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EXECUTIVE SUMMARY

The central objective of this study is to examine the effectiveness of franchising as a vehicle for business ownership by individual entrepreneurs and small businesses. This study, initiated and sponsored by the Small Business Administration (SBA), examines trends in franchising since 1975 and the factors that influenced these trends. It also assesses investment and costs of franchising, characteristics of franchisees, franchisor assistance, solicitation and sale of franchises, and the franchise relationship. The study concludes with projections of franchising through the Year 2000 and provides recommendations on how franchising’s continued growth might be fostered. The findings of this study are based on a systematic review of the literature on franchising, existing aggregate data on franchising trends, and interviews with franchising experts, franchisors, and franchisees.

To discuss franchising, a large amount of proxy data from several sources is used to provide inferences and generalizations about the appearance and performance of small firms which use the franchise form of business. Rather than classifying firms by their assets or employment, franchising firms are typically arrayed by the number of units owned by franchising companies. We know, however, that about two-thirds of franchisees are organized as single sole proprietorships, and that about 62 percent of franchise owners have only their own unit. Therefore, at the outset, it is important to realize that approximately two thirds of the universe of franchising firms are small businesses. There have been some important structural changes among franchises during the past 15 years. Key findings and implications of this study are summarized below.
A. TRENDS IN FRANCHISING, 1975-1990

Franchising has grown substantially since 1975, as measured by increases in sales, establishments, and the number of persons employed:

- **Sales.** Annual sales through franchises grew (in current dollars) by a total of $528.7 billion between 1975 and 1990, from $185.8 billion to $714.5 billion (see Exhibit ES-1). When adjusted for inflation (in constant dollars), the increase in sales over the period was 58.5 percent. In relative terms, franchising sales increased from 28.2 percent of retail sales in 1975 to 34.0 percent of retail sales in 1990 (see Exhibit ES-2). While product/tradename franchises continue to account for two-thirds of all franchise sales, one of the most significant trends in franchising since the 1970s has been the rapid emergence of business format franchising (see Exhibit ES-3). In inflation-adjusted (constant) dollars, business format franchise sales increased by 115.5 percent between 1975 and 1990, compared to 42.4 percent for product/tradename franchising.

- **Establishments.** Between 1975 and 1990, the number of franchise establishments increased by about 20 percent -- from 434,538 to 521,215 units (see Exhibit ES-4). During this period, while business format franchising experienced an 83.2 percent increase in establishment units, the number of product/tradename establishments declined by 39.6 percent. Where product/tradename establishments represented 51.5 percent of all franchise establishments in 1975, by 1990 they accounted for 25.9 percent of establishments (see Exhibit ES-5).

- **Employment.** Between 1975 and 1988, the total number of persons employed in franchising doubled -- increasing from 3.5 million persons to 7.0 million persons (see Exhibit ES-6). Over 90 percent of the net increase in employment within franchising occurred within business format franchises. Employment in business format franchises grew by 161.5 percent between 1975 to 1988, compared to a 17.7 percent increase in employment within product/tradename franchises. The number of persons employed per establishment grew by about 80 percent between 1975 and 1988 -- from 8.1 to 14.6 employees per establishment (see Exhibit ES-7).

General growth and change in franchising was also reflected at the franchisor level. Between 1975 and 1988, the number of business format franchisors doubled -- increasing from 1,115 to 2,239 franchisors (see Exhibit ES-8). Large franchisors, those with more than 500 franchise establishments, dominated in terms of franchising sales and establishments. For example, just 5.8 percent of business format franchisors had more
EXHIBIT ES-1:
TRENDS IN TOTAL FRANCHISE SALES,
1975-1990

EXHIBIT ES-2:
FRANCHISE SALES AS A PERCENT OF
U.S. RETAIL TRADE, 1975-1990

EXHIBIT ES-3:
TRENDS IN PRODUCT/TRADENAME AND
BUSINESS FORMAT FRANCHISE SALES

EXHIBIT ES-4:
TRENDS IN FRANCHISING ESTABLISHMENTS,
1975-1990

Note: Sales in Actual (Current) Dollars.
EXHIBIT ES-5:  
TRENDS IN PRODUCT/TRADENAME AND BUSINESS FORMAT ESTABLISHMENTS, 1975-90

EXHIBIT ES-6:  
TRENDS IN FRANCHISE EMPLOYMENT, 1975-1990

EXHIBIT ES-7:  
TRENDS IN FRANCHISE EMPLOYMENT PER ESTABLISHMENT, 1975-1990

EXHIBIT ES-8:  
TRENDS IN THE NUMBER OF BUSINESS FORMAT FRANCHISORS, 1975-1990

Note: Data not available for 1976 and 1987.
than 500 franchise units in 1986, but this group accounted for about two-thirds of franchise sales and establishments.

B. FACTORS AFFECTING THE GROWTH OF FRANCHISING

Franchising is one of several alternative growth strategies for small companies considering expansion. Among the key reasons for franchising (over other forms of business expansions) from the perspective of the small franchisor are the following:

- Franchising provides an effective method for raising capital to finance expansion. Franchising may be particularly advantageous for the smaller, less mature franchisor who lacks ready access to traditional capital markets.

- Franchising enables the franchisor to use the pooled resources of franchisees to advertise, thereby strengthening customer recognition and fostering a rapid growth in sales.

- Franchising provides an opportunity for the franchisor to recruit talented and motivated managers, and to expand without a large management group. Franchising transfers substantial risk and responsibility to the franchisee whose income is dependent on the success of the franchise unit.

- Franchising provides the franchisor control and consistency over goods and services produced. Franchising’s emphasis on standardized operations and methods is particularly applicable for managing service sector operations.

The growth of franchising over the past two decades could not have occurred without the strong appeal of franchising to franchisees who were willing and able to invest both their time and resources in franchise units. Among the key reasons that individuals and small businesses are attracted to franchising are the following:

- Franchising provides a recognized good or service that attracts customers. In contrast to an independent small business, franchising offers the new franchisee a way to begin his/her business with a product or service which is well-known to potential customers.

- Franchising provides relevant training and on-going technical assistance.

- Franchising provides a tested system, which reduces risk of small business failure.
In addition to these internal factors, a host of external economic, technological, and demographic factors influenced overall growth of franchising and shaped trends within individual sectors of franchising. Among the key external factors were the following:

- **Economic Factors**: General economic conditions (e.g., recession and growth) substantially influenced franchising’s rate of growth over the period 1975 through 1990. In addition, corporate downsizing increased the availability of well-trained corporate executives.

- **Demographic Factors**: The "baby boom," resulting in an increase of persons in their prime working years, provided a steady source of persons interested in purchasing and operating franchise units between 1975 and 1990. Other factors contributing to franchising’s growth were:
  - The recognizable products/services sold by franchises -- along with the ability of franchises to advertise nationally -- appealed to the highly mobile U.S. consumer.
  - The growing affluence and education of the American consumer seemed to boost demand for niche products.
  - Increases in the number of working women both created markets for new products and increased the number of potential new business owners.

- **Technological Factors**: Changes in the technology of retailing and the emergence of new products/services that were well-suited to franchising fostered the expansion of franchising, particularly within business format franchising.

C. **FRANCHISEE INVESTMENT AND COSTS**

On average, franchisees reported investing a total of about $150,000 in their franchise unit, with median start-up costs ranging from $25,000 to $50,000 in most franchising sectors. However, across sectors and individual franchise systems there were wide disparities in both start-up and overall investment levels (see Exhibit ES-9). Some areas of franchising (e.g., fast-food restaurants, hotels, and motel chains) have moved beyond the reach of many individuals and small businesses. However, dynamic growth
and flexibility of franchising over the past two decades, also has meant that there are still many franchise opportunities available involving less than $25,000 in start-up costs and $50,000 in total investment. Moreover, it is not clear that opening and operating a successful franchise requires more funds than a comparable, successful independent small business in the same sector.

In addition to the initial investment, franchisees typically make a number of other ongoing payments to franchisors. The most important of these are royalty payments -- typically based on the gross sales of the franchisee. While there is some variability, royalty payments tend to be in the four-to-six percent range (see Exhibit ES-10). Franchisees also typically make ongoing payments to franchisors for advertising (see Exhibit ES-10), as well as payments for products and services supplied by the franchisor.

D. CHARACTERISTICS OF FRANCHISEES

Available data suggest that existing franchisees have achieved income levels well above those found in the general population. According to a recent survey of franchisees, the average annual gross income for franchisee owners was about $125,000. About 57 percent of respondents reported gross income under $100,000, with about one-quarter (26 percent) reporting incomes less than $50,000. About 20 percent report gross income of $200,000 or more (see Exhibit ES-11).

Initial and on-going investment requirements mean that prospective franchisees must bring more than their own time and energy to franchising -- they also need to bring financial resources and, increasingly, business experience and management skills. As franchise systems (and units) grow in their size and complexity, there appears to be even greater emphasis on the business experience and management skills. Franchisors indicate
that a growing number of their franchisees have this experience, coming from white collar professional or management positions.

The role of women and minorities in franchising appears to have grown in recent years -- though involvement still lags well below what might be expected based on the general labor force involvement of these two groups. Recent surveys suggest that about 10 percent of franchise units are owned solely by women, with an estimated 30 percent owned solely or jointly by women. The level of women ownership of franchises is about the same as the level of women ownership of U.S. firms, but below what might be expected based on the growing level of labor force involvement of women.

Between 1975 and 1986 the number of minority-owned franchise establishments about tripled (see Exhibit ES-12). Despite this growth, about 5 percent of franchises were owned by minorities (in 1986), which was well-below the percentage of minorities within the U.S. population and somewhat below general levels of minority ownership of U.S. firms (8.8 percent, in 1987). Relatively low levels of minority involvement in franchising suggests that minorities face generally greater obstacles to establishment of franchise ownership (especially with regard to raising capital) and the need for franchisors to reexamine their efforts to recruit minorities.

E. FRANCHISOR TRAINING PROGRAMS, SUPPORT, AND TECHNICAL ASSISTANCE

A major aspect of the franchising relationship which differentiates it from independent businesses is the provision of support and technical assistance by franchisors. When a franchisee purchases a franchise, he or she is purchasing not only a license or right to distribute particular products or services, but also the technical knowledge and experience of the franchisor. Franchisor assistance is typically provided in the following
areas:

- site selection and premise development,
- financial assistance,
- initial training,
- pre-opening and opening support,
- ongoing operational assistance and training,
- advertising and marketing,
- purchase of supplies, and
- research and development.

