to sue to oppose a specific change.

- Does it make sense to require corporate locations to implement changes before the franchised ones? If the system is franchisee-heavy, that restriction may make sense.

- Should the franchise agreement address or cap costs? Should the franchisor at least commit to consider the costs?

- Will the franchisor limit the number of times improvements can be required during the life of the agreement?

- Will there be a grace period toward the end of the franchise agreement when no changes will be mandated? For how long?

- Will notice be required? Will that contain a deadline for implementation?

- Will franchisees be given a reasonable or fixed period of time to comply?

In most instances, a franchisor will reserve in the franchise agreement rights not explicitly granted to the franchisees. In certain cases, the franchisor may want to state what those rights are (such as the option to expand to non-traditional locations like airports or offer branded products in stores).

Startup franchisors might also consider agreements with a term of 5-10 years rather than 15-20 years. A shorter term agreement generally gives a franchisor greater flexibility to require changes to system standards upon renewal of the contract. Franchisors typically determine the length of the contract based on the amount of the initial investment, so a shorter term for something like a QSR concept is particularly reasonable.

Finally, the disclosure documents should be drafted in conjunction with the franchise agreement and operations manual to address the issue of brand evolution. Franchisees should know up front that the brand and system may change, and that they are required to comply with system standards and specifications notwithstanding.

ii. Evolution of the Franchise Program and Strategies

1. Selecting High Potential Franchisees in the Right Locations

Selecting the right franchisees for the system requires the franchisor to answer some important questions: (1) What kind of experience is necessary or most desirable in a franchisee candidate to run a franchised business? Is that experience focused on a particular industry, business management skills or educational background? (2) What are the financial qualifications? Net worth of the individual(s), personal financial history,

financial history of prior-owned businesses, banking relationships, and access to working capital. (3) What is the prospective franchisee's reason for wanting to buy this franchise? Current or past franchise experience is relevant information. (4) Desired location or territory and whether the prospect is interested in developing multiple locations, or a larger territory.

Asking a new franchisor to draft a franchise application for prospective franchisees early on in the process of structuring a franchise system is instructive because it forces the franchisor to identify the key requirements for a qualified franchisee candidate. Going through this process often results in the new franchisor realizing that there are criteria like industry experience and a positive outlook that are more important than net worth that will help determine the best franchise candidate.

Counseling a new franchisor to be selective in choosing its franchisees is a key part of an attorney's role in advising a start-up franchisor. Often a new franchisor is anxious to make a sale to the first candidate who promises to pay the initial fee; this can be a big mistake. If the first group of franchisees are not well qualified and do not become successful franchise operators, the franchisor will find herself having to explain why they were terminated or left the system (as disclosed in Item 20) or why they are giving the system a bad review when contacted by prospective franchisees. The first group of franchisees can be the best ambassadors for a new franchise system going forward.

Planning the geographic expansion of a new franchise system is important to the health of the system and should not be overlooked. Granting franchises in select regions – and only in those regions -- can be vital to the establishment of the brand and building a loyal customer base. If franchise locations are scattered in different states, new franchisors are often not able to adequately support the franchisees, putting the entire system in jeopardy. Franchise attorneys should question a new franchisor's request to register in all of the registration states 'just in case' a prospective franchisee presents himself from one of these states. The franchisor should be encouraged to employ a slow, measured growth strategy and resist the temptation to sell to a distant relative three states away. Costs related to travel and staffing can be minimized if stores are clustered together. Likewise, marketing programs will be easier to implement and less expensive if they are targeted to a particular region.

A regional approach may not work for all types of franchise systems, however. If a particular retail store will only work in locations with a high concentration of tourists or in outlet malls with extremely high foot traffic, for example, then only a few locations may be available in some regions. National expansion may be appropriate in the early planning stages for more aggressive and well capitalized franchise systems as well.

2. Building and Maintaining Franchisee Relationships/Franchisee Advisory Councils

New franchisors should treat a potential franchisee like a potential business partner, because the well-being of the franchise system depends on the performance of both the franchisor and its franchisees. Beginning with the first prospective franchisee meeting, a new franchisor should look for a person who will bring enthusiasm and a cooperative attitude to the franchisor-franchisee relationship. A positive attitude toward customers and toward the franchisee's own employees are characteristics of many successful franchisees. An ability to work with the franchisor for the benefit of the entire system is key to building and maintaining good franchisee-franchisor relationships. Most franchisors interview prospective franchisees in person more than once before awarding a franchise in order to gauge that person's personality. Some franchisors use standardized personality tests to determine whether a person is suited to be a productive franchisee.

Once a franchise system achieves a certain size, often when there are 25-50 franchisees in different regions, many franchisors establish franchisee advisory councils or FACs. FACs are usually comprised of a representative group of franchisees from different geographic areas and often one member of the franchisor's management. Franchisors may appoint the franchisee members or they might be elected by a group of franchisees from a particular region to represent them on the FAC. Elected member FACs often have more credibility with the franchisees than those with franchisees who are appointed by the franchisor. The franchisor should establish criteria for a franchisee to be eligible to participate in a council, including number of years in the system, number of franchised units owned, etc.

The purpose of the FAC is to involve the franchisees in the franchisor's decision-making process, typically in decisions related to advertising and marketing pieces used by the franchised businesses. Franchisee advisory councils also serve as sounding boards for the franchisees to communicate issues and concerns to the franchisor about a variety of topics, however, including operations or procurement. Franchisors may even form multiple FACs, each one with a specific purpose. It is important that whatever the purpose of the FAC, decisions are made by the FAC after receiving feedback from the franchisees and that consideration is given to different viewpoints expressed by franchisees. If the FAC is seen as a rubber stamp for the franchisor's decisions, it will lose credibility with the franchisees.

iii. Evolution of Growth Strategies

For many new franchisors, seeing beyond the first few franchise sales is challenging. The prospect of growing to 50 plus units or expanding internationally seems daunting and like a problem to be conquered another (later) day. But, long term growth strategies, like so many parts of a franchise system, are best mapped out well in advance, and maintaining agility to shift focus between franchise and company development can be key to the longevity of the system as unit-level economics, the

ability of the company to fund infrastructure, and development philosophies change over time.

The easiest place to start is with an analysis of what the initial growth plan will include. For example, new franchisors should decide which methods of development they will utilize—single unit, multi-unit, master franchising, or development agent. They should consider how many units will be developed and how many of them will be franchised versus corporate-owned. From there, consider the schedule for that development and how internal infrastructure and staff will need to grow and change to support it. Finally, it is essential to consider how the franchisor will obtain capital to finance its growth strategy.

Once the initial plan is formalized, it is easier to consider how that plan may change over time and figure out the pressure points. A franchisor may realize for example that it only wants to grow the business to a certain point before taking it public or bringing in private equity. Regardless of what the future holds, franchisors will need to be flexible, and there are four commons ways new franchisors can prepare early on to face whatever growth challenges or market developments lay ahead.

First, hire an excellent management team with franchise experience. This is perhaps the single most important factor to a franchisor's future success. Good management possesses the skill and adaptability to respond to changing market and competitive circumstances. They will ensure funding is available by controlling capital expenditures and raising new capital if necessary. This skill allows a franchisor to grow more rapidly if necessary.

Franchising differs from running the core business, so new franchisors should prepare to hire managers and staff (or train existing employees) regarding the new responsibilities related to the franchise system. For example, franchisors should plan for who will be responsible for franchisee training, advertising fund management, franchise marketing, franchise sales, lead handling, providing assistance to franchisees, and real estate selection. As growth escalates or changes to new markets, a franchisor will quickly find itself unprepared if it does not have a plan—and a budget—to support these staffing needs.

