Farrell Fritz, P.C.

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Focus on Franchising

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Welcome!

Welcome to the second edition of Focus on Franchising. We wish to thank those of you who have told us how much you liked our inaugural edition. Your comments are certainly motivation to not only continue but to make each edition more informative and better than the previous one. We hope you enjoy this issue as much or more than the last. Your comments about articles and suggestions for future topics are welcome. Contact us at franchise@farrellfritz.com.

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Inside

Training: The Hidden Profit Strategy

By Mary Ann O'Connell

Franchising is a very competitive field these days, and you need to seize every strategic advantage you can. No matter where you look or what you read, we are in tough economic times; and cuts need to be made to shore up our businesses. To make those cuts we look to the balance sheet and determine what departments are not profitable. Invariably, the training department falls into that category. Most companies cannot see a direct return on that investment, so they cut - too deeply - because it seems that training doesn't pay.

Or does it? What are the payoffs to a good franchise organization that is trying to be conservative in these tough economic times?

A well-crafted training program can increase customer satisfaction, employee retention, unit sales, royalties, franchise profitability, and cash flow.

Customer satisfaction drives decisions in successful businesses. An exceptional service experience creates a sense of value for the customer. If they have a good experience they will become loyal customers. Retained customers create a greater ROI than do new ones.

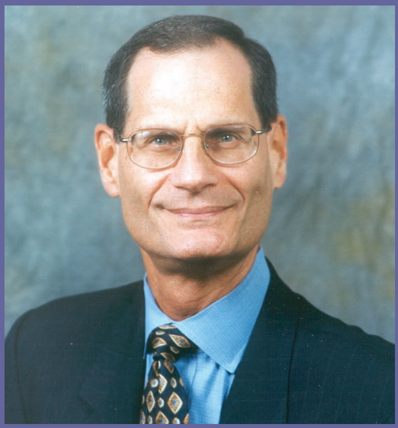
Create a training program that can be delivered to your franchisees' employees and increase employee retention. A leading cause of employee turnover is that they don't know what is expected of them, so they are bound to disappoint their employers and fail themselves. Rather than face that, they leave. Employee turnover is costly: it is expensive for the franchisees, alienates customers and slows growth.

A franchisee that knows how to operate well will have more confidence and should reach profitability sooner. Training allays the fears of those with no industry experience who are considering entering your system. They can see that you help protect their investment by educating them well. This can close the sale for you. When the franchisees are trained well they require less ongoing support, and you can save costs on field support staff. Franchisors can expect less franchisee turnover, fewer closed units, and system expansion as profitable franchisees open more units. When it all comes together, the customer and the employee that had a great experience with your brand may become franchisees themselves.

Consider this: franchisees that are profitable are less likely to exit the system or complain about it. Most franchisees are not skilled at training, however, and therefore will try to avoid it. If you provide the training for them, the job gets done well and the profits can flow.

To recap, a strong training program will increase unit sales, franchise profitability, royalties, licensing and cash flow. Added up: training becomes the most profitable department in the company.

Mary Ann O'Connell is the principal consultant with O'Connell and Company, Franchise Advisors. She has 25 years' experience in franchise operations and training as a franchisee, franchisor and consultant. She can be reached at maryann@oconnellco.com



By Harold L. Kestenbaum, Esq.

Glass Half Empty?

I don't have to tell our readers how the franchise phenomenon continues to overwhelm our struggling economy, but I came across a not-so-encouraging survey that I would like to share with all of you.

The survey that was published recently revealed that 40% of existing franchisees, as a whole, are not happy with their franchisors. Those franchisors out there can spin this by saying that 60% are satisfied, which is more half! I know that most of our readers are franchisors and 60% is not a bad percentage. However, I think that many of you would like to see that rise to 90% or even 100% (not very likely given the mindset of our franchisee community).

Relationships are vital in franchising, and building good ones should be the ultimate goal of all franchisors. One way to achieve this goal is through communication. I have found, over the years, that open communication with your franchisees makes for a more cohesive and more successful system. I will discuss this more in our next edition.

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Beware of Claims Based On Misuse of Advertising Contributions

By Eric W. Penzer, Esq.

The advertising fund is an important component of the franchisor-franchisee relationship. However, with it comes important rights and obligations for both the franchisor and the franchisee.

Typically, franchise agreements require franchisees to pay into a marketing and advertising fund. The payments are usually calculated based on a percentage of the franchisee's revenues. The failure to make these required advertising fund payments is a common basis for a declaration of default and, indeed, termination. On the other hand, it is not uncommon for franchisees to assert claims against franchisors - either defensively, in response to a default or termination notice, or otherwise - for misuse or misapplication of advertising funds.

Certain of these claims are transparently meritless and are dealt with accordingly. For example, in a relatively recent California state court case brought against a sandwich shop franchisor, the court held that a franchisee failed to allege sufficient predicate acts under the racketeering statute, where it was claimed that the franchisor "extorted" the payment of advertising fund fees. The court found that the payments were required by contract and further, that the threat of termination if such contributions were not made did not constitute extortion. Likewise, in a federal case brought by a donut shop franchisor in Illinois, the court found that the franchisee's counterclaims for negligence, unjust enrichment, conversion, and breach of fiduciary duty - all based on alleged misuse of advertising funds - could not possibly have been asserted in good faith and, indeed, were sanctionable.