F. SOLICITATION AND SALE OF FRANCHISES

For the franchisee, the process of investigating various franchise opportunities can vary from an impulsive decision to lengthy and systematic evaluation of alternative franchising systems. Many prospective franchisees are reluctant to use professional advisors (such as attorneys or accountants) to evaluate franchise offerings because of the cost and/or difficulty of identifying an advisor with appropriate expertise. Most franchisees, franchisors, and experts strongly recommend that prospective franchisees interview other franchisees (within the same and competing franchise systems) when considering whether to purchase a franchise unit.

Both federal and state governments regulate solicitation and sale of franchises. The main thrust of these federal and state laws is to ensure a complete and honest disclosure of information during the sales process. Federal regulation governing solicitation and sale of franchises was established by the Trade Regulation Rule on Franchising and Business Opportunity Ventures (16 CFR 436.1), issued in 1979 by the Federal Trade Commission.
FTC). Franchisors are not required to provide data on expected sales, income, and earnings, but the regulation prescribes the format to be used if such claims are made. The terms of the franchise agreement are not regulated and no filings with the FTC are required. However, the FTC reserves the right to take enforcement action against franchisors for providing incorrect or misleading information to prospective franchisees.

While the FTC rule is intended to offer a minimum level of protection, individual states can enact laws which offer a higher level of protection to franchise buyers. Fifteen states have enacted laws governing the solicitation and sale of franchises (under specific franchising laws or under other state laws, such as business opportunity and unfair trade practices). State franchising laws generally focus on requiring the franchisor to register with the appropriate state agency prior to solicitation of prospective franchisees within the state.

There has been some controversy in recent years over the adequacy of both existing franchise solicitation/sales regulation and enforcement (at the federal and state levels) of these regulations. However, because of the costs and burdens already imposed upon franchisors by existing laws and regulations -- and the uncertainty as to whether new laws/regulations would substantially decrease fraud and abuse -- every effort should first be made on improving the existing framework. Specifically, efforts should be focused on:

- greater uniformity in disclosure rules across states and reduction in costs and burdens of the state-level registration process;
- more stringent and uniform enforcement of existing disclosure laws at the federal and state levels;
- increased emphasis on disclosure of earnings claims by franchisors and ensuring quality of such claims;
- increased availability of information during the disclosure process that will facilitate prospective franchisees in more effectively validating the reliability of franchisor claims with existing and former franchisees; and
an increased role for federal (e.g., the FTC and SBA) and state government agencies, as well as private organizations (e.g., International Franchise Association), in informing franchisees about the step-by-step procedures for effectively evaluating franchise systems.

G. THE FRANCHISE RELATIONSHIP

The relationship between franchisors and franchisees has been at the center of considerable controversy over the past decade. Franchisors and franchisees, as well as federal/state governments, have struggled with the issue of whether additional laws and regulations are needed to eliminate abuses and enhance the relationship between franchisors and franchisees. Our interviews with franchising experts, franchisors, and franchisees, as well as the existing data on franchising and views expressed within the literature on franchising, suggest that considerable care should be taken in enacting new regulations. A number of factors argue against substantial change to current laws and regulations governing franchising relationships:

- **Satisfaction with Franchising Relationships Appears High Among Franchisees.** Findings of a recent survey of about 1,000 franchisees indicate that most franchisees are satisfied with their existing franchise relationship. Nearly 80 percent rated their relationship with their franchisor as excellent or good; only 6 percent rated their relationship as poor.

- **Feasibility of Implementing Effective and Generally Applicable Relationship Regulation Is Questionable.** Given the diversity of franchising relationships and very differing circumstances of franchisees (even within the same franchise system), the feasibility of enacting regulations that would effectively apply to all franchising situations is uncertain.

- **Substantial Recent Growth in Franchising Indicates Its Popularity and Acceptability Among Franchisors and Franchisees.** Growth of franchising -- especially within the business format sector -- has outpaced general economic growth over the past two decades. Although it is impossible to know whether added protections would have increased the growth of franchising (above actual growth levels), the sustained growth that occurred would seem to argue against radical changes.

- **General Legal Framework and Franchising Disclosure Laws Provide Basic**
**Protections for the Franchisee.** There is an existing body of law (e.g., common law, tort law, securities law, and trademark law) which provides a basic level of protection for franchisees against deceptive and unfair business practices. General legal protections are further reinforced and extended by federal and state disclosure pertaining to franchising.

- **New Regulations May Increase Costs/Burdens of Franchising, Which Could Affect Willingness of Franchisors to Franchise.** New regulation and increased enforcement could increase regulatory burden and costs of franchising. For example, new regulations and legal restrictions could increase legal costs for franchisors (and franchisees) as they cope with understanding the implications of these laws and make necessary changes to franchise agreements.

**H. FUTURE OF FRANCHISING**

There is a general consensus that franchising will continue to grow during the 1990s (particularly business format franchising) unless there is a major and prolonged recession or introduction of legislative/regulatory changes that significantly alter the underlying incentives to franchise. Expected trends through the Year 2000 include the following:

- Overall, franchising sales are likely to continue to expand and could reach a level of one trillion dollars by the Year 2000 (see Exhibit ES-13).\(^1\) Product/tradename franchising could be expected to reach a level of about $750 billion in sales by the Year 2000, while business format franchising could be expected to reach a level of about $300 billion.

- Based on patterns of growth over the past 15 years, it seems likely that franchising's share of retail sales will increase by three to five percentage points during the 1990s -- possibly reaching a level as high as 38 percent of retail sales by the Year 2000.

- The pace of growth in business format franchise establishments since 1975 suggests that business format franchising could reach a level of slightly over 450,000 establishments by the Year 2000 (Exhibit ES-14). Given the

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\(^{1}\)The estimates for the years 1991-2000 are derived from a regression of data for the years 1975 to 1990. The future estimates prepared by this method should be interpreted as indicating the broad underlying trend within the data for the future, if major conditions remain essentially unchanged.
EXHIBIT ES-13:
FRANCHISE SALES, OVERALL,
ACTUAL AND ESTIMATED TRENDS, 1975-2000

EXHIBIT ES-14:
BUSINESS FORMAT ESTABLISHMENTS,
ACTUAL AND ESTIMATED TRENDS, 1975-2000

EXHIBIT ES-15:
BUSINESS FORMAT FRANCHISE EMPLOYMENT
ACTUAL AND ESTIMATED TRENDS, 1975-2000

EXHIBIT ES-16:
BUSINESS FORMAT FRANCHISORS,
ACTUAL AND ESTIMATED TRENDS, 1975-2000

Note: Data were not available for 1976
and 1987.
adaptability of business format franchising to high growth service sectors over the past two decades, it is possible that business format franchising establishments may even exceed this level.

- **Employment within franchising may reach a level as high as 10 million persons by the Year 2000.** Much of this growth will continue to come within business format franchising, which could grow to a level of about 8.2 million persons (see Exhibit ES-15). While growing at a slower rate than business format franchising, product/tradename franchising could reach a level of about 1.8 million persons by the Year 2000.

- **The number of business format franchisors is likely to continue to grow at a rate of about four percent per year and may reach a level of nearly 3,500 by the Year 2000** (see Exhibit ES-16).

- **A number of factors are likely to provide continued impetus for expansion of foreign units by U.S. franchisors,** including: saturation of existing domestic markets, growing prosperity and expanding demand for consumer goods in many foreign markets, increasing emphasis on the global marketplace and reduction in barriers to trade, improving international communications and transportation systems, growing interest on the part of investors in many foreign countries, and lack of specific regulations governing franchising in most foreign countries.

According to experts that we interviewed and the literature on franchising, other likely trends include the following:

- A growing number of franchisors (especially larger and mature franchise systems) are likely to concentrate on generating higher returns from their franchising units, as opposed to expansion in the number of franchise units.

- **Stricter enforcement of standards is likely to continue, particularly within larger, more mature franchising systems.**

- **Trends during the 1980s suggested that three groups -- middle managers, women, and independent small business owners -- were increasingly attracted to franchising as a method for opening and operating small businesses. These three sources are likely to continue to provide a disproportionate share of new franchisees.**

- **While large franchisors (i.e., those with more than 500 franchise establishments) are likely to continue to dominate franchising, small and medium size franchisors are likely to grow in importance.**
I. RECOMMENDATIONS TO FOSTER THE GROWTH OF FRANCHISING

Key recommendations that emerge from this study, which are intended to improve the prospects for growth of franchising in the coming decades, are briefly summarized below:

- **Recommendation #1:** The Federal Trade Commission Should Continue Efforts to Improve and Streamline Financial Disclosure and Encourage the Provision of Earnings Claims by Franchisors. While franchisees and franchisors are generally satisfied with much of the current disclosure process, many feel that additional financial information would be helpful. The FTC should expand efforts to promote disclosure of financial information and earnings claims by franchisors.

- **Recommendation #2:** The Federal Trade Commission and State Governments Should Better Coordinate Review and Enforcement of Existing Sales/Solicitation Regulations. There has been criticism of the lack of federal and state efforts to review disclosure statements by franchisors and to enforce existing regulations against fraudulent or deceptive franchisors. Total resources for enforcement might be more effectively deployed if states reduced variation in requirements of their disclosure laws and better coordinated review of disclosure documents. Further, increased coordination and targeting of enforcement activities by the FTC and state agencies may also result in more cost-effective enforcement of existing sales/solicitation laws.

- **Recommendation #3:** Federal and State Governments Should Avoid Extensive Government Regulation of Franchising Relationships. A number of factors (discussed earlier) suggest that federal and state governments should avoid extensive new regulation of the franchise relationship. Rapid rates of growth in franchising over the past two decades and recent surveys of franchisees suggest that current regulations have created an environment that is conducive to franchising and made franchising an attractive alternative for business expansion by franchisors.