Second, all franchisors should keep accurate records. It sounds simple, but many new franchisors do not put systems in place early on to track FDDs and agreements. This creates a huge risk down the road whether in the context of litigation, a sale of the company, or just plain continuity. For example, any franchisor looking to attract private equity must be able to produce, among other things, its full slate of historical FDDs and registration information, complete copies of its franchise agreements and FDD receipts, amendments, copies of leases and critical communications between it and its franchisees to facilitate the private equity's due diligence on things like continuity of the system (expiration dates of franchise agreements and lease, franchisee defaults), disputes, vendor arrangements, and employment-related issues.

Third, successful growth strategies require good research and preparation. The costs and risks of venturing into a new market can be substantial. Thus, a franchisor can prepare early on by learning the laws and regulations that affect its operations, the contractual controls in its franchise agreement that allow for system uniformity, and the practical aspects of the business such as providing marketing and operational support. Franchisors that impulsively change growth plans in response to perceived "can't miss" opportunities often end up less viable than systems that grow through careful and thoughtful analysis.

One area of fruitful research is competitors. Franchisors can examine the ease or difficulty with which others in their industry have duplicated the concept to new markets or adapted the growth strategy depending on the size or market penetration of the brand. Here, franchisors can also examine the current and future demands for their products and services. Is the market becoming flooded? Is the core service a fad?

Franchisors might also prepare for growth by keeping a watchful eye on the strength of their brand, including the trademarks and other critical intellectual property. This analysis also involves examining whether the core of the brand will translate to new markets, particularly international ones. United States franchisors are well advised to develop and test the brand and systems domestically before expanding internationally. This allows for adjustments to achieve acceptance of the brand's products and services by new consumers with different expectations and preferences.

Capital must also be part of a franchisor's preparation for growth. Only with adequate capitalization will a franchisor be able to seize on the proper growth opportunity when it's presented. New franchisors should educate themselves early on about the sources of capital available and begin to build relationships for the future. Similarly, franchisors must be diligent in ensuring good unit economics and return on investment for franchisees. This will attract capital when needed. In addition, successful company-owned units can be used to test possible changes and prove their worth.

International expansion carries its own set of planning challenges. To a large extent, international expansion will depend on the franchisor's strengths and weaknesses, the local partner's strengths and weaknesses, the business opportunity to be franchised, and extrinsic factors over which the franchisor has no control. But franchisors that carefully develop international programs by evaluating the nature of their systems, identifying the extrinsic factors that could affect them, and crafting the best structure for expansion have a better chance of success. The planning will involve developing a profile for an "ideal" business partner abroad and seeking partners that fit the profile. Regardless, new franchisors should develop a business plan that allows time and budget for the necessary analysis and preparation.

Finally, the best advice for new franchisors is to plan to be adaptable. Entering new markets or switching growth strategies will require adaptations. These adaptations

may be fundamental such as adjustments to menus, franchise agreement controls, and logos. At a certain point, no amount of planning and preparation can fully ready a franchise system for finding the right business partners abroad or moving to a primarily franchised from primarily corporate system. Each type of growth carries its own risks and benefits, and no one type is appropriate to every system. There will be legal and operational challenges, so franchisors should develop key relationships with advisors like attorneys and marketing consultants early on as those people will be able to help the franchised business adapt as necessary throughout the life of the brand.

D. Dealing With Legacy (Friends/Family) Franchise Deals and "Unintentional" Franchises Already Granted

New franchisors may have previously tried to grow through non-franchise expansions. In addition to company-owned units, this comes in many forms such as licenses, joint ventures, partnerships, distributorships, or business opportunities. The would-be franchisor might also have made statements or offers on their website about business opportunities or franchise offerings. Any number of reasons can trigger these efforts from the need for capital, business relationship with family, bad legal advice, to pure excitement about the business. Unfortunately, more often than not, supposedly "non-franchise expansions" efforts are arguably franchises sold in violation of federal and state law.

In order to deal with these "franchises" and limit liability, new franchisors must first understand what constitutes a franchise and what activities are prohibited under applicable law.

Franchising is heavily regulated at both the federal and state levels. The Federal Trade Commission has enacted the FTC Rule which defines a "franchise." In addition, fifteen states have franchise registration or disclosure statutes. Twenty-three have franchise relationship laws. And twenty-six have enacted business opportunity laws which may also come into play in the sale of a franchise or other business opportunity. New franchisors must understand that running afoul of these laws can lead to criminal and civil penalties for illegal franchising, plus private lawsuits by "franchisees" that are unhappy with their investments. Thus, it is critical for new franchisors to understand the elements of a "franchise" under the FTC Rule and state law and deal with unintentional "franchises" already granted.

The FTC Rule defines a "franchise" as:

> [A]ny continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:
>
> (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or

distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;

(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and

(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.[3]

The states that regulate franchising have not agreed upon a uniform definition, so each state's definition must be carefully analyzed. Generally speaking, the registration and disclosure statutes of most states consider a franchise to exist whenever a franchisee is granted the right to sell goods or services under a marketing plan or system prescribed (or, in some cases, suggested) by the franchisor in return for a fee, if the operations of the franchisee's business are substantially associated with the franchisor's trademark, service mark, or other commercial system. Note that the fee and trademark elements mirror the FTC Rule. Also, there is no "significant control or assistance" requirement in the state definition, but only the reference to a marketing plan or system. A minority of states look at whether there is a "community of interest" between the franchisor and the franchisee in marketing the goods or services rather than if there is a prescribed "marketing plan or system."

Once the new franchisor understands what it means to be a "franchise," it and its counsel should make themselves aware of all the agreements that could arguably constitute the grant of a franchise, determine which ones are potentially unlawful, and then map out a strategy for dealing with them. This analysis should address:

- How many possible franchises were granted?
- When were they granted? And have the statutes of limitations run?
- Where were they granted? And are registration states involved?
- Are the "franchisees" profitable?
- Was the franchisor aware of the franchise laws and its potential noncompliance?
- Does the franchisor have a history of noncompliance and government actions?

[3] 16 C.F.R. § 436.1(h) (2007).

This analysis is essential because in nearly all cases, non-franchise arrangements will need to be disclosed in the initial FDD, which will naturally be a red flag for state examiners. One strategy for dealing with this is to proactively contact the state examiner to explain the situation and the remedy the franchisor is willing to provide to the "franchisee." A state examiner may show leniency to a franchisor that raises this issue without prompting.

In terms of cleaning up the system, one common tool is to offer rescission to "franchisees" which involves paying any net losses and returning fees. In several states, this strategy will reduce the time period in which a franchisee can bring a claim for violation of applicable law.

The franchisor may also provide the "franchisee" with the opportunity to convert its location to a proper franchise by executing a franchise agreement. Generally, convincing a prior owner to covert requires some sort of concession, such as favorable treatment. That in turn carries the added requirement that the franchisor disclose the deal in the FDD, including the nature of the conversion. Even though this disparate treatment may well raise questions in the sales process, it is beneficial to deal with and resolve "unintentional" franchises early. Letting the issue fester and develop will only cause bigger problems down the road, but timing plays a critical in the decision-making process - whether to do something or sit with fingers crossed waiting for the statute of limitations to expire.

In addition to limiting liability, cleaning up the system early has the added benefits of advancing system uniformity and operational ease. A pieced-together franchise system can cause havoc to the sales process and hamper growth.