Not all claims alleging misuse of advertising contributions fail, however, which a donut shop franchisor recently found out the hard way. The case involved the franchisor's ongoing efforts to collect revenue from under-reporting franchisees - for its "loss prevention activities." The franchisees, in turn, claimed that the franchisor wrongfully diverted the fees collected to its own account, rather than placing a percentage in the advertising fund. The court denied the franchisor's motion for judgment in its favor. The court noted that the franchisor's failure to make contributions to its advertising fund from money collected through its loss prevention activities appeared to run afoul of the provisions of the franchise agreement. The agreement required the franchisor to remit a percentage of revenue collected for advertising expenses and did not distinguish between fees collected in the ordinary course of business and fees collected as a result of loss prevention activities. Thus, the court permitted the action to continue.

Negotiating A Franchise Lease

By Robert E. Sandler, Esq.

When negotiating a space lease for a franchise tenant, there are many issues and concerns unique to franchise businesses which should be addressed. The following checklist is intended to identify some of the more significant issues in connection with the review of a typical landlord form of lease. This checklist is not intended to be a complete list of issues to be raised by franchise tenants, but is a list (top 10) of their more substantive issues and concerns.

FRANCHISE CHECKLIST OF LEASE ISSUES

1. ALTERATIONS

Rights to prototype leasehold improvements unique to the particular franchise operation without landlord consent. Tenant must also maintain flexibility for remodeling or changing merchandising programs during the term of the lease.

2. ASSIGNMENT AND SUBLETTING

Maintain right to transfer lease to franchisor or subsequent franchisee without Landlord's consent.

3. SIGNAGE

Permit standard franchise signage (logos, colors, etc.) without landlord's consent.

4. PREMISES

Identify any exclusive and non-exclusive areas for franchise use, such as parking spaces, dumpster areas, HVAC systems, freestanding signs, etc.

5. USE

Permitted uses should include sale of merchandise and services customarily sold at other franchise or corporate locations for particular franchise operation.

6. TRADE AND OTHER FIXTURES

Provide for lien rights for lien holders and landlord waiver of any rights to trade and other fixtures.

7. CONDITIONS PRECEDENT

Clearly set forth all of the conditions precedent to the effectiveness of the Lease, such as (i) franchisor approval; (ii) receipt of all permits and approvals; (iii) engineering, environmental or other due diligence/inspections.

8. END OF TERM

Provide for right of removal of all trademark items at end of term.

9. EXCLUSIVES

Set forth any exclusive uses that landlord will grant to tenant during the term of the lease.

10. FRANCHISE ADDENDUM

The lease should provide for any franchisor rights set forth in a standard form of Franchisor Addendum to be attached to the lease.

Did You Know?

Franchising Fast Facts:

- There are an estimated 1,500 franchise companies operating in the U.S., doing business through more than 316,000 retail units.
- 75 industries use franchising to distribute goods and services to consumers.
- Average initial investment level for nearly 8 out of 10 franchises, excluding real estate, is less than $250,000.
- Average royalty fees range from 3% to 6% of monthly gross sales.
- Most franchise companies have fewer than 100 units.
- Average length of a franchise contract is 10 years.

Top 10 States for Franchising
(Based on IFA Members)

1. **California**
2. **Texas**
3. **Florida**
4. **Georgia**
5. **New York and Minnesota**
6. **Ohio**
7. **Maryland and New Jersey**
8. **Illinois**
9. **Colorado**
10. **Michigan**

Source: International Franchise Association

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Know How to Grow

For those of you trying to fast-track your growth, I want to alert you to a recent South Dakota case involving alleged fraud committed by a Master Franchisor. Those of you who know me, have heard me say, time and time again, Master Franchising is not the ideal way to grow successfully in the United States. It only creates more trouble than it is worth. Lawsuits such as the South Dakota one are a prime example of this. In this case the Master Franchisor misrepresented certain facts about the franchisor and was held liable for $995,000 in punitive damages.

I have always advocated, and continue to do so, that multi-unit or area development expansion is the best vehicle for quick growth. This method grants a single person or group the right to build, open and operate their own units within a pre-negotiated territory, over a pre-determined time frame. This method permits you to know who your franchisee is, and you know that they are committed to your system and to opening and operating multiple units. Clearly this is the safest growth vehicle. But, there are many franchisors who are not satisfied with this particular method, which also can be slow, depending upon the development schedule. Therefore, my recommendation is the use of the hybrid vehicle known as the area representative or development agent (made famous by Subway). More about this method in our next edition.

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For complete information about our practice areas and attorneys, please visit us online at www.farrellfritz.com.

Events Calendar

March 19
Farrell Fritz Quarterly Franchise Forum.To reserve a place, contact Helen Rajcooar: phone, 516-227-0720; e-mail, hrajcooar@farrellfritz.com