- **Recommendation #4:** The SBA and Minority Business Development Agency (MBDA) Should Streamline and Expand Financial Assistance Programs Available to Franchisees; Franchisors Should Examine Alternative Methods for Assisting Prospective Franchisees in Securing Financing. The SBA and MBDA should focus on making existing financial assistance programs more effective and on marketing these programs to franchisors (perhaps through franchise industry groups). In particular, the focus should be on reducing delays in processing, identifying clear criteria for qualification, developing loan programs for less expensive franchises, and expanding assistance available to women and minorities. Given the difficulties that many small businesses have experienced in recent years in obtaining financing through
conventional sources, there is an urgent need for the SBA, MBDA, and the Commerce Department to closely examine the levels of funds available through lending programs for small businesses and the procedures that individuals must go through to access these resources. Franchisors also need to examine how they are assisting prospective franchisees in securing the funds needed to both establish and maintain franchise units.

**Recommendation #5:** The Federal Government -- Perhaps through a Joint Effort by the U.S. Department of Commerce and the SBA -- Should Reestablish Its Regular Survey of Franchising. Understanding underlying trends in franchising is essential for companies and individuals to make informed decisions about whether to invest in franchising and in what specific areas of franchising to invest. Policy makers at the federal and state levels need valid and reliable information to determine whether changes in legislation and/or the regulatory environment are needed, and then, to monitor possible impacts of such changes. Therefore, the federal government -- perhaps through a joint effort by the U.S. Department of Commerce and SBA -- should reestablish a comprehensive and regular survey of franchising. The results of the survey should be published in a form similar to the previous Franchising in the Economy. In addition, a well-documented public use data tape should be made available to researchers and other private organizations to support additional research efforts.

**Recommendation #6:** Private Sector Organizations Should Continue to Fund, Publicize, and Provide Information and Programs on Franchising. There is a major need for private sector organizations, such as the International Franchise Association, to work in conjunction with SBA and other business groups to develop and provide additional materials (e.g., videos, books, pamphlets, and other print media) and workshops on how to buy a franchise. A particularly difficult problem for many prospective franchisees is how to obtain relatively skilled and economical legal help so that they can understand and consider the obligations involved in franchise agreements. Other major problems faced by many potential franchisees concern securing necessary financing, and collecting and evaluating information on the wide range of available franchising opportunities.
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CHAPTER 1:
INTRODUCTION

Over the past two decades, the sale of goods and services through franchises and the number of franchise establishments has undergone rapid growth. This growth has provided many small entrepreneurs with the opportunity to own and operate their own businesses. The central objective of this study is to document and explain growth of franchising as a means of business expansion by franchisors and as a vehicle for business ownership by individuals and small businesses. This chapter begins with a definition of franchising and an overview of the development of franchising in the United States. It then discusses the two principal types of franchising -- product/tradename and business format franchising. The chapter concludes with a discussion of the purpose of this study, study methodology, and organization of the report.

A. BACKGROUND ON FRANCHISING

1. Definition of Franchising and Overview of Its Development in the U.S.

There is not a single, generally-accepted definition of a franchise. The most commonly-recognized criteria for determining whether a business arrangement is a franchise is that promulgated by the Federal Trade Commission (FTC) in its regulatory rule governing the disclosure requirements for franchises and business opportunity ventures.¹ Under this rule, a continuing commercial relationship is classified as a franchise, and subject to the requirements of the rule, if three central characteristics are present:

• the franchisee distributes products or services associated with the franchisor's trademark or identifying symbol;

• the franchisor provides significant assistance and/or exercises significant control over the franchisee's method of operation; and

• the franchisee is required to pay at least $500 in payments to the franchisor during the first six months of operation of the franchise.

While definitions of franchising used among states differ, particularly with regard to the threshold amount paid to acquire a franchise, all use similar criteria as the FTC's franchise rule. Franchising is characterized by a continuing relationship involving certain responsibilities on the part of both the franchisor and franchisee:

In its basic form, franchising is a system characterized by a continuing relationship in which the franchisor grants to the franchisee a licensed privilege to do business and provides assistance in organizing, training, merchandising, and managing, usually in return for a consideration from the franchisee. In many cases, the franchisee, with or without an agreed upon consideration, gains the right to sell a certain product or service and to use a certain brand name, trademark, business technique, or technical process as developed by the franchisor.

According to the U.S. Small Business Administration (SBA), a "franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name, or advertising symbol and an individual or group seeking the right to use that identification in a business." 

According to most franchising historians, franchising by a private company originated in the modern industrial era with the Singer Sewing Machine Company. Beginning in 1851, Issac Singer accepted fees from independent salesmen and granted

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4Small Business Administration, Evaluating Franchise Opportunities, Management Aids No. 7.007.
them territorial rights to sell his recently invented sewing machines. This franchising system enabled Singer to expand and sell sewing machines nationally. At the turn of the 20th century, franchising was used by General Motors (beginning in 1898) and Rexall Drugs (in 1902) as a means to expand sales and operations. Soon afterwards, other companies in the fields of automobile manufacturing, petroleum, soft drink bottling, auto accessories, and a variety of other manufacturing fields embraced franchising as a means for expansion and distribution. The adoption of franchising by the automobile and soft drink industries in the early 20th century and the conversion of gasoline service stations to franchises in the 1930s were particularly important in solidifying franchising as an increasingly important method of business expansion and distribution. Franchising expanded into an emerging service sector during the 1930s and 1940s:

Elements of franchising were introduced into retail marketing with the development of the Ben Franklin general merchandise stores in 1920 and the emergence of a national network of A&W "walk up" root beer stands after 1925. Its expansion to an emerging service sector of the economy came with the initiation of national chains of Authur Murray Dance Studios in 1938, Baskin-Robbins ice cream stores in 1940 and Duraclean carpet cleaning services in 1943.\(^5\)

Sustained growth and development of franchising continued after World War II up to the present day. The emergence of "business format franchising" (discussed below) in the 1950s was particularly important in sustaining growth within the field of franchising and in enabling franchising to adapt to increasingly more complex consumer demands within an expanding service sector. Other factors, such as the expanding post-war economy and the growing interstate highway system also gave an impetus to franchising:

The decade of the 1950s was a period of significant growth and innovation in franchising. An expanding post-war economy and a growing interstate highway system encouraged the growth of gasoline stations, restaurants, and other franchise ventures directed to an increasingly mobile American public. A significant

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early convert to franchising was Harlan Sanders who initiated his Kentucky Fried Chicken franchise in 1950 and built a chain of more than 600 restaurants during the decade. Other franchisors, including Dairy Queen, Orange Julius, Tastee Freeze, Dunkin’ Donuts and McDonald’s followed Sanders’ lead in building national chains along the growing interstate highway system.8

Franchising as a method for business expansion quickly spread into new service industries during the 1950s, including the real estate and hotel industries, dry cleaning, employment services, and tax accounting between 1953 and 1956. Where at the start of the 1950s less than 100 companies used franchising in their marketing operations, by the close of the decade more than 900 companies had franchise operations involving an estimated 200,000 franchised units.7

The expansion of franchising continued into and throughout the 1960s, as companies found that franchising could be successfully adapted to an increasing range of products and services. Growth in franchising was also fueled by an expanding U.S. economy:

The success and rapid growth of these early franchise chains, together with an expanding economy during the mid-1960s, set off a surge of franchising activity after 1964, as hundreds of companies turned to franchising to build national marketing networks. An estimated 100,000 new franchise businesses were initiated between 1964-1969.8

Although beginning to moderate in the early 1970s, an additional 50,000 franchises were initiated between 1969 and mid-1973, bringing the number of franchised businesses to nearly 375,000. However, as discussed in Chapter 2, the mid-1970s -- with the rapid emergence of business format franchising establishment units and a decline in

product/tradename franchising units -- represented an important turning point in the development of franchising in the U.S.

Since World War II, franchising has evolved from an important, but relatively narrow marketing technique serving principally the auto and restaurant industries, to a broad business technique for entrepreneurial expansion in many diverse industries. This has occurred because franchising serves the mutual interest of franchisors and franchisees. Franchising allows entrepreneurial businesses -- both large and small -- who have developed a successful business concept to expand their businesses more rapidly and more economically by finding entrepreneurs and selling them the right to market the parent’s goods and services, and/or to use the parent’s tested and proven operating system and business methods. According to Axelrad and Rudnick:

Franchising provided the small, financially limited company, challenged by giant competitors, with the means of rapid entry and broad penetration of the marketplace without the large-scale capital and management personnel requirements demanded by traditional expansion through company outlets.9

Franchising’s appeal to those who seek franchises -- the franchisees -- is due to the fact that franchises allow individuals to operate small businesses, while still drawing upon the knowledge and experience of the franchisor.

2. "Product/Tradename" and "Business Format" Franchising

The field of franchising is customarily divided into "product/tradename franchising" and "business format" franchising.10 The performance of these two kinds of franchising

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10Product/tradename franchising is also sometimes referred to as "product/trademark" franchising in the literature.
has been different historically, with product/tradename franchising accounting for much of the early growth in franchising, while business format franchising has been responsible for much of franchising's growth since 1950.

Product/tradename franchising consists of product distribution arrangements in which franchisees are granted the right to distribute a manufacturer's products within a specified territory or at a specific location, generally with the use of the manufacturer's identifying name or trademark.\(^\text{11}\) Product/tradename franchising began as a sales relationship between supplier (manufacturer) and dealer (retailer) in which the dealer acquired some of the identity of the supplier. Over the years, product/tradename franchising has been widely adopted by manufacturers of products with a strong brand identity that require extensive pre-sale or post-sale service. According to Axelrad and Rudnick:

...By franchising a limited number of dealers with exclusive territories and further limiting the sales by each dealer to the assigned territory, the sponsor assures each franchise a sufficient protected market to induce the Franchisee to invest in the development of the market, as well as the capacity to effectively deliver the desired product and services.\(^\text{12}\)

Typically, under product/tradename franchising the dealer/franchisee is closely linked to the identity of the supplier/franchisor, such as auto/truck dealers, gas stations, and soft drink bottlers. Some of the best-known or typical product/tradename franchises include automotive dealers like Ford, gas stations like Exxon or Shell, and soft drink bottlers like Coca-Cola. As discussed in greater detail in Chapter 2, while product/tradename franchises account for about two-thirds of all franchise sales, they now represent fewer than 30 percent of all franchising establishments.