2. LEGAL PERSPECTIVES AND IMPLICATIONS OF SHIFTING FROM BUSINESS OWNER TO FRANCHISOR

A. Create Appropriate Organizational Structures

Shifting a business from operator to franchisor requires numerous legal decisions—one of which is how the new organization will be structured. This decision depends on the franchisor's disclosure obligations under the FTC Rule, the logistics inherent in providing services and licensing intellectual property, how to best protect the business assets and avoid liability, and ownership of the company and brand.

i. Choice of Entity

An early decision in crafting a corporate structure is what type of entity or entities will be used to protect the assets and if a change is warranted. Common types of entities considered for a franchise business are sole proprietorships, general partnerships, corporations, and limited liability companies. The core distinctions among these entities are summarized in the table below:

	Sole Proprietorship	General Partnership	Corporation	Limited Liability Company
Definition	A business in which one person owns all the assets, owes all the liabilities, and operates in her or his personal capacity	A partnership in which all partners participate in running the business and share in profits and losses	An entity having authority under law to act as a single person distinct from the shareholders who own it and having rights to issue stock and exist indefinitely	A company—authorized by state statute—that is characterized by limited liability and management by its members or managers
Owners are called	N/A	Partners	Shareholders or Stockholders	Members
Ownership units are called	N/A	Partnership Interest	Shares or Stock. There can be different types (e.g., preferred shares, A-class, B-class, etc.)	Membership Units or Membership Interests. There can be different types.
Managed by	The individual	Any partner can bind the partnership	The shareholders elect a board of directors. The board of directors appoints officers (e.g., CEO, President, Treasurer, Secretary, etc.). The officers manage the daily operations of the corporation. The shareholders and/or board of directors must approve certain fundamental changes (e.g., mergers) or large transactions.	Can be member-managed or manager-managed. Lots of flexibility in how the LLC can be managed. For instance, the members can appoint officers (such as CEOs, president, VPs, etc.). However, there is no requirement that they appoint officers.
Liability	The owner has unlimited personal liability for the liabilities of the business	Each partner has unlimited personal liability for the liabilities of the business	Limited liability for shareholders, even if they participate in management	Limited liability for members, even if they participate in management
Tax implications	Single level of tax; all income and expenses reported on Schedule C of the owner's 1040	Pass-through tax treatment. The partnership files a form 1065 with the IRS, but all income and expenses pass through to the individual partners on a Schedule K-1	S Corp election = pass-through tax (single level of tax). Must file an election with the IRS. C Corp = double-taxation	Pass-through tax treatment. The LLC files a form 1065 with the IRS, but all income and expenses pass through to the individual members on a Schedule K-1

	Sole Proprietorship	General Partnership	Corporation	Limited Liability Company
Formation and governing documents	Nothing to file (unless you want to operate under an assumed name). No governing document.	Don't have to file anything to form the partnership. Partners may create a Partnership Agreement, but they don't have to.	File Articles of Incorporation (sometimes called a Certificate of Incorporation) with Secretary of State or State Dept. of Corporations. If opting for S-Corp taxation, must file an election with the IRS. Directors approve corporate bylaws. The shareholders may create a Shareholders' Agreement. Must file an annual report with the Secretary of State or State Dept. of Corporations. Must have board meetings and shareholders meetings. Good idea to keep minutes of these meetings. Shareholders elect board of directors at periodic meetings.	File Articles of Organization (sometimes called a Certificate of Organization) with Secretary of State or State Dept. of Corporations. Members enter into an Operating Agreement. Must file an annual report with the Secretary of State or State Dept. of Corporations. No meetings or minutes required, but a good idea to do so.

There are risks and benefits associated with each entity, and different types might be preferable for different brands. However, it behooves a new franchisor to consider the liability and tax implications of the entity it selects. Both LLCs and corporations protect owners from personal liability. The importance of this benefit cannot be overstated. However, both LLCs and corporations require that corporate formalities be observed and require additional formation and governing documents. Corporate taxation is also seen by many as a big benefit, but others consider the inflexible requirements relating to the board of directors and how the corporation is managed to be prohibitive of choosing that entity. All told, many franchised companies choose limited liability companies to create the corporate structure.

ii. Liability Silos to Shield Company Operations and Intellectual Property From Franchise-Related Risks

In forming a corporate structure for a business on the precipice of franchising, the owners should consider creating separate entities for separate assets. Common assets to segregate are company operations, franchise activities, and ownership of intellectual property. Numerous questions must be answered in this analysis, for example: If the corporate operations have multiple owners, should they all also be owners of the intellectual property entity? Does forming a franchise arm create liability regarding the

primary assets, like the trademarks? Are the corporate officers and mangers the right people to run the franchised entity or the intellectual property entity? What tax implications are raised? How should the ownership be structured? In which state should the entity be formed?

For example, if the intellectual property to be used in the franchised system is transferred to a separate entity, that transfer may have tax consequences. Thus, care should be given to how the transfer is accomplished whether through bill of sale, assignment, or otherwise. Further, inter-company license agreements will need to be prepared and executed so that the franchisor has the right to use and license the intellectual property. While costly, segregating intellectual property protects the business's core assets from lawsuits against the franchisor by the franchisees, liabilities of corporate locations for things like employment discrimination or personal injury suits, or even a bankruptcy.

It is also valuable to shield and segregate corporate operations for the simple fact that operating a franchise system can vary greatly from the business's existing operations. If the franchisor fails, the owner will want company operations to continue unscathed. In addition, as a franchised system grows, separating entities early can simplify financial reporting and tracking and allow for a clearer picture of operations.

iii. Putting Resources Where They Belong

Because the franchisor entity will need to make disclosures in the FDD, special attention should be given to how it is structured and where resources are put in relation to it. Numerous factors come into play in the decision of which existing entity should be the franchisor or if a new entity should be formed. For example, a new franchisor should consider how the business's history—including ownership and management—would look in the FDD. Items 1 (The Franchisor, any Parents, Predecessors and Affiliates), 2 (Business Experience), 3 (Litigation), 4 (Bankruptcy), 8 (Restrictions on Sources of Products and Services), 13 (Trademarks) 14 (Patents, Copyrights, and Proprietary Information), 18 (Public Figures), 19 (Financial Perform Representations) and 21 (Financial Statements) should all figure into this analysis.

Especially relevant to this analysis is how Items 2, 3, and 4 are affected by current management personnel. While many new franchisors start off with the same management team that ran their core business, it may make sense to shuffle these people to another business entity before drafting the FDD. Addressing each director and principal officer's business, litigation, and bankruptcy history may be unpleasant, but it must be done sooner rather than later. Initial marketing of the franchise may not proceed well if the business experience or bankruptcy disclosures are unfavorable. Notably, just because a person is not a formal director or officer of the franchisor entity, does not mean he or she is immune from disclosure. Any person with management responsibility relating to the sale or operation of franchises must be disclosed.

Similarly, a new franchisor should consider its financial picture in the FDD when allocating resources. Can its financial statements stand on their own? Even if they can, a franchisor should analyze whether its parent's financial statements would need to be disclosed in Item 21 even if it forms a new entity. If the answer is "yes" and those statements are not favorable, then the company as a whole may consider allocating resources to affiliates. Generally, there are fewer disclosures related to affiliates than parents.

On balance, most franchisors do create a new entity for franchise operations. It is particularly useful in litigation down the road if franchisees and others are only able to proceed against the assets of the one franchisor entity.

iv. Administration Of and Accounting For the Ad Fund

The advertising piece of the transition from business owner to franchisor is complicated to say the least. Here, professional assistance of a marketing firm will go a long way toward success.

Often the first time new franchisors consider the advertising component of their system is when faced with Item 11. Item 11 of the FDD requires extensive disclosures regarding the advertising program. As with other areas, the FDD asks a new franchisor to consider its programs years down the road and predict how the programs will be funded, what media will be used, who will participate, and operations related thereto.

