

2018 IFA

# LEGAL SYMPOSIUM

• May 6-8 | Washington, DC



# A Practical Guide to Managing Issues Faced by Start-Up and Small Franchisors

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# Introduction

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- Small and Startup Franchisors
  - Initial Offering through first 5 years
  - Generally, 25 or fewer outlets

# Introduction

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1. Franchise Program Structure
2. Franchise Sales Compliance Programs
3. State Franchise Registration Strategy
4. Estimated Initial Investment and FPRs
5. Managing Franchisee Relations

# La Concha Cidery

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## HYPOTHETICAL FRANCHISOR:

- Family-owned restaurant with farm-to-table Basque menu featuring cider and traditional Basque tapas (“pinxtos”) and traditional décor
- Company-owned outlets: Bakersfield, CA (2010) and Las Vegas, NV (2013)
- Both restaurants have been successful, and the family is ready to expand via franchising
- Applied to register the trademark, “La Concha Cidery,” in January 2018

# Franchise Program Structure

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## **HYPOTHESIS #1:**

La Concha intends to structure the franchise program as follows: \$80,000 initial franchise fee, 5% royalty, 2% advertising contribution, and 30-year term

# Franchise Program Structure

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- **Fees:** Initial fee to cover costs to get franchisee in business and ongoing fees that are “market” but allow franchisee to make ROI
- **Initial Training Program:** Empower franchisees with a turnkey operation
- **Franchise Term:** Franchise terms that are “market” and long enough to allow franchisee to make ROI

# Franchise Program Structure

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- Experienced franchisor attorneys and consultants
- *Entrepreneur* magazine's "Franchise 500" list and "Top New Franchises Ranking"
- CA, MN, and WI online repository of filed FDDs



# Franchise Sales Compliance Program

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## HYPOTHESIS #2:

- Interest in the concept is strong and La Concha intends to rely solely on brokers for initial sales so they don't have to worry about the "paperwork"
- The owner's cousin's friend is interested in opening a La Concha restaurant
  - 30-year old engineer who is bored with current job
  - Doesn't meet net worth requirements

# Franchise Sales Compliance Program

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- Franchisor responsibility – even if brokers used
- Appoint an administrator
- Three Components
  - Minimum Qualifications for Franchisees
  - Sales compliance process/procedures
  - Training

# Franchise Sales Compliance Program

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- Establish and follow minimum franchisee qualifications
  - Net worth
  - Liquidity
  - Experience
  - References
  - Credit and PATRIOT Act verification



# Franchise Sales Compliance Program

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- Develop franchise sales compliance procedures
  - Spreadsheets and checklists
  - CRM software
- Franchise sales training program – train everybody involved in the sales process early and often