\(^\text{12}\)Axelrad and Rudnick, op. cit., p. 3.
The principal difference between the product/tradename franchise relationship and the conventional supplier-dealer relationship is a matter of degree. The franchisee is generally more closely associated with the sponsor’s markets, receives more comprehensive marketing and other services, and may handle the sponsor’s product line on an exclusive or semi-exclusive basis. In an ordinary supplier-dealer relationship, the dealer may carry several complementary or even competing products.\textsuperscript{13}

Business format franchising generally incorporates the licensing of a trademark with the conveyance to franchisees of a business format, or an entire system for conducting a business.\textsuperscript{14} According the U.S. Department of Commerce, business format franchising "is characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service, and trademark, but the entire business format itself."\textsuperscript{15} Typical elements of this franchise format include the requirements that the franchisee deal exclusively in sponsoring the franchisor’s products or services, adopt and utilize the franchisor’s trade identity and image, and conduct business operations in accordance with prescribed and standardized procedures.\textsuperscript{16} Franchisors of business format franchises typically exert control over the following:

- quality of franchisee’s product or services;
- location of the business;
- equipment, fixtures, and furnishings;
- design, layout and appearance;

\textsuperscript{13}Axelrad and Rudnick, op. cit., p. 3.
\textsuperscript{14}Franchising in the U.S. Economy: Prospects and Problems, op. cit., p. 3.
\textsuperscript{16}Axelrad and Rudnick, op. cit., p. 4.
Business format franchising is found in such diverse sectors as: auto products and services; auto and truck rental services; business aids and services; construction-home improvement-maintenance and cleaning services; convenience stores; educational products and services; fast food restaurants; hotels, motels, and campgrounds; laundry and dry cleaning services; recreation, entertainment, and travel; rental equipment and services; and food and non-food retailing. Some of the best-known business format franchises are restaurants like McDonald's, Kentucky Fried Chicken, Subway, Pizza Hut, Dairy Queen, and Baskin-Robbins and automotive service franchisors like Goodyear, AAMCO Transmissions, and Western Auto Supply. Business format franchises also include companies such as: H&R Block, Century 21, and Norell Services in business services; Jani-king and Servicemaster in cleaning services; Southland (7-Eleven Stores) in convenience stores; and Holiday Inns in hotels and motels. Business format franchising is the fastest growing segment within franchising -- e.g., the number of business format franchises has doubled since 1972 and now accounts for nearly three-fourths of all franchise establishments.

B. STUDY OBJECTIVES

The central objective of this study is to examine the growing use of franchising as a means of business expansion by franchisors and as a vehicle for business ownership by individual entrepreneurs and small businesses. Despite the growing importance of franchising to the U.S. economy and increasing legislative activity that could substantially

17 Axelrad and Rudnick, op. cit., p. 4.
affect the relationship between franchisors and franchisees, systematic research into franchising has been limited in the past -- particularly with respect to franchising effects on small business development. For example, up until 1988, the only complete and authoritative source of data and economic information about franchising was the annual survey, *Franchising in the Economy*.

This study, initiated and sponsored by the Small Business Administration (SBA), is intended to synthesize existing research and bring a small business perspective to the study of franchising. For example, it provides a detailed analysis of the growth of franchising, as well as factors that played a role in shaping that growth. It is also intended to enhance understanding of the dynamic relationship between franchisors and franchisees, so that the SBA, small business organizations, franchisors and franchisees, and other industry groups can formulate effective strategies for the development of franchising as a tool for fostering small business development in the U.S.

Key areas of analysis and evaluation questions underlying this study included the following:

- **Recent Trends in Franchising:** What have been the overall trends in franchising in the U.S. since 1975? In what sectors has franchising shown the strongest growth over the period from 1975-1990? Have there been differences in growth patterns for individually-owned units versus company-owned stores? If so, what explains these differences?

- **Factors that Affected the Growth of Franchising:** What factors explain the rapid growth of franchising in the U.S. over the past two decades? From the perspective of prospective franchisors and franchisees, why has franchising proved to be an effective means for business expansion?

- **Types of Costs Borne by Franchisees:** What are the costs typically associated with start-up and on-going operation of franchisees in various

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19This survey was discontinued by the U.S. Department of Commerce in 1988. During the period 1988-1990, this survey was taken over by the International Franchise Association Educational Foundation and Horwath International.
sectors? Have escalating costs (and required investment levels) affected the ability of individuals and small businesses to gain entry into franchising?

- **Characteristics of Franchisees:** What are the key characteristics of individuals that enter franchising and how have these characteristics changed over time?

- **Franchisor Training and Support:** What types of training programs and technical assistance are provided by franchisors? Are there major differences in types of assistance provided across franchise systems? Are there specific practices by franchisors which facilitate start-up and encourage long term success by franchisees?

- **Solicitation and Sale of Franchises:** What is the existing legal and regulatory framework that governs the solicitation and sales process? How might this process be improved to ensure that prospective franchisees are well-informed and to reduce costs/burden of regulation on franchisors?

- **Franchising Relationship:** What is the existing legal and regulatory framework that governs franchising relationships? How satisfied are franchisees with their relationship with franchisors? What area of the relationship are most problematic? What steps can be taken to improve the relationship between franchisors and franchisees?

C. STUDY METHODOLOGY AND LIMITATIONS

We have relied on both primary and secondary data in carrying out the study. The two types of data are useful for meeting different objectives of the study, and they are likely to be complementary. For example, published secondary data are useful for tracking historical trends in franchising, but are not very useful for examining the franchising relationship and concerns that franchisor/franchisees may have with existing or proposed regulation. Below, we provide an overview of data collection activities and study limitations.
1. **Use of Existing Literature and Data on Franchising**

During the initial part of this study, the project staff conducted an in-depth search and review of available literature on franchising. This enable the study team to:

- refine the key research questions,
- identify the various data series for analysis,
- identify franchising practices to be studied and discussed in interviews,
- identify experts and franchise systems for interviews, and
- identify major trends in franchising.

Next, project staff collected and analyzed existing data on franchising trends for the period 1975-1990. The goal of this phase of the study was to identify major statistical trends in franchising, including overall trends, trends by sector, trends for company-owned stores versus franchisee stores, characteristics of franchisees, and other aggregate trends. A major source used for analysis of trends in franchising over this period was *Franchising in the Economy*.

In using data from *Franchising in the Economy*, the study team was limited to using existing (published) data. Hence, it was not possible to conduct additional analyses of survey data at the franchisor/franchisee level. A second limitation was that the U.S. Department of Commerce terminated its survey efforts in 1988. While the survey effort was continued by a private organization (under the sponsorship of the International Franchise Association), comparability of the data series after 1988 with earlier data may have been somewhat affected.

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2. Interviews with Franchise Experts, Franchisors and Franchisees

In addition to analysis of existing data, we also conducted in-depth interviews with a number of franchising experts, franchisors and franchisees. We generally gathered candidates for interviews by reviewing the literature on franchising and through referrals by trade associations, researchers, and government officials.

Interviews were conducted (generally by telephone) with 12 experts in the field of franchising, including franchise attorneys, consultants, and academics (see Appendix 1-A for a list of these experts). These interviews were particularly focused on identifying and explaining trends in franchising and examining the relationship between franchisors and franchisees. Discussion areas depended upon each interviewee's area of expertise. Some major topics of discussion included the following (see Appendix 1-B for a copy of the discussion guide):

- the recruitment and evaluation process (e.g., how well franchisees are prepared to make franchising decisions, who franchisees should talk to, and types of assistance that they may need during the evaluation process);
- legal issues and costs for franchisors and franchisees (e.g., typical legal problems faced by franchisors and franchisees, costs for preparing and reviewing disclosure statements);
- types of assistance provided by franchisors and which are most important;
- reasons for franchisee failure;
- fees and royalties paid by franchisees;
- relationship between franchisor and franchisee, particularly relating to major problem areas and the effectiveness of advisory councils;
- government regulation, including problem areas and the need for future regulation; and
- trends likely to affect franchising in the coming years.
In-depth interviews were also conducted with franchisors and franchisees within 13 franchising systems. These interviews were intended to developed an understanding of franchising practices and perspectives of franchisors/franchisees. While the selection of franchising systems was not intended to be statistically representative, we sought a mix of franchisors by industry sector, number of franchise establishment units, and geographic location.\(^\text{20}\) At franchisor-level, we interviewed top-level company officials, as well as operational executives who had frequent contact with franchisees. Within each of the selected franchise systems, we also interviewed individual franchisees (usually the owner of the franchise unit). A total of 30 franchisees (within 13 franchising systems) were interviewed.

Where possible, we conducted these case studies in-person; others were conducted by telephone. Interviews typically required 30 to 60 minutes to complete, though some interviews ran longer because the interviewees were very interested in the study. The interviews were semi-structured. An interview guide was used to elicit information we considered relevant, but respondents were encouraged to speak their minds, and the discussions varied significantly in terms of topics covered and depth, depending upon the knowledge and interests of the respondents. Some of the topics that were covered included the following (see Appendix 1-C for a copy of the discussion guide): training programs; site selection and premises development; support prior to and during opening; ongoing operational assistance; charges to franchisees; reporting requirements and inspections; purchasing, advertising and marketing; financial assistance; annual payments; major problems or causes of failure; and views about the future of franchising. In addition,

\(^\text{20}\)To ensure that the franchisors and franchisees would candidly express their views on a range of topics, we assured those that we interviewed that the name of the franchise system and specific franchisees would remain confidential.
the franchisee's evaluation process was examined in detail, including the search process, the evaluation of the disclosure statement, the evaluation of earnings claims, and the use of professional advisers in the process. Throughout this study we have attempted to incorporate the many comments that we received from experts, franchisors, and franchisors.21

D. ORGANIZATION OF THE REPORT

This remainder of this report is divided into eight chapters. Chapter 2 reviews major trends in franchising sales, establishments, and employment between 1975 and 1990. It also considers trends at the franchisor-level (e.g., trends toward company-owned versus franchise outlets).

Chapter 3 examines economic, technological, and demographic factors that explain overall trends in franchising over the past 15 years.