It is sometimes best advised for new and less mature franchisors to not immediately implement national or regional advertising or advertising co-ops but rather to focus on local advertising. However, franchisors are equally well advised to think of the "Ad Fund" as a brand promotion fund, rather than a national advertising fund, and to require franchisees to contribute to it immediately. In either event new franchisors should focus their attention on developing basic promotional approaches that can actually be used by new franchisees and grow the system.

One key consideration here is costs. Except in the unusual case of the "hot" brand, franchisees of start-up brands may lack the resources to pay a percentage of their revenue to a national advertising fund in addition to a local spending requirement right away. Once the system gains some traction, local spending requirements can be capped when the national or regional requirements commence. Still, new franchisors should consider (and disclose) any limits on the percentage of gross sales allocated to national and regional funds.

The initial franchise agreement should designate a required level of local advertising expenditures to ensure that the franchisees are adequately promoting the brand and their unit. The level required will vary system to system, but a good litmus test is the franchisor's own historical advertising expenditures in local markets.

In addition to the local advertising requirements, new franchisors typically require franchisees to contribute to a system-wide marketing fund which is used for advertising development costs. Here, a new franchisor should draft its agreements to maintain as much flexibility as possible so that it can respond to a changing competitive landscape. A franchisor should also consider and disclose how the funds it collects will be held and defined, and it should provide in the franchise agreement that it is not required to spend the funds in any particular market. This protects it against claims of discrimination.

B. FDDs, Franchise/Development Agreements, Advertising

One of the most important steps in establishing a new franchise system is drafting the FDD, the franchise agreement and the development agreement. The primary role of the franchise attorney is to help franchisors comply with the Federal Trade Commission's Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities ("the FTC Rule") and the various state franchise and business opportunity registration, exemption, and advertising laws. Various states also have franchise or business opportunity relationship laws, which primarily regulate the renewal, transfer and termination of the franchise relationship, and these laws should also be considered when drafting the relevant terms of the franchise and development agreements.

i. Fees

The franchisor is required to disclose in its FDD all fees charged by the franchisor to its franchisees. Although there are exceptions, the vast majority of franchise systems charge initial franchise fees and ongoing fees, which are often labeled royalties or service fees.

1. Initial Franchise Fee

The initial franchise fees are usually intended to reimburse the franchisor for training and other services provided to new franchisees in connection with the establishment and opening of their franchises. Thus, the initial franchise fees received from franchisees should not be relied on as a profit center for the franchisor but used as a cost recovery tool. The franchisor will want to determine which of its costs must be covered by the initial franchisee fee when determining how much to charge franchisees. These costs may include advertising costs, franchise broker and seller commissions, legal fees, costs associated with initial franchisee training and costs to assist franchisees as they establish their businesses and commence franchise operations. The franchisor should also consider the initial franchise fees of its competitors in order to be competitive in the market for franchise sales. If the franchisor is offering the opportunity to develop multiple franchises under a development agreement, it may also want to consider charging discounted initial fees for each unit in order to incent prospects to develop more than one franchise each, thereby encouraging rapid growth of the franchise system.

2. Continuing Fees

Continuing fees are usually consideration for the franchisees' continued use of the franchisor's intellectual property, ongoing training, creation of advertising materials and the maintenance of any national advertising fund, ongoing support of the franchisees' businesses and other services the franchisor provides its franchisees over the course of their franchise agreements.

Royalties are the primary source of continuing income for most franchise systems and are generally calculated as a percentage of franchisees' gross revenues, although some franchisors may choose to charge a flat royalty or require franchisees to pay a minimum royalty. When determining the amount of continuing fees it will charge to its franchisees, the franchisor should consider several factors, including its actual costs in providing certain products and services to franchisees covered by the fees, how much profit it intends to generate from providing those products and services, and what its franchisees can generally afford to pay while still generating a profit.

Most franchise systems with national advertising funds (discussed in further depth below) also usually require franchisees to contribute to the fund used to promote the franchise system and brand on a national or system-wide level. Like royalties, these fees are often a percentage of franchisees' gross revenues, but can also be assessed as a flat fee. When determining the amount franchisees will be required to contribute to advertising efforts, the franchisor should consider the anticipated costs of its national advertising campaign. The franchisor should also reserve the right in the franchise agreement to increase the national advertising fund contributions collected from franchisees as the system grows and the franchisor attempts to expand brand awareness to more geographic areas.

The franchisor may also generate revenue by marking up the costs of products and services provided to franchisees by the franchisor or its affiliates. The franchisor may choose to designate itself or an affiliate as the only or one of several approved suppliers of certain products or services that franchisees are required to purchase. There are also other fees that many franchisors charge to franchisees to cover specific costs, such as renewal fees upon the renewal of a franchise agreement, transfer fees upon the transfer of a franchise from a franchisee to a third party and information technology fees, such as website development and maintenance and software licensing, and other fees often assessed as penalties upon a franchisee's default of the franchise agreement.

ii. Brand Protection

1. Confidentiality and Copyrights

The franchisor's brand is much more than a trademark. The franchisor also licenses to its franchisees the right to use its trade secrets and other confidential and proprietary information in the operation of the franchisees' businesses. This information may include distinctive trade dress, proprietary recipes or business methods, software,

and supplier and customer lists and other information that the franchisor considers distinct and proprietary. Often this information is aggregated in the franchisor's operations manual. It is essential that the franchisor protect this information through the use of confidentiality provisions in its franchise agreements and nondisclosure agreements with its franchisees, their owners, operators, employees and even immediate family members, which protect the contents of the franchisor's operations manual and other materials distributed to franchisees containing confidential or proprietary information.

The franchisor may also claim a copyright in any "original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device."[4] The franchisor can avail itself of federal copyright protection by placing a "©," the name of the franchisor and the year the material was prepared conspicuously on the bottom of each page or by registering the work with the U.S. Copyright Office. Franchisors should seek to protect copyrights in their advertising materials, website, operations manual and other materials provided to franchisees containing proprietary information. The franchisor should also include language in its franchise agreements that prohibits franchisees from making unauthorized, derivative works and requires franchisees to assign all permitted derivative works to the franchisor.

2. Noncompetition

Another way the franchisor can protect its intellectual property and brand is by requiring franchisees to enter into noncompetition agreements with the franchisor that prohibit franchisees from competing with the franchisor both during the term of their franchise agreements and after they expire. Such noncompetition agreements, however, are only as good as they are enforceable, and the enforceability of noncompetition agreements is largely an issue of state law. Thus, the noncompetition terms contained in the franchisor's standard franchise agreement may not be equally enforceable against all franchisees in every state.

States vary considerably in their willingness to uphold covenants not to compete between a franchisor and franchisee, especially once the term of the relevant franchise agreement has expired. Many states have statutes or case law creating a state public policy against covenants not to compete as undue restraints of trade. Some of these states have created exceptions to their general public policies which allow for noncompetition agreements in certain scenarios, and other states have adopted specific statutes that support the use of covenants not to compete specifically in the franchise context.

California does not have a statute that specifically addresses noncompetition agreements between franchisors and franchisees, but the state has a statute that generally prohibits covenants not to compete, stating that "every contract by which

[4] 27 U.S.C. § 102(a).

anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void."[5] While the statute purports to allow parties to enter into noncompetition agreements in limited situations, California courts have rarely upheld covenants not to compete among franchisors and franchisees.

Kansas, on the other hand, does not have any laws that address covenants not to compete in general or franchise-specific settings. Kansas courts have, however, stated that the time and geographic restrictions in a covenant not to compete must be reasonable, there must be a legitimate business interest for the covenant, the covenant must not place an undue burden on the restrained party, and the covenant must not be injurious to the public welfare.[6] The Kansas courts have held a covenant not to compete lasting three years to be reasonable,[7] and another covenant covering a 250-mile radius to be reasonable.[8] The Kansas courts have been clear, however, that the reasonableness of covenants not to compete are determined on a fact-specific basis.

