Key Franchising Policies

The most critical aspect of franchising is not the sale of the franchise units but rather the policies the franchisor incorporates into the Franchise Agreement. These policies will dictate how the franchisees operate, what they are allowed and not allowed to do, and what obligations are place on each party. From the franchisors perspective, the more control retained the less issues are likely to arise as time goes on. From the franchisees perspective, the more freedom secured, the less rules he/she needs to live by. While there is validity to both sides, the fact is that for the franchise operation to succeed the interests of the franchisor need to be primary. This article is about the policies the franchisor needs to consider.

The Franchise Agreement is a broad legal document that seeks to foresee any and all scenarios under which the two separate legal entities that are the franchisor and the franchisee might interact. The Agreement seeks to define the relationship and regulate the activities of all sides, so that the business of the franchisor and the business of the franchisee will, while being mutually exclusive, succeed in operating side by side and one with the other.

From Tudog's perspective, while there are many scenarios and many aspects to the agreement that need review and careful consideration, there are really 4 specific areas that require policymaking and can differ depending on the policies the franchisor seeks to pursue and enforce. These policy areas are:

- Ownership of franchises
- Franchisee compliance
- Term of the agreement
- Marketing

Covering these four areas will enable you to bring to your lawyers the foundation and parameters within which you want the Franchise Agreement to be constructed. Understanding the four areas is therefore critical:

Ownership of Franchises

The key issue with franchise ownership is whether or not you will require the franchisee to also be the operator of the business. While this may seem logical, it really depends on the kind of business you are franchising and whether the franchisee's full time attention is required, as opposed to that of his/her dedicated staff trained by you.

Perhaps against logic, more than 75% of all franchisors do not require the franchisee to be the operator. The reason is primarily because most companies want to be able to have multi-unit franchisees and the operator requirement would disable this option. The studies however indicate that non-operator franchise units perform significantly lower than owner/operator units because the owner/operator has all the proper incentives to perform to maximum capacity.

Deciding whether to allow passive ownership is a question you need to address not from the multi-unit perspective, but from the performance per unit approach. If you are willing to have some units under-perform so that you can, in exchange, sell more units via multi-unit agreements, then passive ownership is the right way to go. If, on the other hand, you want to maximize the performance of each unit, you need to require owner operation.

Franchisee Compliance

The structure of franchising – governed by an agreement between two separate business entities – requires that the franchisor take a number of vital steps to ensure that the agreement reached is kept. It is important to recognize that franchisee non-compliance can have tremendous effects on the franchisor, as misbehavior or failure to meet market promises can erode the brand, scare off new franchisees, and affect revenues. Conversely, franchisors that go too far in regulating franchisee behavior can breed resentment, inhibit franchisee activity and growth, and chase away prospective franchisees not interested in working under such tight restrictions.

So the question is, how do you balance your need to ensure franchisee compliance with the equal need of being attractive to franchisees? The answer is by understanding what aspects of operations are essential to control and which ones offer the opportunity for some flexibility. The areas that demand strict structure are:

- The enforceability of the agreement – you need to make sure you will be able to demand and compel compliance for every clause in the agreement. Having clauses that you cannot or will not enforce dilutes the strength of the agreement and could lead to franchisees testing your resolve.
- Termination rights – you need to make sure you have a legal means of terminating the franchise relationship if the franchisee proves to be unable or unwilling to comply with the terms of the agreement. While the reasons for termination need to be reserved for extreme conditions, the right to terminate needs to be preserved.
- Controlling quality – you need to keep in mind that the quality of the product/service being delivered by or via the franchisee is a reflection of your company. You need to make certain you have reserved the ability to control quality whether through the provision or approval of designated suppliers or through quality control mechanisms.
- Ensuring royalty payment – the primary source of sustained revenue for your company will be franchisee royalty payments. The need to secure timely, accurate payments is essential to the financial health of your company. You need to make certain that your agreement spells out the methods for calculating royalties, your rights to audit to ensure proper payment, the schedule for royalty payments, and the assigned late fees for payments not paid on time.

Term of Agreement

The term of the agreement is a critical issue because it determines the length of your association with the separate legal entity that will own and operate a franchise of your company. The initial term – typically 10 or 15 years – is usually supplemented with an additional 10 or 15 year renewable term.

There are two sides to this matter. First, you want to make sure that your term is sufficient for the franchisee to feel your franchise is a value. For example, a term that is too short could lead prospective franchisees to fear that they are buying something that will expire before its true value can be realized. A term that is too long can serve to intimidate prospective franchisees who may see the commitment as too great an undertaking.

Another thought to keep in mind is that in many circumstances a franchisee elects not to renew a franchise because he/she feels that the ongoing royalties are not justified in light of their ability to proceed without the franchise brand. For example, an ice cream store franchise operator that has been on the same corner for 15 years may feel that he/she has the customer base and market presence necessary to give up the brand and move to his/her own name. For this reason, you may want to include a renewal clause that requires conditions for non-renewal.

Marketing

The policies you adopt with regard to your marketing are critical to the success of your franchise. Firstly, your marketing has two primary objectives – to raise awareness and create interest in prospective franchisees, and to do the same in the markets you are targeting for your products/services. As relates to your franchisees, only the latter is important and you must create policies that demonstrate to the franchisee that your marketing will serve as a way to drive business to their franchised unit.

Your marketing needs to aim toward the creation and maintenance of your brand and the ongoing establishment of new interest in your products and services. The decision to advertise nationally or regionally is a function of where you currently have franchisees and which areas you expect to expand your franchise base. In addition you need to provide your franchisees with the capacity and guidelines within which they will engage in local marketing.

In almost every case the franchisor requires the franchisee to pay an additional percentage of gross revenue (above the royalty fee) of between 2% and 3% for the purpose of supporting marketing activities to be led by the franchisor. In addition, many agreements call for franchisees to spend an additional sum (often also 2%-3% of gross revenue) on local marketing. In these situations, the franchisor usually leads the way with prepared marketing materials for the franchisees to use.

The development of strong policies in the 4 major areas that call for well conceived policy decisions is the best way to make certain that you have laid the groundwork for a stable, predictable, and reliable franchising operating.