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IS YOUR BUSINESS FRANCHISABLE IN THE UNITED STATES? AN ALTERNATIVE METHOD FOR BUSINESS ENTERPRISE GROWTH

When business owners contemplate expansion and growth of their business enterprise and brand in the United States, they must first make a fundamental decision on strategy and method of expansion. Should they (a) expand on their own, utilizing their own time, capital and other resources on a location-by-location basis, or should they (b) leverage the efforts of others who are willing to invest their own time, effort and assets to grow the business brand?

Successful businesses typically have a solid and growing market share as well as strong profitability and brand recognition in their core geographic markets. So, if a business owner can sufficiently capture and efficiently package the business model and underlying business formulas which generated this success into a franchise model, then franchising might be the best path for expansion. But that is easier said than done.

Franchising allows a business to expand into new geographic markets by allowing others to use an owner's established systems and branding to duplicate the systems and expand the brand into other markets. Setting up a franchise system provides for growth by utilizing capital provided by others to acquire capital assets, operating assets, as well as funding opening and other operational costs for additional storefronts under the business brand. A franchise arrangement also reduces certain risks and liabilities for the owner-turned-franchisor such as those related to loans, leases, employees and vendors, as those become franchisee responsibilities.

Once a business has developed a franchise model, finding the right people to sign up as franchisees is the next step. Those are people who are genuinely interested in an opportunity to own a business and be their own boss, but do not necessarily have the abilities or resources to build a new business completely from scratch and, therefore, wish to join in on a successful and proven business model. On the other end of spectrum, are mature investors who are ready, willing and able to bring and grow a successful brand into the U.S. market.

Franchising incentivizes franchisees to become invested in the success of their franchised business because they pay both an up-front initial franchise fee and ongoing royalty fees (and other fees, such as brand advertising fees) to the franchisor, and in many cases, invest a significant part of their net worth into the new business. Many businesses who turn to franchising find talented individuals and investors who are very committed to making sure their franchise is a success. However, businesses looking into franchising should keep in mind that the success of one or even several pre-franchising owner-operated storefronts (by such prospective franchisor business owner) is not a sure prediction of success of additional storefronts in a franchise model.

Franchising is not the best solution for every business considering expansion into the United States. An owner relinquishes some control when bringing in others to open and run a business unit as a franchise. Under U.S. law, while a franchisor retains certain powers over franchisees in the wider scope the operation of the business unit, such as through the implementation of system-wide standards applicable to all franchisees, a franchisor is not permitted to exercise too much control over a franchisee, and certainly not over day-to-day operations of the franchisee's business.

Businesses must also consider the costs to set up the franchise system and access to capital to cover such costs. While franchising can be a lower-cost means of expansion in the long run after the franchise system is set up, the conversion to a franchise model requires an initial investment by the business owner. The business will need to develop legal documents in accordance with United States laws, such as a federally mandated Franchise

Disclosure Document, and a franchise agreement form, as well as other legal and business documents and procedures such as operations manuals, marketing and advertising programs, and training programs prior to offering a franchise business opportunity to prospective franchisees.

While "franchise law" is Federal law based, some U.S. states impose additional legal requirements and documentation on franchisors pursuant to state law before the franchisor can solicit prospect franchisees in that particular state. Also, one of the cornerstones of a franchise system, its intellectual property, must be sufficiently protected, which typically includes Federal registration of the owner's trademarks in the United States Patent and Trademark registry.

Businesses need to carefully analyze the underlying reasons for their own business success. In most cases, it is due to both the owner's day-to-day efforts as well as the model and processes built and implemented in the business. If, however, the owner and/or the business management team is indispensable to the business, this over-reliance on the owner or management will be a challenge for moving forward in a franchise system.

Furthermore, the business model must be capable of being a blueprint for replication by others seeking entrance into a franchise system by being sufficiently detailed to provide the roadmap to potential success. A common misconception among businesses contemplating expansion via franchising is that they can simply take the current written materials describing and demonstrating their current business model, make a few tweaks, translate into English language legal terms, and those revised materials are then ready to be disseminated into a franchise system environment.
Even more common is the miscalculation of how much time and effort is needed by the business to get what is not currently on paper, i.e. the essential operational or managerial processes that only exist at the corporate leadership level, into print format so that others can implement that part of the business model. The successful business owner-to-franchisor conversions are those which can bridge the gap between the pre-franchise written and non-written business model materials in existence, and the written materials needed for a franchise system.

Businesses should also keep in mind that while franchise law is based in contract law, i.e. a franchise agreement is a written contract between two parties, it is definitely a specialized area of contract law and should be maneuvered through with the properly trained and credentialed professionals. For example, franchisors must address a modification to the Federal rules governing revenue recognition issued by the Financial Accounting Standards Board (FASB), formally titled “ASC 606, Revenue from Contracts with Customers” (“ASC 606”)1. This change impacts, via restriction, the timing of business owners’ recognition of certain revenue generated from a franchisee – for example, the initial franchise fee paid to a franchisor by a franchisee. Having well-informed accounting and legal professionals to guide a business owner through this maze of regulatory compliance is key to not having the IRS knocking at your door.

A properly structured franchise system in the United States gives business owners an alternative method for business enterprise growth. Converting to a franchise system takes some time, effort and financial resources, but once the franchise system is properly set up, a business owner can focus on finding the right people to utilize their own resources and assets to expand the reach of the owner’s brand into new markets.

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[1]Due to COVID-19 interruptions to business functionality, on April 8, 2020, FASB implemented one-year deferrals on implementation of certain aspects of ASC 606.

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