In Colorado, much like in California, there is a statutory presumption against the enforcement of covenants not to compete.[9] Unlike California, however, Colorado has identified four exceptions to the statutory presumption: (1) the purchase of a business; (2) contracts for the protection of trade secrets; (3) recovery of education and training expenses; and (4) protection from competition by executive and management personnel.[10] The legitimate interests of franchisors in entering into noncompetition agreements with franchisees have been explicitly recognized in two of these categories—the purchase of a business and the protection of trade secrets.[11]

Indiana statutes, on the other hand, specifically address covenants not to compete between franchisors and franchisees. The Indiana Deceptive Franchise Practices Act provides that it is unlawful for a franchise agreement to contain a covenant not to compete that prohibits the franchisee from competing with the franchisor for a period of longer than three years following the termination or non-renewal of the franchise agreement or in an area greater than the exclusive territory granted to the franchisee in the franchise agreement or, if the franchisee was not granted an exclusive territory, an area of reasonable size. [12]

iii. Advertising/Marketing

Advertising and marketing efforts will help both the franchisor and its franchisees expand brand recognition and sell products and services to customers. Advertising may occur through traditional media (television, radio or print) or through digital and social

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[5] Cal. Bus. & Prof. Code § 16600.
[6] *Wichita Clinic, P.A. v. Louis*, 185 P.3d 946, 953 (2008).
[7] *Weber v. Tillman*, 913 P.2d 84 (1996).
[8] *Chem-Trol, Inc. v. Christensen*, 2009 WL 331625 (D. Kan. 2009).
[9] Co. Rev. Stat. § 8-2-113.
[10] *Id*.
[11] *See, e.g.*, *DBA Enterprises vv. Findlay*, 923 P.2d 298, 302 (Colo. Ct. App. 1996); *Gold Messenger, Inc. v. McGuay*, 937 P.2d 907, 911 (Colo. Ct. App. 1997).
[12] Ind. Code §23-2-2.7-1 (9)

media and generally occurs on several levels: national marketing campaigns, which appeal to a broad, national audience; regional marketing campaigns, which may be crafted to appeal to a more targeted demographic in a particular geographic area; and local marketing, which will likely be directed at the specific customers of a particular company-owned or franchised business.

1. General

Advertising and marketing efforts are generally initiated by franchisees through grand opening campaigns. The franchisor usually sets a minimum amount it expects its franchisees to spend on their grand opening marketing campaigns. The materials for these campaigns are often purchased by franchisees directly from the franchisor for upfront fees due to the franchisor prior to the opening of the franchised locations, although the franchisor may also require its franchisees to spend additional funds to sustain their campaigns. By providing franchisees with the materials for their grand opening marketing campaigns, the franchisor can maintain a level of control over the franchisees' introduction of the brand into localized markets.

After the grand opening marketing campaign, franchisees may be required by the franchisor to engage in ongoing local advertising efforts. The franchisor should consider the level of involvement it wishes to maintain in the franchisees' local advertising efforts. Generally, the franchisor will want to help franchisees develop a local advertising goal, budget, and plan. The franchisor will also need to determine whether it will continue to provide all of the materials its franchisees will use for local advertising. Often, the franchisor will allow franchisees to develop their own local advertising materials but require franchisees to obtain the franchisor's approval prior to their use. In this way, the emerging franchisor is not responsible for creating advertising materials specifically designed for numerous local markets but has the ability to prevent franchisees from using advertising materials that are inconsistent with the brand's image.

While the franchisor may not want responsibility for the development of local marketing materials for each of its franchisees, the franchisor will want to dictate the brand's national advertising plan and its implementation, as national advertising efforts may be the general public's first point of contact with the brand. The franchisor may choose to establish a national advertising fund to pay for national marketing efforts. Generally, each company-owned and franchised business is required to contribute to the national advertising fund. The required contribution may be a flat dollar amount or a percentage of gross revenues and is usually contributed to the national advertising fund on a monthly or weekly basis, consistent with the payment of any royalties by franchisees to the franchisor.

If the franchisor collects national advertising fund contributions from franchisees, there are several best practices that the franchisor should employ. The franchisor should establish a separate affiliate entity through which the franchisor will administer the national advertising fund. The franchisor should also ensure that the national advertising fund is not commingled with the franchisor's other funds, that the franchisor

does not use the funds to advertise the sale of franchises or pay other expenses unrelated to advertising, and that the franchisor attempts to keep the overhead costs paid for by the national advertising fund to a minimum. Finally, the franchisor should disclaim any fiduciary duty to its franchisees in the administration of the national advertising fund.

Franchisors who have mishandled national advertising funds have been the target of substantial litigation by franchisees. For example, in *Broussard v. Meineke Discount Muffler Shops, Inc*.,[13] Meineke franchisees brought a class action lawsuit against the franchisor and the franchisor subsidiary managing the advertising fund for breach of contract, breach of fiduciary duty, negligence, intentional interference with contractual relations, negligent misrepresentation, fraud, unjust enrichment, and unfair and deceptive trade practices. The jury ruled for the plaintiffs finding, among other things, that Meineke had committed fraud, made negligent representations to franchisees, and breached its franchise agreements with its franchisees when it used advertising funds to defend and settle a lawsuit with a third-party marketing firm and paid its subsidiary which managed the marketing fund abnormally high commissions for developing and placing advertisements. The trial court entered a judgment for the plaintiff franchisees of over $590 million dollars. While an appellate court later overturned the verdict, the appellate decision was based on a technical issue (improper certification of the class) and did not address the merits of the trial court decision. As a result, it is widely believed that the plaintiffs would have prevailed on the substantive legal issues on appeal, and this case continues to serve as a warning to franchisors regarding mismanagement of national advertising funds.

In addition to local and national advertising efforts, some franchisors choose to establish regional advertising programs, often through regional advertising cooperatives, or co-ops. Regional marketing efforts generally focus on features of the business that may be unique to a particular geographic area, such as specific products, sales, special offers or local events. Regional advertising co-ops are often established after the franchisor is comfortable with the implementation of its national marketing campaign and its management of the national advertising fund. Regional co-ops are often managed by a group of franchisees in a particular region, and the group generally determines what percentage of each franchisee's local advertising requirement will be contributed to the co-op and how the co-op will use the funds for the benefit of its members. Although the co-op may be given considerable freedom by the franchisor to determine the level of individual franchisee contributions, in order to protect the brand, the franchisor should retain the right to approve all advertising materials generated by the co-op prior to their use.

2. Internet/Social Media

Businesses are relying with increasing frequency on the Internet, social media and web applications to spur business development by generating brand awareness and connecting with customers. The franchisor should determine whether it wishes to

[13] *Broussard v. Meineke Disc. Muffler Shops*, 155 F.34d 331,335 (4th Cir. 1998).

control all advertising, marketing, and customer outreach conducted via the Internet and social media. While this level of control will allow the franchisor to dictate the brand's image on various digital platforms, the franchisor may not want this level of responsibility. In addition, marketing and outreach via social media is often most effective when it appears authentic to consumers, and the franchisor may determine that its franchisees are best-suited to generate and maintain authentic social media relationships with their local customer base. The franchisor should, however, determine if that is the case for all types of social media activity. For example, the franchisor may want to control the brand's presence on LinkedIn or Twitter but may want its franchisees to administer their own Facebook pages. The franchisor should, therefore, develop a comprehensive social media strategy that clearly identifies the social media platforms where they wish to feature their brand. If the franchisor allows franchisees to use social media to promote their individual franchises, the franchisor should still reserve the right in its franchise agreements to maintain final approval over all social media content generated by franchisees. The franchisor should also provide comprehensive guidance to franchisees on how to interact with customers and the general public on social media, such as guidelines for posting pictures of products, for maintaining the confidentiality of proprietary information, and for responding to negative Facebook posts or blog comments.

iv. Financial performance representations

The FTC Rule also requires that all financial performance representations ("FPRs") made in connection with the offer of a franchise must be included in Item 19 of the franchisor's FDD. In order to make FPRs, the franchisor must have a reasonable basis and written substantiation for the representations at the time they are made.