Chapter 4 analyzes costs and investment requirements for starting up and sustaining franchise units. It examines levels of initial fees, royalties, advertising fees, and purchases of goods and services from the franchisor.

Chapter 5 examines basic characteristics of franchisors and franchisees, particularly focusing on the financial and educational characteristics of franchisees. The chapter also considers the role that women and minorities play in franchising today.

Chapter 6 examines the types of training and technical assistance provided by franchisors to franchisees. It includes a discussion of specific practices which make a difference in facilitating start-up and encouraging long-term success by franchisees.

21These comments have been italicized within the text.
Chapter 7 focuses on the solicitation and sales process within franchising. It provides an overview of the existing legal and regulatory framework which governs the solicitation and sales process, then examines the solicitation and sales process from the perspectives of the franchisor and franchisee. The chapter also assesses areas of regulation and the overall process that might be enhanced to ensure that prospective franchisees are well-informed, to reduce burden and costs of regulation, and to further the overall growth of franchising in the U.S.

Chapter 8 focuses on the relationship between franchisors and franchisees. It provides an overview of the existing legal and regulatory framework which governs this relationship. It examines general levels of satisfaction among franchisees with franchisors and specific relationship issues that have been sources of controversy between franchisors and franchisees. The chapter also includes a discussion of steps that can be taken by franchisors and franchisees (outside of the general legal/regulatory framework) that can be helpful in maintaining effective franchisor/franchisee relationships.

Chapter 9 discusses key findings, implications and conclusions of this study. This chapter includes a discussion of likely future trends in franchising and their implications for small business development in the U.S.
CHAPTER 2:
TRENDS IN FRANCHISING, 1975-1990

This chapter examines statistical trends in franchising in terms of sales, establishments, and employment from 1975 to 1990. It examines trends over the 15-year period for product/tradename and business format franchises, as well as by sector.¹ This chapter also examines trends in the number and size of franchisors and the extent to which franchisors use company-owned versus franchisee-owned stores as a method of business expansion. The chapter closes with an examination of recent trends in international franchising.²

A. TRENDS IN FRANCHISE SALES

1. Overall Increase in Sales Reported Since 1975

Since 1975, the sale of goods and services through franchises has undergone substantial growth. As shown in Exhibit 2-1, annual sales through franchises grew (in current dollars) by a total of $528.7 billion between 1975 and 1990, from $185.8 billion to $714.5 billion. This increase represents a 284.6 percent increase for sales over the 15-year period. When adjusted for inflation (in constant dollars),³ the increase in sales over the period was 58.5 percent.

¹There is, unfortunately, no systematic data on financial performance of franchisors and franchisees that would permit analysis of the general profitability of franchising.

²Chapter 3 examines factors that affected patterns of growth over the 15-year period.

³The Consumer Price Index (CPI) was used to adjust for inflation. Source: U.S. Bureau of Labor Statistics; monthly data in U.S. Bureau of Economic Analysis, Survey of Current Business.

2-1
**EXHIBIT 2-1: TRENDS IN TOTAL FRANCHISING SALES, 1975-1990**

![Graph showing trends in total franchising sales, 1975-1990.](image-url)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>TOTAL SALES</th>
<th>CHANGE FROM PREVIOUS YEAR</th>
<th>% CHANGE FROM PREVIOUS YEAR</th>
<th>TOTAL SALES</th>
<th>CHANGE FROM PREVIOUS YEAR</th>
<th>% CHANGE FROM PREVIOUS YEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>185.8</td>
<td>17.2</td>
<td>10.2%</td>
<td>185.8</td>
<td>3.3</td>
<td>1.0%</td>
</tr>
<tr>
<td>1976</td>
<td>217.9</td>
<td>32.1</td>
<td>17.3%</td>
<td>205.9</td>
<td>37.4</td>
<td>10.8%</td>
</tr>
<tr>
<td>1977</td>
<td>261.7</td>
<td>43.8</td>
<td>20.1%</td>
<td>232.1</td>
<td>48.7</td>
<td>12.7%</td>
</tr>
<tr>
<td>1978</td>
<td>282.2</td>
<td>20.5</td>
<td>7.8%</td>
<td>232.6</td>
<td>0.8</td>
<td>0.2%</td>
</tr>
<tr>
<td>1979</td>
<td>313.3</td>
<td>31.1</td>
<td>11.0%</td>
<td>232.6</td>
<td>0.1</td>
<td>0.0%</td>
</tr>
<tr>
<td>1980</td>
<td>334.4</td>
<td>21.0</td>
<td>6.7%</td>
<td>218.5</td>
<td>-26.1</td>
<td>-6.0%</td>
</tr>
<tr>
<td>1981</td>
<td>364.8</td>
<td>30.4</td>
<td>9.1%</td>
<td>215.4</td>
<td>-5.7</td>
<td>-1.4%</td>
</tr>
<tr>
<td>1982</td>
<td>376.0</td>
<td>11.2</td>
<td>3.1%</td>
<td>209.3</td>
<td>-11.4</td>
<td>-2.8%</td>
</tr>
<tr>
<td>1983</td>
<td>422.8</td>
<td>46.9</td>
<td>12.5%</td>
<td>228.1</td>
<td>35.0</td>
<td>9.0%</td>
</tr>
<tr>
<td>1984</td>
<td>492.1</td>
<td>69.3</td>
<td>16.4%</td>
<td>254.4</td>
<td>48.8</td>
<td>11.5%</td>
</tr>
<tr>
<td>1985</td>
<td>543.0</td>
<td>50.9</td>
<td>10.3%</td>
<td>271.0</td>
<td>31.0</td>
<td>6.6%</td>
</tr>
<tr>
<td>1986</td>
<td>569.1</td>
<td>26.1</td>
<td>4.8%</td>
<td>279.5</td>
<td>15.7</td>
<td>3.1%</td>
</tr>
<tr>
<td>1987</td>
<td>599.4</td>
<td>30.3</td>
<td>5.3%</td>
<td>283.8</td>
<td>7.9</td>
<td>1.5%</td>
</tr>
<tr>
<td>1988</td>
<td>648.1</td>
<td>48.7</td>
<td>8.1%</td>
<td>294.9</td>
<td>20.8</td>
<td>3.9%</td>
</tr>
<tr>
<td>1989</td>
<td>677.9</td>
<td>29.8</td>
<td>4.6%</td>
<td>294.3</td>
<td>-1.2</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1990</td>
<td>714.5</td>
<td>36.6</td>
<td>5.4%</td>
<td>294.4</td>
<td>0.2</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

| CHANGE 1975-90 | 528.7 | 284.6% | 201.9 | 58.5% |
| ANNUAL CHANGE 1975-90 | 35.2 | 9.4% | 13.5 | 3.1% |


2-2
As shown in Exhibit 2-1, though fluctuating substantially from year-to-year, overall sales experienced sustained growth (in current, non-inflation adjusted dollars) throughout the 15-year period. Growth was as high as 20.1 percent (between 1976-77) and as low as 3.1 percent (between 1981-82). However, as can be seen in Exhibit 2-1, franchising sales fluctuated both positively and negatively from year-to-year in terms of inflation-adjusted (constant dollar) sales. For example, inflation-adjusted sales increased at very high annual rates between 1975 and 1977 (e.g., 10.8 percent in 1975-76 and 12.7 percent in 1976-77), but levelled off and then declined between 1977 and 1983 (e.g., with growth declining by as much as 6.0 percent between 1979 and 1980). Beginning in 1983 inflation-adjusted growth returned (reaching as high as 11.5 percent between 1983-84) and continued through 1988. Between 1988 and 1990, franchising sales (after inflation) remained at about the same level.

Franchising’s growth is also reflected in the fact that its share of retail sales in the U.S. substantially increased between 1975 and 1990. As shown in Exhibit 2-2, the percentage of sales by franchising firms of all retail sales in the U.S. grew from 28.2 percent in 1975 to over one-third of all retail sales (34.0 percent) in 1990. The percentage of sales by franchising firms substantially increased between 1982 and 1985, but since 1985 has remained consistently at about one-third of all retail sales in the U.S.

2. Product/Tradename Sales Still Dominant, But Business Format Franchising Emerging

As discussed in Chapter 1, franchise arrangements are generally considered to fall into two categories:

- **Product/tradename franchises** include arrangements in which franchisees are granted the right to distribute a manufacturer’s products within a specified

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Retail Sales (Billions $)</th>
<th>Retail Sales by Franchise Firms (Billions $)</th>
<th>% of Sales by Franchise Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>588.1</td>
<td>165.7</td>
<td>28.2%</td>
</tr>
<tr>
<td>1976</td>
<td>656.1</td>
<td>196.0</td>
<td>29.9</td>
</tr>
<tr>
<td>1977</td>
<td>722.5</td>
<td>225.1</td>
<td>31.2</td>
</tr>
<tr>
<td>1978</td>
<td>804.2</td>
<td>251.2</td>
<td>31.2</td>
</tr>
<tr>
<td>1979</td>
<td>896.8</td>
<td>278.0</td>
<td>31.0</td>
</tr>
<tr>
<td>1980</td>
<td>957.4</td>
<td>293.7</td>
<td>30.7</td>
</tr>
<tr>
<td>1981</td>
<td>1,038.7</td>
<td>320.8</td>
<td>30.9</td>
</tr>
<tr>
<td>1982</td>
<td>1,069.4</td>
<td>327.8</td>
<td>30.7</td>
</tr>
<tr>
<td>1983</td>
<td>1,170.8</td>
<td>370.2</td>
<td>31.6</td>
</tr>
<tr>
<td>1984</td>
<td>1,287.8</td>
<td>435.8</td>
<td>33.8</td>
</tr>
<tr>
<td>1985</td>
<td>1,375.7</td>
<td>476.9</td>
<td>34.7</td>
</tr>
<tr>
<td>1986</td>
<td>1,450.3</td>
<td>496.4</td>
<td>34.2</td>
</tr>
<tr>
<td>1987</td>
<td>1,542.1</td>
<td>520.0</td>
<td>33.7</td>
</tr>
<tr>
<td>1988</td>
<td>1,651.4</td>
<td>565.6</td>
<td>34.1</td>
</tr>
<tr>
<td>1989</td>
<td>1,741.7</td>
<td>587.5</td>
<td>33.7</td>
</tr>
<tr>
<td>1990</td>
<td>1,807.2</td>
<td>614.7</td>
<td>34.0</td>
</tr>
</tbody>
</table>

Note: Retail sales by franchise firms has been adjusted to exclude the non-retail portion of total franchise sales.

territory or at a specific location, generally with the use of the manufacturer's identifying name or tradename.

