RuskinMoscouFaltischek P.C.

The Greatest Myths About Franchising

By Harold L. Kestenbaum, Esq.

Harold L. Kestenbaum

Franchising is a method of expanding one's own business using the capital and human resources of a third party, the franchisee. An example of how this works is as follows:

Company A has a proven, successful operation – let's say in the pizza business. It has at least one and perhaps two fully operational locations; it has a catchy name and an excellent product; and features some family owned and developed recipes. It has seen how Sbarro, Pizza Hut and Dominos have grown, so now the owner decides that's what he wants to do. The owner then goes out and hires consultants and professionals versed in the franchise industry to put together the package that is needed, and the owner is "off to the races". Once established, he will sell franchises for a fee to a person who will buy the franchise (franchisee), find a location, build the store with his own capital and operate it with his own employees. That franchisee will pay an upfront fee to the founder and an ongoing royalty for the right to use the name, recipes, etc. This is, in essence, the franchise model.

This sounds all easy, so why doesn't every business do it? The answer is not as simple as it seems. Here is where some of the myths about franchising come into play.

Myth Number One: It costs hundreds of thousands of dollars to franchise a business. Certainly, one can spend that much to franchise but with the proper consultants and professionals, it will cost less than $125,000 to put the program together and roll it out. This amount is reduced if the company is a home-based franchise concept or a non-retail concept. Those types of businesses can be rolled out for under $75,000. Some entrepreneurs may say that even that amount is too much. However, if you take a close look at what the ultimate potential is, this is indeed a small price to pay.

Let's again take the example of our pizza shop owner. He wants to roll out a franchise program. It costs him $125,000 to get all of the documents, manuals, website, etc. in place. Let's say that his initial franchise fee is $30,000 and that his ongoing royalties are 6% of gross revenues. If he sells 5 franchises the first year, he has essentially recouped his initial outlay, plus he will have a royalty stream of approximately $30,000 per store per year, assuming the stores gross $500,000 in sales. That is an additional $150,000 in revenue. If he chose to build five stores on his own, at a cost of $250,000 per store, he would have spent $1,250,000 to build the stores, not to mention the cost of operations and human resources to generate a 15% bottom line on the same $500,000 in sales, or $75,000 in revenue, along with the aggravation of worrying about employees and other issues. Hardly worth the effort.

Myth Number Two: Many believe franchising is too regulated and it will cost too much to follow the laws. It is true there are no ongoing rules or laws that our pizza shop owner would have to follow if he opened the five units on his own as opposed to following the regulations as a franchisor. Are these laws too burdensome and therefore not worth the effort to become a franchisor? Not in my experience.

In actuality, if the pizza shop owner chose to become a public company, the laws and regulations would be truly burdensome and quite costly, much more so than in the franchise model. So if our pizza owner chooses to avoid franchising for this reason, he will have passed up an opportunity to grow exponentially because he thinks that the franchise laws are too expensive and burdensome to comply with. First, the cost of compliance is not expensive compared to the benefits of franchising. I estimate that on an annual basis, the cost of compliance would be less than $15,000. If our pizza owner was a public company, the costs would be five to ten times that amount, at the very least. With the proper professionals, the burden is substantially reduced.

> ***"...you will also have passed up on a potential of growing your business to the point where you can sell it for many multiples..."***

Myth Number Three: As a franchisor, I will be sued by my franchisees. While it is true that a franchisor does have some exposure to franchisee litigation, the number of franchisee lawsuits in any given year is not more than those brought in the ordinary course of operating a business, such as slip and fall suits, food poisoning and the like. However, if you treat your franchisees fairly and perform under the franchise agreement, there will be no lawsuits. I have been involved with franchisors that have never had a franchisee lawsuit. Will there be some? It is possible, but none that will jeopardize the business if you have done what you are supposed to do. If you choose not to franchise you will never be sued by a franchisee, but you will also have passed up on a potential of growing your business to the point where you can sell it for many multiples, whereas, as a single store operator, that will never happen.

If you have a non-retail business that you are thinking about franchising, then the second two myths are basically eliminated since it will be less expensive to comply and the risk of franchisee lawsuits will be substantially reduced or even eliminated. The reason for this is because the franchisee's investment in this type of franchise is substantially less than in a retail environment, and the risk of losing large sums of money if the business fails is eliminated.

Finally, the franchise model is one that can be inadvertently put in place without a company even realizing that it has done so. Companies try to explain that all they are doing is "licensing" their name and know how to end-users. Unfortunately, they are often operating a franchise without even realizing it.

Harold L. Kestenbaum, Esq. is Counsel to Ruskin Moscou Faltischek, where he chairs the firm's Franchise Licensing and Distribution Practice. He can be reached at 516-663-6613 or hkestenbaum@rmfpc.com