According to the FTC Rule, a "financial performance representation" is "any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables."[14] Examples of FPRs include disclosures of historical sales or earnings, profit and loss statements, financial pro formas, forecasts and projections, charts showing earnings or profit levels and statements concerning estimated break-even points. The FTC has also noted that providing non-monetary measures of performance, such as room occupancy rates for hotels, or providing bits and pieces of financial information from which a prospect can fill in the blanks and draw his or her own conclusions about a specific level of earnings may also be considered FPRs. Simply providing information or estimates regarding potential costs and expenses to franchisees does not constitute making FPRs under the FTC Rule. Be aware, however, that although the law distinguishes between mere "puffing" and FPRs, "puffing" is oftentimes considered misleading and an unfair and deceptive trade practice under other provisions of the FTC regulations or under state laws.

[14] 16 C.F.R. § 436.1(e).

Making FPRs of any sort which are not disclosed in Item 19 of the FDD or which are inconsistent with anything in the disclosures is a violation of federal law and the laws of certain states. If the franchisor does not present an FPR in the franchise disclosure document, then it should not discuss the earnings potential of its franchises with prospective franchisees. There are a couple of exceptions to this rule, however. If a franchisor has made FPRs in the FDD, the franchisor may deliver to prospective franchisees a supplemental FPR directed to a particular location or circumstance, apart from the disclosure document. This supplemental FPR must be in writing, explain the departure from the FPRs in the FDD, be prepared in accordance with specific guidelines and be left with the prospective franchisee. Forecasts in franchising are inherently different from conventional financial forecasts.

In summary, you cannot present facts to a prospective franchisee which suggest or infer a specific level or range of actual or potential sales, income, gross profits, or net profits, other than the facts which are presented in your franchise disclosure document. You should not be "puffing" the success of your franchise program. Therefore, if you are generalizing as to your growth and success potential, stick to fact-based representations.

v. Dispute resolution

The franchisor will need to determine and disclose in its FDD where and how it wishes to resolve disputes with franchisees. Generally the franchisor will indicate in the franchise agreement which state's law will govern the franchise relationship and in which state the franchisor and franchisee will resolve disputes. Despite including terms in the franchise agreement regarding choice of law and forum for dispute resolution, however, certain state statutes and case law dictate that the franchisor resolve disputes with franchisees in the state in which the franchisee resides or operates in franchise.

Mediation is a non-binding method of dispute resolution facilitated by a neutral third party. The franchisor may wish to mediate disputes with franchisees and then, if such disputes cannot be resolved through mediation, proceed to arbitration or litigation. The franchisor may choose to require mediation in its franchise agreements for several reasons: the cost of mediation is generally lower than arbitration and litigation and resolving disputes through mediation can allow the franchisor and franchisee to maintain their franchise relationship in a manner that is mutually beneficial.

If mediation is ineffective or if the franchisor chooses not to pursue mediation, the franchisor may require its franchisees to resolve disputes through either arbitration or litigation. Arbitration offers several benefits—arbitration is generally private, may be binding (eliminating the opportunity for appeals), and the parties generally have more flexibility to choose the location, applicable law, arbitrator and rules of procedure and evidence that will apply in arbitration. Contrary to popular belief, however, arbitration is not necessarily faster or less expensive than litigation. As a result, some franchisors prefer to litigate disputes with franchisees in through the court system.

vi. Financing/SBA Participation

The franchisor must disclose the material terms of all financing arrangements with franchisees in Item 10 of the FDD. The FTC Rule requires the franchisor to include the rate of interest, any financing charges, the number of payments, any penalties upon default, and any consideration the franchisor will receive from franchisees in return for acting as a lender. Many franchisors do not offer to finance their franchisees' entire business operations. If, however, the franchisor chooses to do so, it must disclose the required material terms of the financing in Section 10 and include as exhibits to the FDD any form of loan and security agreement or promissory note it will require franchisees to sign in connection with the financing. It is more common for franchisors to "finance" the initial franchise fees of franchisees by allowing franchisees to pay these initial fees in installments. If the franchisor allows franchisees to pay their initial fees in installments over time, it must still make the required disclosures and attach as exhibits to the FDD any agreements franchisees must sign in relation to the installment payment of the initial fess, which often includes a promissory note for the remaining balance of the initial franchise fees due after execution of the franchise agreement.

If the franchisor does not offer traditional financing or an installment plan for the payment of initial fees, franchisees must often seek financing from banks or credit unions. This financing often takes the form of SBA loans, or loans provided by banks that are guaranteed by the U.S. Small Business Administration. If the franchisor wants to provide its franchisees with expedited processing of an SBA loan, the franchisor must submit its standard franchise agreement and all related, ancillary agreements to the SBA for approval. If the SBA approves the franchisor's materials, the franchisor will appear on the SBA's registry of approved franchise brands. It is advisable for the franchisor to submit its updated FDD to the SBA each year following the FDD's annual renewal in order to maintain its presence on the SBA's registry. The franchisor should be aware, however, that its status as an SBA-approved franchise will not ultimately determine whether franchisees are eligible for financing.

C. Expansion into Registration States

i. Registration and Exemption

The FTC Rule does not require the franchisor to register or file the FDD or any related agreements with the FTC or other federal agencies. Certain states, however, require the franchisor to register the FDD with a state agency, or obtain an exemption from the state’s registration requirement, prior to selling franchises in those states. The states which require annual registration of FDDs are commonly referred to as the “registration states” and include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin, and the states which allow the franchisor to seek exemption from the state’s franchise or business opportunity registration laws include Connecticut, Florida, Kentucky, Michigan, Nebraska, Texas and Utah. Prior to

registration or exemption, the franchisor must refrain from selling or advertising the sale of franchises in these states.

ii. Advertising of Franchise Sales

Advertising the sale of franchises is regulated on both the federal and state level. Prior to selling franchises in a specific state, in addition to determining whether the state is a registration or exemption state, the franchisor (aided by franchise counsel) should also determine whether the state regulates advertising the sale of franchises. If so, the franchisor must submit all potential advertisements to the relevant state agency prior to use in that state. State submission may not be necessary if the franchisor is running a national advertising campaign that is not targeted to a specific state, but only if the campaign appears in a "national publication" or on the Internet. Generally, a publication is considered "national" if two-thirds of its circulation occurs outside of any particular state. Internet advertisements, such as information about franchise sales on the franchisor's website, need not be submitted to most registration states for approval, but if such Internet advertisements are not submitted to the states for approval, the franchisor must also include disclaimers on such Internet advertisements that notify the public that franchise sales will not be conducted in states where the franchisor has not registered its FDD. In addition, while some states do not specifically regulate advertising the sale of franchises, the vast majority of states and the federal government regulate the content of all advertisements generally.

D. Employment Issues

The franchisor will generally require each franchisee to conspicuously disclose that its franchise is an independently owned and operated business. Each franchisee should have control over the day-to-day operations of its business and the compensation, hiring and firing of its employees. This system allows the franchisor to avoid vicarious liability for the actions of the franchisee and its employees. Conversely, if the franchisor exerts too much control over the franchisee and its employees, it can be held responsible for their actions toward third parties. In addition, the franchisor can also be found liable to the franchisee's employees for violations of labor and employment laws as a "joint employer" of those employees. The "joint employer" issue is an especially hot topic right now.