- **Business format franchises** are characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service and tradename, but the entire business concept itself -- a marketing strategy and plan, operating manuals and standards, quality control, and a continuing process of assistance and guidance.

While product/tradename franchises continue to account for two-thirds of all franchise sales, one of the most significant trends in franchising since the 1970s has been the rapid emergence of business format franchising. As shown in Exhibit 2-3, both product/tradename and business format franchising have grown substantially over the past 15 years. In current dollars, product/tradename sales grew from $144.9 billion in 1975 to $500.7 billion in 1990. This represented a 245.5 percent increase over the 15-year period. In inflation-adjusted (constant) dollars product/tradename franchise sales increased by 42.4 percent between 1975 and 1990. Business format franchising sales grew (in current dollars) from $40.9 billion in 1975 to $213.8 billion in 1990 -- an increase of 422.9 percent. In inflation-adjusted (constant) dollars, this represented a 115.5 percent increase over the 15-year period. Hence, while product/tradename franchising grew more in absolute terms, business format franchising grew at a much faster rate (in relative terms).

The emergence of business format franchising is also reflected in its growing percentage of total franchise sales. As also shown in Exhibit 2-3, the percentage of total franchising sales by business format franchises grew from 22.0 percent in 1975 to 29.9 percent in 1990. Despite this surge in business format franchising -- which is even more evident in the patterns of establishment growth (see Section B of this chapter) -- product/tradename franchising still remains predominant in terms of overall sales (accounting for 70.1 percent of total franchise sales).
EXHIBIT 2-3: PRODUCT/TRADEMARK FRANCHISE AND BUSINESS FORMAT SALES, 1975-1990

<table>
<thead>
<tr>
<th>YEAR</th>
<th>PRODUCT/TRADEMARK</th>
<th>BUSINESS FORMAT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SALES ($ BILLIONS)</td>
<td>% OF TOTAL</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FRANCHISE SALES</td>
</tr>
<tr>
<td>1975</td>
<td>144.9</td>
<td>78.0%</td>
</tr>
<tr>
<td>1976</td>
<td>171.3</td>
<td>78.6%</td>
</tr>
<tr>
<td>1977</td>
<td>195.9</td>
<td>76.9%</td>
</tr>
<tr>
<td>1978</td>
<td>217.9</td>
<td>77.2%</td>
</tr>
<tr>
<td>1979</td>
<td>241.0</td>
<td>76.9%</td>
</tr>
<tr>
<td>1980</td>
<td>250.8</td>
<td>75.0%</td>
</tr>
<tr>
<td>1981</td>
<td>275.7</td>
<td>75.6%</td>
</tr>
<tr>
<td>1982</td>
<td>277.0</td>
<td>75.7%</td>
</tr>
<tr>
<td>1983</td>
<td>312.3</td>
<td>73.9%</td>
</tr>
<tr>
<td>1984</td>
<td>369.8</td>
<td>75.1%</td>
</tr>
<tr>
<td>1985</td>
<td>401.6</td>
<td>74.0%</td>
</tr>
<tr>
<td>1986</td>
<td>413.5</td>
<td>72.7%</td>
</tr>
<tr>
<td>1987</td>
<td>429.8</td>
<td>71.7%</td>
</tr>
<tr>
<td>1988</td>
<td>469.8</td>
<td>72.5%</td>
</tr>
<tr>
<td>1989</td>
<td>485.0</td>
<td>71.5%</td>
</tr>
<tr>
<td>1990</td>
<td>500.7</td>
<td>70.1%</td>
</tr>
</tbody>
</table>

PERCENT CHANGE  245.5%  422.9%
INFLATION ADJUSTED CHANGE  42.4%  115.5%

3. Sales Concentrated in Three Major Sectors, But Considerable Shifts Among Sectors in Past 15 Years

Sales within the franchising are heavily concentrated within a few sectors. As shown in Exhibit 2-4, nearly half (48.4 percent) of all franchising sales were in the automobile and truck dealer sector in 1990. Gasoline service stations (18.0 percent) and restaurants (10.9 percent) were the next largest. In 1990, these three sectors accounted for over three-fourths (77.3 percent) of all franchising sales. Other franchising sectors with two percent or more of total franchising sales were: non-food retailing (4.1 percent); soft drink bottlers (3.7 percent); hotels, motels, and campgrounds (3.3 percent); business aids and services (2.6 percent); and convenience stores (2.0 percent).

Although there have been only minor shifts in ranking of the sectors by the percentage of all franchising sales, there have been some important percentage shifts in sales within several sectors. As shown in Exhibit 2-4, while automotive and truck dealers remained the leader in sales at about the same percentage share of total franchising sales, the percentage of sales for the two other types of product/tradename franchises decreased: sales by gasoline service stations declined from about one-quarter (25.6 percent) of all franchising sales in 1975 to 18.0 percent in 1990, while sales by soft drink bottlers decreased from 4.4 percent to 3.7 percent over the 15-year period. In terms of the share of total franchising sales, the largest increase occurred for restaurants, which increased from 6.6 percent to 10.9 percent of all franchising sales. Other sectors that had significant increases in their share of overall sales included business aids and services (from 0.8 percent to 2.6 percent), food/non-convenience store retailing (from 0.8 to 1.6 percent), and recreation, entertainment and travel (from 0.1 percent to 0.7 percent).

Sector trends over the 15-year period are also revealed by percentage shifts in sales. As shown in Exhibit 2-5, all sectors of franchising experienced sales growth.
## EXHIBIT 2-4: TOTAL FRANCHISE SALES BY FRANCHISE SECTOR, 1975 AND 1990

<table>
<thead>
<tr>
<th>1990 RANK</th>
<th>FRANCHISE SECTOR</th>
<th>1975 ($ MILLIONS)</th>
<th>1990 ($ MILLIONS)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>TOTAL SALES</td>
<td>RELATIVE %</td>
<td>CUMULATIVE %</td>
</tr>
<tr>
<td>1</td>
<td>* AUTOMOBILE AND TRUCK DEALERS</td>
<td>89,195</td>
<td>48.0%</td>
</tr>
<tr>
<td>2</td>
<td>* GASOLINE SERVICE STATIONS</td>
<td>47,547</td>
<td>25.6%</td>
</tr>
<tr>
<td>3</td>
<td>RESTAURANTS (ALL TYPES)</td>
<td>12,262</td>
<td>6.6%</td>
</tr>
<tr>
<td>4</td>
<td>RETAILING (NON-FOOD)</td>
<td>9,031</td>
<td>4.9%</td>
</tr>
<tr>
<td>5</td>
<td>* SOFT DRINK BOTTLERS</td>
<td>8,165</td>
<td>4.4%</td>
</tr>
<tr>
<td>6</td>
<td>HOTELS, MOTELS, CAMPGROUNDS</td>
<td>4,601</td>
<td>2.5%</td>
</tr>
<tr>
<td>7</td>
<td>BUSINESS AIDS AND SERVICES</td>
<td>1,397</td>
<td>0.8%</td>
</tr>
<tr>
<td>8</td>
<td>REAL ESTATE</td>
<td>237</td>
<td>0.1%</td>
</tr>
<tr>
<td>9</td>
<td>EMPLOYMENT SERVICES</td>
<td>553</td>
<td>0.3%</td>
</tr>
<tr>
<td>10</td>
<td>MISCELLANEOUS BUSINESS SERVICES</td>
<td>196</td>
<td>0.1%</td>
</tr>
<tr>
<td>11</td>
<td>PRINTING AND COPYING SERVICES</td>
<td>84</td>
<td>0.0%</td>
</tr>
<tr>
<td>12</td>
<td>TAX PREPARATION SERVICES</td>
<td>161</td>
<td>0.1%</td>
</tr>
<tr>
<td>13</td>
<td>ACCOUNTING, CREDIT, COLLECTION</td>
<td>165</td>
<td>0.1%</td>
</tr>
<tr>
<td>14</td>
<td>CONVENIENCE STORES</td>
<td>3,906</td>
<td>2.1%</td>
</tr>
<tr>
<td>15</td>
<td>AUTOMOTIVE PRODUCTS AND SERVICES</td>
<td>5,006</td>
<td>2.7%</td>
</tr>
<tr>
<td>16</td>
<td>RETAILING (FOOD/ NON-CONVEN. STORES)</td>
<td>1,445</td>
<td>0.8%</td>
</tr>
<tr>
<td>17</td>
<td>CONSTRUCTION, HOME IMPROVEMENT</td>
<td>639</td>
<td>0.3%</td>
</tr>
<tr>
<td>18</td>
<td>RECREATION, ENTERTAINMENT AND TRAVEL</td>
<td>162</td>
<td>0.1%</td>
</tr>
<tr>
<td>19</td>
<td>MISCELLANEOUS</td>
<td>414</td>
<td>0.2%</td>
</tr>
<tr>
<td>20</td>
<td>EDUCATIONAL PRODUCTS AND SERVICES</td>
<td>173</td>
<td>0.1%</td>
</tr>
<tr>
<td>21</td>
<td>RENTAL SERVICES (EQUIPMENT)</td>
<td>157</td>
<td>0.1%</td>
</tr>
<tr>
<td>22</td>
<td>LAUNDRY AND DRYCLEANING SERVICES</td>
<td>214</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

Note: (*) Denote product/tradename franchising.
## EXHIBIT 2-5: CHANGE IN FRANCHISE SALES BY FRANCHISE SECTOR, 1975 AND 1990

