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FEATURING....

RICHARD L. ROSEN

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Should You Set Up Your Business as a Franchise?

After their business plan has taken flight and is off to a positive start, entrepreneurs may be considering their next, business-savvy move. Speaking to Richard Rosen, we discuss when franchising your business is a good idea and what to look out for. In this insightful interview, Richard offers nuggets of advice and knowledge on how lawyers often assist business owners to ensure they are protected throughout the process turning their business into a franchise.

When is setting up a franchise a smart move for businesses? When should an entrepreneur opt for a different route?

While there are many circumstances that may motivate an entrepreneur to franchise his or her business or concept, amongst the most typical would involve having a proven business that is viable, replicable and profitable. While "concepts" can be franchised, a business that has demonstrated that it can operate cohesively and successfully is more likely to be successful when it is owned and operated by third parties (franchisees), than one that has not. The business and its ongoing operation plan need to be replicable, meaning that the business can be copied by others and, under normal circumstances, can be operated with a consistent (albeit projected) level of success. The business to be franchised should also be profitable, as a few things can lead to a successful franchise more so than franchisees who are making money, and a few things can undermine a franchise more than unhappy franchisees who are suffering losses. Further motivating factors include the need to enhance the ability to distribute a product that the franchisor manufactures or supplies, together with the desire to expand brand recognition and awareness. When the entrepreneur finds that it doesn't have the capital (or access to capital) necessary to expand its market internally, franchising is frequently a good alternative, as typically, it is the franchisee who funds the expansion.

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On the other hand, when an entrepreneur finds that it already has an extensive, company owned chain of operating units, along with the capital (or access to capital or financing) necessary to expand, he or she may not feel the need to bring in franchisees to further expand the

About Richard L. Rosen, Esq.

I am the founding member of the Richard L. Rosen Law Firm, PLLC now (as of January 1, 2021) Rosen Karol Salis, PLLC. We are located at 110 East 59th Street, in New York City, New York. I, my firm and its predecessors have been practicing franchise law, representing both franchisors and franchisees, for over 40 years and there is virtually nothing in the franchise field that we haven't done, whether it be on the transactional side or involving dispute resolution (mediation, arbitration or litigation). During that time, we have been well recognized in the franchising field and I have been fortunate enough to have received many awards and honors during my career, including having received the Lifetime Achievement Award for having been listed in Who's Who in America for over 30 years.

business. This may be especially the case where the operating units in the "chain" are extremely profitable and the entrepreneur may not want to dilute the profits that can result from its own expansion by letting franchisees take over the expansion. Simplistically (very simplistically), a business (unit) that generates $2,000,000.00 in revenues and a 25% profit ($500,000.00) for the entrepreneur, as compared to a franchise that generates $2,000,000.00 in revenues and a 5% royalty ($100,000.00) may be too rich for the entrepreneur to give up. There are also many entrepreneurs who just aren't psychologically or emotionally equipped to lose the "hands-on" approach (and complete control) that may have fueled his or her success. Having third persons (franchisees) operating locations with their brand on it just may not be right for them.

What criteria does an entrepreneur need to meet in order to consider setting up a franchise?

In addition to the general criteria discussed above, I like to see three or more successful, operating units, preferably not all dependent on "super" locations for their success. A registered trademark (or one that is registerable) is essential and a certain level of brand awareness with the entrepreneur's existing (local) market will provide a good indication of potential success. While an adequate depth of management necessary to extend the existing business into the franchising field will be helpful, the willingness (and wherewithal) to acquire such management will typically suffice. Strong leadership and good character is essential for me, especially when it is combined with a "willingness to listen" and being responsive to the input that will, inevitably, be received over time, from franchisees. The entrepreneur will also need to have sufficient capital to both implement and to carry out the program. As to investors, I recommend that where possible, the entrepreneur implement the franchise program on his or her own and bring in investors later (if at all), after success has been established.

What trademark issues can arise here?