In June 2014, the General Counsel for the National Labor Relations Board ("NLRB") filed an amicus brief in a matter before the NLRB involving Browning-Ferris Industries of California, Inc. ("BFI").[15] In its brief, the General Counsel proposed a new joint employer standard where the NLRB would find joint employer status, given all of the circumstances, where an entity exercised or possessed the power to exercise significant direct or indirect control over the employment terms and conditions of another's employees, or where the entity was essential to meaningful collective

[15] Amicus Brief of the General Counsel, *Browning-Ferris Industries d/b/a BFI Newby Island Recyclery*, Case 32-RC-109684 (June 26, 2014).

bargaining with another's employees.[16] In December 2014, the NLRB issued complaints against McDonald's and numerous McDonald's franchisees as joint employers.[17] The complaints allege that McDonald's and its franchisees violated employee rights by retaliating against employees for seeking improved wages and working conditions. The NLRB asserted that McDonald's "possessed and/or exercised control over the labor relations policies" of its franchisees and was a "joint employer" of the franchisees' employees.[18]

In April 2015, the NLRB's Division of Advice provided further insight on this issue. In response to an inquiry about the potential joint employer status of Freshii Development, LLC ("Freshii"), the franchisor of a fast-casual restaurant chain, and one of its franchisees, the NLRB discussed in detail the reasons why it did not consider Freshii to be a joint employer of its franchisee's employees.[19] The NLRB's analysis was fact specific and reviewed the role of the franchise agreement, the operations manual, training, evaluations and labor relations in determining joint employer status. Specifically, the NLRB noted that: (1) The franchisor clearly distinguished the mandatory portions of its operations manual from the portions that offered recommendations to franchisees; (2) The franchisor did not play a role in the franchisee's decisions regarding hiring, firing, disciplining or supervising employees; (3) Although applicants could apply for jobs at franchised outlets via the franchisor's website, the franchisor did not screen or analyze the applications before passing them to franchisees; (4) The franchisor did not determine the wages, raises or benefits of the franchisee's employees; (5) While the franchisor supplied a sample employee handbook to its franchisees, it did not require them to use it, and indeed the franchisees used different employee handbooks with varying personnel policies; (6) Language in the franchise agreement gave the franchisee the freedom to decide whether to use the franchisor's personnel policies or procedures; (7) The franchisor was not involved in scheduling and setting the work hours of the franchisee's employees, even though the franchisor provided guidance on how to calculate labor costs; (8) The franchisor did not have any input in the scheduling algorithms or methods used in the franchisee's scheduling software, and did not require all franchisees to use the same software; (9) The initial training provided by the franchisor dealt primarily with restaurant operations, and after the initial training, the franchisor was not involved in future training of the franchisee's employees; (10) Evaluations of the franchisee were limited to inspecting the franchisee's adherence to mandatory brand standards and were not used to examine employment-related policies, and these evaluations never affected the employment status of the franchisee's employees; (11) When the franchisee's employees attempted to unionize, the franchisor did not communicate with the franchisee about the organizing effort; and (12) The franchisor was not in the practice of terminating franchise agreements for non-brand related reasons, including the franchisee's terms and conditions for its employees.[20]

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[16] *Id*. at 2.
[17] McDonald's USA LLC, a joint employer, et al., 362 NLRB No. 168 (2015).
[18] *Id*. at 2.
[19] Nutritionality, Inc. d/b/a Freshii, Cases 13-CA-134294 et. Al. (April 28, 2015).
[20] *Id*.

Then, on August 27, 2015, the NLRB finally issued a decision in its case involving BFI.[21] In the decision, the NLRB expanded its joint employer standard and essentially overruled decades of precedent. Under the new standard, the NLRB can find an entity to be a joint employer if such entity exercised or has the power to exercise direct or indirect control over the essential terms and conditions of employment of another entity's employees. Under this test, the NLRB may find joint employer status if multiple entities "share or codetermine those matters governing the essential terms and conditions of employment."[22] To reach this finding, the NLRB must determine whether there is a common law employment relationship between these entities and the employees in question. If a common law employment relationship exists, the NLRB must then determine whether the alleged joint employer is a necessary party to meaningful collective bargaining with the employees. To be meaningful to the collective bargaining process, the alleged joint employer must control or have the right to control the essential terms and conditions of employment.[23]

In its decision, the NLRB stated that the essential terms and conditions of employment include matters related to hiring, firing, discipline, supervision and direction. Expanding on this statement, the NLRB stated that examples of control over essential terms and conditions of employment include setting hiring qualifications, requesting the termination of workers, dictating the number of workers required at specific times and to perform specific tasks, controlling scheduling, seniority, and overtime, assigning work tasks, determining the manner and method of work performance and counseling workers on these topics, maintaining constant oversight of worker performance, setting worker wages (by creating a wage ceiling or otherwise), and requiring approval over work pay increases.[24]

These examples may seem like common indicia of employer status and, indeed, have long been considered in determining whether an entity exercises control over a particular group of workers. However, the NLRB was clear that it will no longer only consider whether an entity has exercised the types of control listed above, now it will also consider whether the alleged employer has the right to exercise that control. Thus, the franchisor should continue to avoid exercising direct control over the terms and conditions of employment of the employees of its franchisees. The NLRB's BFI decision is clear that avoiding the exercise of direct control over the essential terms and conditions of franchisees' employees is no longer enough. Now, the franchisor must make sure that its franchise agreements, operations manuals and other agreements do not give the franchisor the right to exercise such control in the future.

In light of the BFI decision, franchisors can take actions to protect themselves by (1) reviewing their franchise agreement, operations manuals, training materials,

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[21] BFI Newby Island Recyclery, 2015 NLRB LEXIS 672,204 L.R.R.M. 1154, 2014 – 15 NLRB Dec. (CCH) P16, 006, 362 NLRB No. 186 (N.L.R.B. Aug. 27, 2015).
[22] *Id.* at 11 .
[23] *Id*. at 12.
[24] *Id*. at 15-16.

corporate policies, and forms to protect against potential arguments that the franchisor has reserved the right to exercise control over the terms and conditions of employment of its franchisees' employees; (2) training and observing their staff to ensure they clearly understand what is and is not acceptable when interacting with franchisees; and (3) engaging their franchisees (for instance, to ensure the franchisees understand they are independently owned businesses and reflect the nature of that relationship to their employees and the public).

E. Supply and Distribution Agreements/Rebates

Recognition of the primary trademark or service mark of a franchise system is often what draws repeat customers to franchises. But familiarity with the products and services offered by the franchise concept, and the quality of those products and services, is often what generates customer loyalty. Customers of a franchise concept should feel confident that they can find the products or services they seek in any franchise location in the country and even, perhaps, around the world. One way in which the franchisor can ensure customer satisfaction in this manner is through product uniformity. Product uniformity can generate revenue for the entire franchise system, and it also brings operational advantages, allowing the franchisor to leverage the buying power of the entire franchise system to improve procurement and distribution functions for franchisees. Such product uniformity is generally achieved through effective supply chain management.

"Supply chain management is the coordination of production, inventory, location, and transportation among the participants in a supply chain to achieve the best mix of responsiveness and efficiency for the market being served."[25]

In order to effectively manage its supply chain, the franchisor must determine what products and services it must procure on behalf of franchisees, the appropriate quantity of products and services, how to deliver the products and services efficiently, and how to collect feedback from various stakeholders in the supply chain, including suppliers, franchisees and customers. Often emerging franchisors can use a broadline distributor to help with supply chain management. Broadline distributors, such as Sysco, generally have large catalogues of products that can supply franchisees with almost everything needed to operate their franchises. While using broadline distributors can lower costs and reduce the franchisor's responsibility for assisting franchisee's in locating suppliers, it can also compromise the franchisor's control over the quality of products available to the franchise system. As it grows, the franchisor may determine that product quality and consistency is more important than ease of procurement and distribution and may move to more localized, specialized suppliers.