<table>
<thead>
<tr>
<th>1990 RANK</th>
<th>FRANCHISE SECTOR</th>
<th>1975</th>
<th>1990</th>
<th>TOTAL SALES (MILLIONS)</th>
<th>CHANGE IN SALES, 1975-90</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>RECREATION, ENTERTAINMENT AND TRAVEL</td>
<td>162</td>
<td>4843</td>
<td>4,681</td>
<td>2889.5%</td>
</tr>
<tr>
<td>2</td>
<td>BUSINESS AIDS AND SERVICES</td>
<td>1,397</td>
<td>18640</td>
<td>17,243</td>
<td>1234.3%</td>
</tr>
<tr>
<td>3</td>
<td>REAL ESTATE</td>
<td>237</td>
<td>6133</td>
<td>5,896</td>
<td>2487.8%</td>
</tr>
<tr>
<td>4</td>
<td>PRINTING AND COPYING SERVICES</td>
<td>84</td>
<td>1759</td>
<td>1,675</td>
<td>1994.0%</td>
</tr>
<tr>
<td>5</td>
<td>MISCELLANEOUS BUSINESS SERVICES</td>
<td>196</td>
<td>3494</td>
<td>3,298</td>
<td>1682.7%</td>
</tr>
<tr>
<td>6</td>
<td>EMPLOYMENT SERVICES</td>
<td>553</td>
<td>5732</td>
<td>5,179</td>
<td>936.5%</td>
</tr>
<tr>
<td>7</td>
<td>TAX PREPARATION SERVICES</td>
<td>161</td>
<td>674</td>
<td>513</td>
<td>318.6%</td>
</tr>
<tr>
<td>8</td>
<td>ACCOUNTING, CREDIT, COLLECTION</td>
<td>165</td>
<td>196</td>
<td>31</td>
<td>18.8%</td>
</tr>
<tr>
<td>9</td>
<td>EDUCATIONAL PRODUCTS AND SERVICES</td>
<td>173</td>
<td>2031</td>
<td>1,858</td>
<td>1074.0%</td>
</tr>
<tr>
<td>10</td>
<td>CONSTRUCTION, HOME IMPROVEMENT</td>
<td>639</td>
<td>6654</td>
<td>5,815</td>
<td>910.0%</td>
</tr>
<tr>
<td>11</td>
<td>RETAILING (FOOD/NON-CONVEN. STORES)</td>
<td>1,645</td>
<td>11706</td>
<td>10,261</td>
<td>710.1%</td>
</tr>
<tr>
<td>12</td>
<td>RESTAURANTS (ALL TYPES)</td>
<td>12,262</td>
<td>77856</td>
<td>65,594</td>
<td>534.9%</td>
</tr>
<tr>
<td>13</td>
<td>MISCELLANEOUS</td>
<td>414</td>
<td>2300</td>
<td>1,886</td>
<td>455.6%</td>
</tr>
<tr>
<td>14</td>
<td>HOTELS, MOTELS, CAMPGROUNDS</td>
<td>4,601</td>
<td>23816</td>
<td>19,215</td>
<td>417.6%</td>
</tr>
<tr>
<td>15</td>
<td>RENTAL SERVICES (AUTO-TRUCK)</td>
<td>1,475</td>
<td>7538</td>
<td>6,063</td>
<td>411.1%</td>
</tr>
<tr>
<td>16</td>
<td>RENTAL SERVICES (EQUIPMENT)</td>
<td>157</td>
<td>732</td>
<td>575</td>
<td>366.2%</td>
</tr>
<tr>
<td>17</td>
<td>*AUTOMOBILE AND TRUCK DEALERS</td>
<td>89,195</td>
<td>345889</td>
<td>256,694</td>
<td>287.8%</td>
</tr>
<tr>
<td>18</td>
<td>CONVENIENCE STORES</td>
<td>3,906</td>
<td>14321</td>
<td>10,415</td>
<td>266.6%</td>
</tr>
<tr>
<td>19</td>
<td>RETAILING (NON-FOOD)</td>
<td>9,031</td>
<td>29265</td>
<td>20,234</td>
<td>224.1%</td>
</tr>
<tr>
<td>20</td>
<td>*SOFT DRINK BOTTLERS</td>
<td>8,165</td>
<td>26170</td>
<td>18,005</td>
<td>220.5%</td>
</tr>
<tr>
<td>21</td>
<td>AUTOMOTIVE PRODUCTS AND SERVICES</td>
<td>5,006</td>
<td>13866</td>
<td>8,860</td>
<td>177.0%</td>
</tr>
<tr>
<td>22</td>
<td>*GASOLINE SERVICE STATIONS</td>
<td>47,547</td>
<td>128647</td>
<td>81,100</td>
<td>170.6%</td>
</tr>
<tr>
<td>23</td>
<td>LAUNDRY AND DRYCLEANING SERVICES</td>
<td>214</td>
<td>401</td>
<td>187</td>
<td>87.4%</td>
</tr>
<tr>
<td>24</td>
<td>PRODUCT/TRADEMARK FRANCHISES</td>
<td>144,907</td>
<td>500706</td>
<td>355,799</td>
<td>245.5%</td>
</tr>
<tr>
<td>25</td>
<td>BUSINESS/FORMAT FRANCHISES</td>
<td>40,882</td>
<td>213769</td>
<td>172,886</td>
<td>452.9%</td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td>185,789</td>
<td>714475</td>
<td>526,686</td>
<td>284.6%</td>
</tr>
</tbody>
</table>

between 1975 and 1990. Even after accounting for inflation, nearly all sectors -- with the exception of laundry and dry cleaning services, and accounting, credit, and collection services -- experienced growth. Certain sectors within business format franchising experienced particularly high levels of growth over the period:

- recreation, entertainment, and travel (1131.8 percent increase in inflation-adjusted dollars between 1975 and 1990);
- business aids and services (449.8 percent increase in inflation-adjusted dollars), with particular growth in the sub-sectors of real estate (966.3 percent) and printing and copying services (762.9 percent);
- educational products and services (383.7 percent increase in inflation-adjusted dollars); and
- construction, home improvement, etc. (316.2 percent in inflation-adjusted dollars).

Among the slowest growing of sectors were three that constitute product/tradename franchising -- gasoline service stations (11.5 percent in inflation-adjusted dollars); automotive products and services (14.1 percent), and soft drink bottlers (32.1 percent). Despite their slow growth, these three sectors remain among the top five sectors within franchising and account for about 70 percent of all franchising sales.

B. TRENDS IN THE NUMBER OF FRANCHISE ESTABLISHMENTS

1. Net Increase of 5,800 Franchise Establishments Per Year Since 1975; But Growth in Franchising Units Lags Far Behind Growth in Total U.S. Establishments.

Since 1975, despite a substantial decline in the number of product/tradename franchises, there has been an overall increase in the number of franchise establishments.\(^4\)

\(^4\)A franchise establishment is a single physical location at which business is conducted. It is not necessarily identical to a company or enterprise which may consist of one or more different establishments. Thus, a multi-unit franchise owner with five units at different locations would have five establishments. For purposes of this report, the terms
As shown in Exhibit 2-6, the number of total establishment units increased from 434,538 in 1975 to 521,215 in 1990. This was a total increase of 86,677 establishments or about 5,800 (net) new establishments per year. Over the 15-year period, the overall increase in establishment units was 19.9 percent.

This general increase in the number of franchise establishments was well below the general growth in establishments within the U.S. as a whole. Between 1975 and 1989, according to the U.S. Census Bureau, the number of establishment units within the U.S. grew by 48.4 percent, compared to a 13.3 percent growth over the same period in franchising units. While franchise establishments accounted for 10.6 percent of the 4.11 million establishments in 1975, by 1989 this percentage had fallen to 8.5 percent of the 6.11 million establishments. Therefore, while franchising sales grew relatively and absolutely between 1975 and 1990, franchise establishments as a percentage of total establishments actually declined in importance during this period.

2. Product/Tradename Establishments Decreased While Business Format Establishments Flourish

The overall increase in the number of establishments masks one of the most important developments in franchising since the early 1970s: while the number of product/tradename franchises has decreased sharply, the number of business format franchises has expanded substantially. As shown in Exhibit 2-7, the number of business format franchise establishments grew by 175,304 between 1975 and 1990 (from 210,814 to 386,118 units), while the number of product/tradename establishments

establishment and unit are used interchangeably.

5U.S. Bureau of Census, County Business Patterns, annual. Data on establishment units were only available through 1989.
EXHIBIT 2-6: TRENDS IN FRANCHISING ESTABLISHMENTS, 1975-90

Number of Establishments (in Thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Establishments</th>
<th>Annual Change</th>
<th>Percent Annual Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>434,538</td>
<td>(6,163)</td>
<td>-1.4%</td>
</tr>
<tr>
<td>1976</td>
<td>443,263</td>
<td>8,725</td>
<td>2.0%</td>
</tr>
<tr>
<td>1977</td>
<td>452,508</td>
<td>9,245</td>
<td>2.1%</td>
</tr>
<tr>
<td>1978</td>
<td>453,590</td>
<td>1,082</td>
<td>0.2%</td>
</tr>
<tr>
<td>1979</td>
<td>452,487</td>
<td>(1,103)</td>
<td>-0.2%</td>
</tr>
<tr>
<td>1980</td>
<td>442,371</td>
<td>(10,116)</td>
<td>-2.2%</td>
</tr>
<tr>
<td>1981</td>
<td>442,418</td>
<td>47</td>
<td>0.0%</td>
</tr>
<tr>
<td>1982</td>
<td>442,413</td>
<td>(5)</td>
<td>0.0%</td>
</tr>
<tr>
<td>1983</td>
<td>441,181</td>
<td>(1,232)</td>
<td>-0.3%</td>
</tr>
<tr>
<td>1984</td>
<td>444,299</td>
<td>3,118</td>
<td>0.7%</td>
</tr>
<tr>
<td>1985</td>
<td>455,220</td>
<td>10,921</td>
<td>2.5%</td>
</tr>
<tr>
<td>1986</td>
<td>462,123</td>
<td>6,903</td>
<td>1.5%</td>
</tr>
<tr>
<td>1987</td>
<td>479,087</td>
<td>16,964</td>
<td>3.7%</td>
</tr>
<tr>
<td>1988</td>
<td>480,789</td>
<td>1,702</td>
<td>0.4%</td>
</tr>
<tr>
<td>1989</td>
<td>492,498</td>
<td>11,709</td>
<td>2.4%</td>
</tr>
<tr>
<td>1990</td>
<td>521,215</td>
<td>28,717</td>
<td>5.8%</td>
</tr>
<tr>
<td>CHANGE 1975-90</td>
<td></td>
<td>86,677</td>
<td>19.9%</td>
</tr>
</tbody>
</table>

declined by 88,627 (from 223,724 to 135,097). Hence, over the period, while business format franchising experienced an 83.2 percent increase in establishment units, the number of product/tradename establishments contracted by 39.6 percent. On an annual basis, while about 11,700 business format establishment units were added, there was a decline of about 5,900 product/tradename franchises. The loss in the number of product/tradename franchise establishments slowed during the latter part of the 1980s to net losses of about 3,700 units (between 1986-90).