Having a registered (or registerable) trademark is essential to franchising successfully. Even if the trademark has been successfully registered, there is always the possibility of competition, or even infringement, from similar or "confusing" marks. Even with a protected trademark, it is prudent to explore, in advance, whether the franchise is likely to have many competitive, similar businesses in its field, even with non-similar trademarks. Further, the entrepreneur would be well advised to explore the availability of international registration for the trademark. If the franchisor implements a franchise program without having registered trademarks protecting its intellectual property, serious problems can arise. The franchisor may not be able to prevent a competitor from using virtually identical or substantially similar marks, which can have a significant negative impact on the franchisees' (and therefore, the franchisor's) profitability. Also, if a third-party is able to register trademarks that are the same or substantially similar to those used by the franchise system, then the franchisor (together with its franchisees) may unknowingly infringe upon the third party's trademark rights, which could expose the franchisor and/or its franchisees to significant legal risk (damages and expenses).

What are the key areas for businesses to protect when franchising and how can they do it?

It is difficult to find an aspect of franchising that should not be protected in some manner, but some areas stand out. At the top of the list is the integrity

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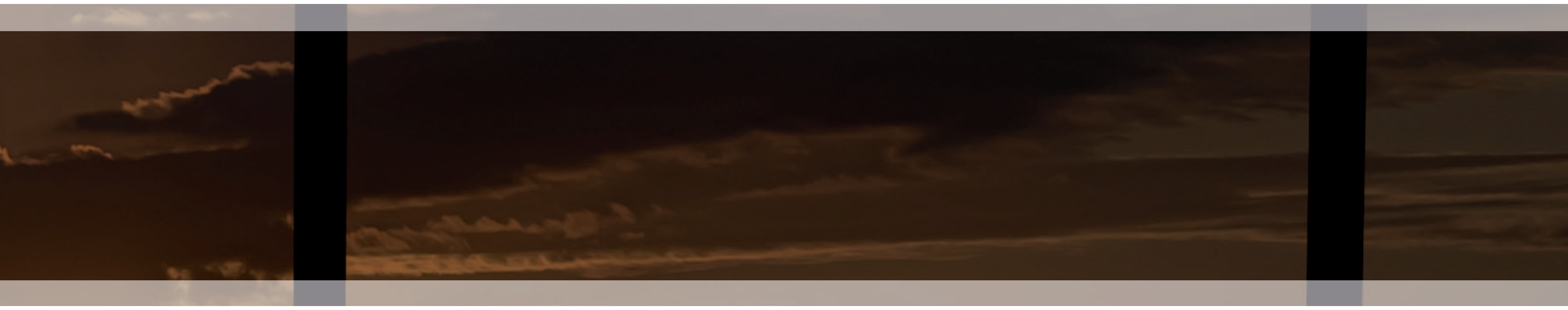
of the brand. The trademarks must be protected to the fullest extent possible, frequently by taking immediate legal action. The franchisor needs to ensure that its franchisees use the brand and sell the products or provide the services in the manner that the franchise program, as is typically set forth in the various franchise documents, including the franchisor's operations manual, calls for.   Virtually all franchisors provide that the franchised business must be operated in accordance with a business plan and specified operations procedures that, ideally, will ensure that there is consistency and recognisability throughout the franchise system. This should ensure that customers know what they will be getting, the manner in which the product or service is being delivered and the quality of that product or service, all in a consistent, system-wide manner. If there is a "secret sauce" that is part of the franchise (either literally or figuratively) it must be protected. The franchisor must protect against the franchisee (and even certain key employees of the franchisee) competing with it, both during the term of the franchise and also for a certain period after the franchise itself (or, where applicable, the employment of the employee) has expired or been terminated. The franchisor needs to monitor the revenues (and typically, the expenses, as well) generated by the franchised business, since, amongst other reasons, revenues will invariably determine the basis upon which royalties and advertising contributions will be calculated and paid to the franchisor. The franchisor will also want to determine the manner in which disputes between the franchisor and its franchisees will be resolved or otherwise dealt with.