In order to make these types of adjustments as the franchise system grows, the franchisor must plan ahead by reserving the right to approve, designate and change the suppliers franchisees must use to obtain various products and services. If, however, the franchisor chooses to restrict the sources from which franchisees may obtain

[25] Michael Hugos, Essentials of Supply Chain Management 4 (2d ed., 2006).

products and services required to operate their franchises, then the franchisor must disclose these restrictions in Item 8 of the FDD. The franchisor must also disclose whether it derives any revenue from franchisee purchases from designated suppliers, whether those suppliers are affiliates pushing revenues up to the franchisor entity or unaffiliated entities providing rebates to the franchisor. While franchisees may at times balk at supplier restrictions, these restrictions are often a key method by which the franchisor ensures product uniformity and protects the image of its brand.

F. Compliance Programs and Tools

A comprehensive training program is essential for a business that wants to replicate itself. Training programs and manuals will be important tools to ensure consistency throughout the system and will also serve as enforcement mechanisms as the system matures.

i. Pre-Opening Training Program.

The franchisor should develop the curriculum for the pre-opening or initial training program with the goals of establishing standards for brand quality and uniformity across the franchise system. All franchisees and their managers should be required to attend and successfully complete an initial training program designed by the franchisor and taught by the franchisor's staff. Operations personnel should be thoroughly schooled in the franchisor's standards and systems before they are permitted to teach the franchisees. Typically, initial training programs take place at a franchisor's headquarters, often in space specially designed to simulate a franchised location. Training courses often last a week or more, during which the franchisees are taught many facets of the business, from inventory ordering to secret recipes. Throughout the training program, brand standards should be emphasized in order to educate the franchisees and also to build brand awareness.

A new franchisor should plan to put substantial time and resources into designing and implementing the initial training program. Often this training session is the first significant investment of time and money that a franchisee makes after paying the franchise fee and finding a location. Most franchisees are required to send at least two people to initial training for a week or longer which requires not only travel and living expenses to come out of the franchisee's pocket, but also wages to be paid by the franchisee to its personnel attending training. If the franchisee is disappointed with the quality of the training program, it can set a negative tone at the beginning of the franchise relationship.

Many franchisors provide a few days of on-site assistance and training at the franchisee's location around the time the franchisee's outlet opens for business. This part of the initial training can be important in making the franchisee comfortable in its new role as an operator and giving customers a good first impression of the franchisee's location and the brand.

ii. On-Going Training Programs

On-going training can take several forms, ranging from more formal classroom sessions at the franchisor's headquarters, to informal reminders from the franchisor's support staff at the franchisee's location. A new franchisor should plan to hire a staff of operations specialists whose job will be to focus on improving unit operations as well as monitoring the franchisees' performance. Some franchisee monitoring should be in-person observations of the franchisee's operations at the franchisee's outlet by field representatives from the franchisor's office. Some franchise systems refer to these periodic visits to the franchisee's locations as support visits, follow-up training or compliance checks but no matter how they are labeled, these visits are usually a combination of observation, training and monitoring the franchisee's compliance with the franchisor's standards of operation. Field representatives wear different hats during on-site visits, often playing good cop and bad cop at different times during the same visit. A useful tool that can be used by field representatives to monitor compliance is an operations checklist which can be completed by the field representative upon arriving at the franchisee's location, observing the appearance of the location, evaluating the franchisee's staff as they perform the tasks on the checklist, and providing feedback to the franchisee in the form of a copy of the completed checklist. If the field representative finds small deficiencies in operations as a result of the checklist evaluation, often that person can provide remedial training to the franchisee on the spot. Note that in light of the new NLRB standard for 'joint employers' under which it is much easier to find that the franchisor is a 'joint employer' of the franchisee's employees, field representatives should be cautioned not to provide feedback directly to the franchisee's employees, but only to the franchisee's owners and designated managers. Larger deficiencies may need to be addressed by more formal training at the franchisor's training center.

Another recommended practice for franchisors is holding periodic supplemental training sessions for its franchisees. Sometimes the reason for supplemental training is that there are new items that the franchisor wants the franchisees to offer at their locations and other times the training might be more of a refresher course, but it is a recommended practice for all franchisors, no matter what the business, to incorporate additional franchisee training into every meeting with the franchisees, including annual meetings or conventions. Anytime a franchisor or its staff can meet face-to-face with franchisees it can be an opportunity to teach the franchisee something new or correct a behavior that is not meeting the franchisor's standards. Annual meetings are a perfect opportunity to get all of the franchisees and the franchisor's staff in the same room and on the same page in terms of operations and brand standards. A franchisor that does not use its annual meetings as supplemental training sessions is missing a valuable opportunity that allows the franchisees to interact and learn from each other in addition to learning from the franchisor.

iii. POS System

A retail business often uses a point-of-sale (POS) system to record sales, calculate taxes and track inventory. Many franchisors require franchisees to purchase a designated POS system that includes hardware and software components that have been tailored to meet the franchisor's specifications. At a minimum, franchisors should customize the POS system's software to include their menu of products or services and inventory lists to assist franchisees in tracking sales and inventory purchases. The technical capabilities of a POS system are outside the scope of this paper; new franchisors should be aware, however, that a POS system can be used not only to facilitate the operating platform for the outlet, but also to monitor a franchisee's compliance with the franchisor's operational standards. The franchisor should reserve the right in the franchise agreement to independently access data from a franchisee's POS system as often as the franchisor deems necessary. Some franchise systems have developed sophisticated proprietary software that tracks the number of employees working at different times of the day and recommends that managers make staffing adjustments based on increases or decreases in sales volume. This kind of employee control was cited as a factor in the NLRB's actions against McDonald's.26

The authors do not endorse using software that makes recommendations regarding the hours worked by employees to avoid scrutiny by the NLRB, but using the POS system software to monitor things like inventory purchases, sales recorded and royalties paid, is a best practice. Frequent polling of POS system data can detect operations problems at an early stage and avoid franchisee conflicts later.

iv. Operations Manual

Creating an effective operations manual should go hand-in-hand with designing the initial training program and many components of the operations manual will be incorporated into the initial training program. A franchise system's standards, specifications, recipes, inventory requirements, design, trade dress, and many other elements related to operating the business will often be included in the operations manual. Some of the items in the operations manual should be labeled as recommendations and others may be considered mandatory or brand standards. Specific brand standards should be reviewed by franchise counsel or experienced franchise consultants to avoid risking claims of vicarious liability, however, by arguably exercising control over the day-to-day operations of the franchisees' businesses. The new franchisor should also be sure to label portions of the operations manual that discuss employment of the franchisee's staff, and security issues, as recommended, or non-mandatory to avoid possible vicarious liability claims. More information about changes in the NLRB's definition of a joint employer are discussed above.

[26] *McDonald's USA, LLC, a joint employer, et al*, 362 NLRB No. 168 (2015).

CONCLUSION

There are countless issues that arise when a new franchise system begins or when a young franchise system begins to take its franchise program to the next level. This paper highlights only some of the more major issues that should, in either case, be addressed in order to minimize the risks to the brand, to the company's financial health, and to the sanity of the company's management. While the answers and strategies of responding to these issues may vary from company-to-company and, frankly, from advisor-to-advisor, what should always be constant is the notion that long-term vision and planning should never be sacrificed for short-term gain.