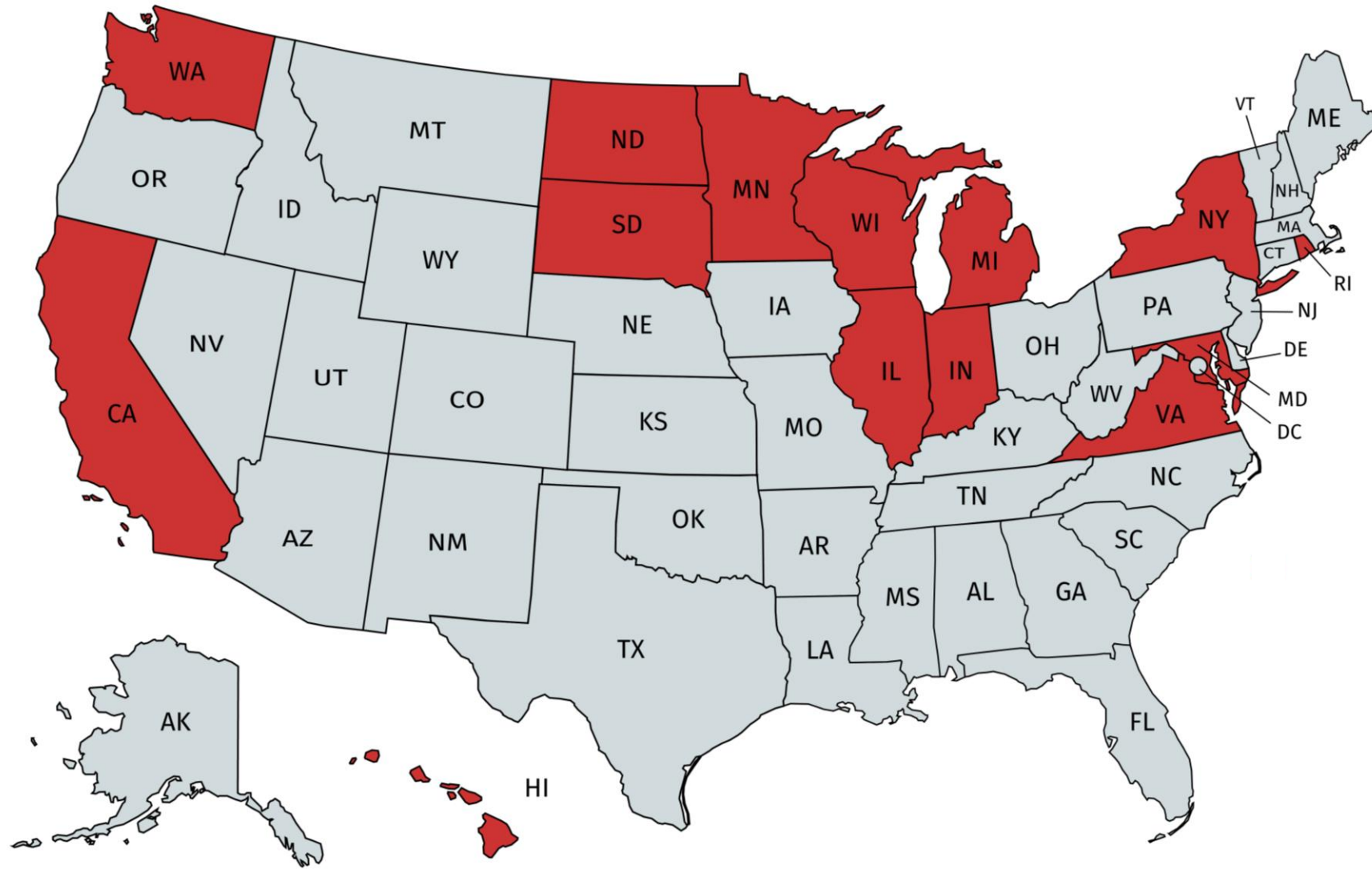
# State Franchise Registration Strategy

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## HYPOTHESIS #3:

- With interest growing, La Concha wants to offer franchises across the West Coast, South, and Midwest
  - Federally registered mark: La Concha Cidery®
  - No federally registered mark: La Concha Cidery™

# State Franchise Registration Strategy



- Must comply with FTC Franchise Rule (any state)
- Must be registered or exempt in 14 states





# State Franchise Registration Strategy

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- **Franchisor resources:** Capital and sales/training staff
- **State franchise laws:** Register unless exempt (filing fees \$250-\$750 per state for new filings + \$100-\$450 per state for renewal filings)
  - Notice filing vs. comprehensive review
  - Financial assurances

# State Franchise Registration Strategy

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- **State business opportunity laws:** Register unless exempt
- **Recommendation:** Federally register the mark, and focus only on states that the franchisor can reasonably support and where prospects exist – avoid nationwide initially



# Estimated Initial Investment

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## **HYPO #4:**

- La Concha prepared its initial Item 7 disclosure based on its historical costs and expenses to develop the existing company-owned outlets: Bakersfield, CA (opened 2010) and Las Vegas, NV (opened 2013)
- La Concha has a strong franchise prospect located in New Jersey
- 8 months after the FDD is issued, La Concha expands its offerings to include delivery at all locations and also upgrades/replaces its POS system at a cost of approximately \$30,000 per restaurant

# Estimated Initial Investment

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- Sources of information
  - Company outlets
  - Competitor FDDs
  - Existing franchisees (franchisee surveys)
- Preparation of explanatory notes (Item 7 chart) – to provide explanations, definitions and caveats
- Updating information/Amending FDD

# FPRs

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## HYP0 #5:

- Two years later: 2 company outlets and 6 franchised La Concha outlets in operation (4 of 6 franchised outlets have been operating for 12 months or longer); 1 additional franchised outlet opened last year but closed after 9 months
- La Concha wants to prepare an FPR based on historical gross sales data from the 2 company-owned outlets, which have been very successful
- Alternatively, it is considering presenting average historical gross sales for a subset of the total system outlets – the top 25%

# FPRs

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- Historical or Projected (Forecast)
- Any representation that states or implies a specific level or range of actual or potential sales, income, gross profits, or net profits
- Reasonable basis and written substantiation

# FPRs

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- New FPR Commentary (adopted May 8, 2017)
  - Historical Gross Sales
  - Historical Gross Profit/Net Profit
  - Financial Forecast/Projections



# FPRs

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- New FPR Commentary (adopted May 8, 2017)
  - Average and Median
  - Use of Subsets
  - Merging Data

# Managing Franchisee Relations

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## **HYPO #6:**

- Three years later: 15 franchised La Concha outlets are open with 35 under development
- Some franchisees complain about inadequate marketing, unpopular menu items, technology upgrade and overall lack of support
- La Concha believes the problem with some franchisees is that they aren't following the system, and the franchisor wants to send a strong message that defaults will not be tolerated
- La Concha wants to focus on new sales and is considering enlisting happy franchisees to assist with the sales effort through a referral program

# Managing Franchisee Relations

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- Franchisor obligations
  - Marketing program, training and other assistance
- System and technology upgrades
- Communication

# Managing Franchisee Relations

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- Enforcing system standards
  - Brand protection
  - Procedures
  - Documentation
  - Flexibility

# Managing Franchisee Relations

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- Balancing new sales efforts vs. assisting existing franchisees
- Use of franchisees in sales efforts
  - Testimonials
  - Referral Programs
  - “Steering” in validation process



# Q&A

## A Practical Guide to Managing Issues Faced by Smaller and/or Startup Franchisors