Franchisors can (and do) protect themselves in a variety of ways. Most of these protections are provided for in the franchise agreement and other documents which may include personal guarantees, operations manuals, confidentiality agreements, non-competition agreements, software and point of sale agreements and on and on. Franchisors will typically provide that the franchisee's advertising must first be approved, and this may include what can, or cannot be disseminated on social media. Compliance with the various agreements is typically guaranteed by the principals of the franchisee (certainly the major ones) and sometimes even by their spouses. Locations for franchised units, as well as the leases for locations, must first be approved by the franchisor. If a franchisee has a specified territory in which it has the exclusive right to open franchised locations, the franchisor may exclude and reserve for itself the right to open in certain types of "non-traditional" locations, such as sports stadiums and arenas, airports, colleges, hospitals, certain shopping centres and, most significantly, the ability to sell its products using "alternate channels of distribution", including on the Internet or in supermarkets located within the franchisee's territory.

The sale of the franchise itself, as well as the sale of interests in the franchisee entity, are typically subject to the franchisor's approval or even "rights of first refusal" or "rights of first purchase". Sometimes, transfers to family members or existing partners are "carved out" of these restrictions, but sometimes they are not. Franchisors almost always provide for the manner in which disputes with their franchisees are resolved, such as by negotiation, mediation, arbitration or litigation and where such matters will take place (venue), typically where it is more convenient for the franchisor (e.g., their home city or county). Franchisors will usually designate what law will apply, how costs (including attorneys' fees) may be allocated and sometimes may even proscribe limitations on damages that may be recovered against it or provide for liquidated damages that may automatically be imposed against the franchisee if it defaults. This is not to



say that these restrictions or provisions are fair or reasonable. Some are, some are not and, as always, the devil is in the details. But these are amongst the many approaches that franchisors have available in order to protect their interests in connection with the franchisor/franchisee relationship.

What support do businesses need to offer to those wishing to invest in their franchises?

At the start of the potential franchisor/franchisee relationship, the franchisor has to evaluate the prospective franchisee as to his or her suitability to become a participant in the franchisor's franchise community. This "vetting," as it were, includes an evaluation of the prospect's background, stability, financial suitability, experience, education and commitment. While it is (and make no mistake about it) a selling process, it is clearly in both the franchisor's and the prospective franchisee's interest that the process is undertaken with a view towards reaching an independent and accurate evaluation of the prospective franchisee's suitability. In reviewing the FDD (Franchise Disclosure Document) the prospective franchisee will learn a great deal about the franchise system, including such areas as the costs of becoming a franchisee, the background surrounding the franchisor and its principals, the franchisor's litigation history, near term growth and, under certain circumstances, its financial background and certain financial information in Item 19, regarding unit operations. The new franchisee and its staff will receive training with respect to business operations and management, assistance in finding and evaluating a location for the franchise and, in some systems, help in negotiating the lease.

An operations manual, which should be updated on an ongoing basis, is ordinarily provided and regular inspections and training (where necessary) should take place. Hopefully, the franchisor will grow and evolve over time and new and improved products will be provided. In an ideal world, the franchisor and its franchisees, sometimes by means of a Franchisee Association, will maintain ongoing communication(s) so as to solve problems together, coordinate advertising, exchange ideas and views as to how to improve the system and, generally, to provide mutual support for the betterment of the franchise system, generally. Is this an idealised view? Perhaps, but my long-time experience, on each side of the table, has told me that it can be done.

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Can an attorney help all this to happen?

The answer is unequivocally, yes. An attorney who is experienced in the field of franchising, preferably on both the franchisor and the franchisee side, can identify the issues in advance and also help to guide the franchisor through the "rough patches" that are sure to arise as the franchise system matures. Most importantly, an experienced, caring and thoughtful franchise attorney can counsel the franchisor as to how, not only to make sound business and legal decisions, but also as to the necessity of maintaining a positive relationship with the franchisees, to seek to achieve a "fair" franchising system as well as a successful one, and to listen to the other side's point of view with the goal of resolving issues amicably, wherever possible.

Richard L. Rosen, Esq.
Rosen Karol Salis PLLC
110 E. 59th Street, 23rd Floor
New York, NY 10022
212-644-6644
212-644-3344 (fax)
www.richardrosenlaw.com

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Richard L. Rosen
Professionalism
Experience
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