Restructuring of the oil industry, beginning in the mid 1970s, explains much of the decrease in the number of product tradename establishments in recent years:

But perhaps the harshest blow to franchising during this period came from abroad with the Arab oil embargo of 1973. Shortages of gasoline supplies forced the closing of nearly 32,000 franchised gasoline service stations between 1973-1976. After 1976, the closing of gasoline service stations continued due to (1) slower growth in gasoline sales, (2) increasing complexity in automotive service, (3) the proliferation of self-service gasoline stations, (4) the consolidation of petroleum companies (and resulting disappearance of some gasoline brands), and (5) major changes in marketing philosophy by gasoline retailers. Over 90 percent of the net overall decrease of product/tradename establishments between 1975 and 1990 was accounted for by the (net) loss of over 81,000 gasoline service stations. Auto-truck dealers and soft drink bottlers also showed consistent, though much smaller, net losses.

The shifting balance in the number of product/tradename versus business format franchises is also reflected in relative terms. As shown in Exhibit 2-7, while product tradename franchises accounted for about half (51.5 percent) of all franchise

---

EXHIBIT 2-7: PRODUCT/TRADENAME AND BUSINESS FORMAT
FRANCHISE ESTABLISHMENTS, 1975-1990

<table>
<thead>
<tr>
<th>Year</th>
<th>PRODUCT FRANCHISING</th>
<th>TRADENAME FRANCHISING</th>
<th>BUSINESS FORMAT FRANCHISING</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>223,724</td>
<td>51.5%</td>
<td>210,814</td>
</tr>
<tr>
<td>1976</td>
<td>220,946</td>
<td>49.8%</td>
<td>222,317</td>
</tr>
<tr>
<td>1977</td>
<td>211,984</td>
<td>46.8%</td>
<td>260,524</td>
</tr>
<tr>
<td>1978</td>
<td>207,896</td>
<td>45.8%</td>
<td>265,694</td>
</tr>
<tr>
<td>1979</td>
<td>199,785</td>
<td>44.2%</td>
<td>252,702</td>
</tr>
<tr>
<td>1980</td>
<td>189,823</td>
<td>42.9%</td>
<td>252,548</td>
</tr>
<tr>
<td>1981</td>
<td>181,863</td>
<td>41.1%</td>
<td>260,555</td>
</tr>
<tr>
<td>1982</td>
<td>174,107</td>
<td>39.4%</td>
<td>268,306</td>
</tr>
<tr>
<td>1983</td>
<td>164,986</td>
<td>37.4%</td>
<td>276,195</td>
</tr>
<tr>
<td>1984</td>
<td>160,723</td>
<td>36.2%</td>
<td>283,576</td>
</tr>
<tr>
<td>1985</td>
<td>153,531</td>
<td>33.7%</td>
<td>301,689</td>
</tr>
<tr>
<td>1986</td>
<td>149,313</td>
<td>32.3%</td>
<td>312,810</td>
</tr>
<tr>
<td>1987</td>
<td>144,571</td>
<td>30.2%</td>
<td>334,516</td>
</tr>
<tr>
<td>1988</td>
<td>141,810</td>
<td>29.5%</td>
<td>338,979</td>
</tr>
<tr>
<td>1989</td>
<td>139,245</td>
<td>28.3%</td>
<td>353,253</td>
</tr>
<tr>
<td>1990</td>
<td>135,097</td>
<td>25.9%</td>
<td>386,118</td>
</tr>
<tr>
<td>CHANGE 1975-90</td>
<td>-88,627</td>
<td>-39.6%</td>
<td>+175,304</td>
</tr>
</tbody>
</table>

establishments in 1975, the percentage steadily decreased during each of the next 15 years. By 1990, only one-quarter (25.9 percent) of all franchise establishments were product/tradename establishments. Finally, as a percentage of total U.S. establishment units, while business format franchise units grew from 5.1 percent in 1975 to 6.3 percent in 1989, product/tradename franchise units fell from 5.4 percent in 1975 to 2.2 percent in 1989.\(^7\)

3. **Significant Sectoral Shifts in Number and Proportion of Franchises Between 1975-1990**

Many of the sectoral shifts in number of franchise establishments paralleled the changes in sales in the sectors reported earlier. As shown in Exhibit 2-8, the five leading sectors within franchising, which accounted for about 70 percent of franchise establishments in 1990, were:

- gasoline service stations (20.6 percent),
- restaurants (19.1 percent),
- business aids and services (12.4 percent),
- non-food retailing (10.4 percent), and
- automotive products and services (7.5 percent).

This exhibit also shows very significant shifts in the proportion of franchise establishments by sector. The most noticeable shifts (in percentage terms) over the 15-year period were in the largest of the franchising sectors:

- gasoline service stations decreased from 43.6 percent of all franchises in 1975 to 20.6 percent in 1990;
- restaurant establishments increased from 9.9 percent to 19.1 percent; and

\(^7\)U.S. Bureau of the Census, *County Business Patterns*. 2-15
### EXHIBIT 2-8: NUMBER AND PERCENT OF ESTABLISHMENTS BY FRANCHISE SECTOR

<table>
<thead>
<tr>
<th>1990 RANK</th>
<th>FRANCHISE SECTOR</th>
<th>1975</th>
<th></th>
<th>1990</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>*GASOLINE SERVICE STATIONS</td>
<td>189,480</td>
<td>43.6%</td>
<td>107,500</td>
<td>20.6%</td>
</tr>
<tr>
<td>2</td>
<td>RESTAURANTS (ALL TYPES)</td>
<td>42,983</td>
<td>9.9%</td>
<td>99,340</td>
<td>19.1%</td>
</tr>
<tr>
<td>3</td>
<td>BUSINESS AIDS AND SERVICES</td>
<td>22,159</td>
<td>5.1%</td>
<td>64,407</td>
<td>12.4%</td>
</tr>
<tr>
<td></td>
<td>MISCELLANEOUS BUSINESS SERVICES</td>
<td>3,394</td>
<td>0.8%</td>
<td>23,561</td>
<td>4.5%</td>
</tr>
<tr>
<td></td>
<td>REAL ESTATE</td>
<td>3,808</td>
<td>0.9%</td>
<td>16,440</td>
<td>3.2%</td>
</tr>
<tr>
<td></td>
<td>TAX PREPARATION SERVICES</td>
<td>7,547</td>
<td>1.7%</td>
<td>8,295</td>
<td>1.6%</td>
</tr>
<tr>
<td></td>
<td>EMPLOYMENT SERVICES</td>
<td>2,721</td>
<td>0.6%</td>
<td>7,308</td>
<td>1.4%</td>
</tr>
<tr>
<td></td>
<td>PRINTING AND COPYING SERVICES</td>
<td>1,141</td>
<td>0.3%</td>
<td>6,845</td>
<td>1.3%</td>
</tr>
<tr>
<td></td>
<td>ACCOUNTING, CREDIT, &amp; COLLECTION</td>
<td>3,548</td>
<td>0.8%</td>
<td>1,758</td>
<td>0.3%</td>
</tr>
<tr>
<td>4</td>
<td>RETAILING (NON-FOOD)</td>
<td>37,179</td>
<td>8.6%</td>
<td>54,428</td>
<td>10.4%</td>
</tr>
<tr>
<td>5</td>
<td>AUTOMOTIVE PRODUCTS AND SERVICES</td>
<td>47,454</td>
<td>10.9%</td>
<td>39,249</td>
<td>7.5%</td>
</tr>
<tr>
<td>6</td>
<td>CONSTRUCTION, HOME IMPROVEMENT</td>
<td>10,821</td>
<td>2.5%</td>
<td>27,415</td>
<td>5.3%</td>
</tr>
<tr>
<td>7</td>
<td>*AUTOMOBILE AND TRUCK DEALERS</td>
<td>31,846</td>
<td>7.3%</td>
<td>26,800</td>
<td>5.1%</td>
</tr>
<tr>
<td>8</td>
<td>RETAILING (FOOD/NON-CONVEN. STORES)</td>
<td>11,761</td>
<td>2.7%</td>
<td>24,511</td>
<td>4.7%</td>
</tr>
<tr>
<td>9</td>
<td>CONVENIENCE STORES</td>
<td>15,513</td>
<td>3.1%</td>
<td>17,208</td>
<td>3.3%</td>
</tr>
<tr>
<td>10</td>
<td>EDUCATIONAL PRODUCTS AND SERVICES</td>
<td>1,304</td>
<td>0.3%</td>
<td>12,539</td>
<td>2.4%</td>
</tr>
<tr>
<td>11</td>
<td>HOTELS, MOTELS, &amp; CAMPGROUNDS</td>
<td>6,427</td>
<td>1.5%</td>
<td>11,046</td>
<td>2.1%</td>
</tr>
<tr>
<td>12</td>
<td>RECREATION, ENTERTAINMENT &amp; TRAVEL</td>
<td>3,510</td>
<td>0.8%</td>
<td>10,887</td>
<td>2.1%</td>
</tr>
<tr>
<td>13</td>
<td>RENTAL SERVICES (AUTO-TRUCK)</td>
<td>6,490</td>
<td>1.5%</td>
<td>10,740</td>
<td>2.1%</td>
</tr>
<tr>
<td>14</td>
<td>MISCELLANEOUS, OTHER</td>
<td>2,707</td>
<td>0.6%</td>
<td>8,406</td>
<td>1.6%</td>
</tr>
<tr>
<td>15</td>
<td>LAUNDRY AND DRYCLEANING SERVICES</td>
<td>3,170</td>
<td>0.7%</td>
<td>3,196</td>
<td>0.6%</td>
</tr>
<tr>
<td>16</td>
<td>RENTAL SERVICES (EQUIPMENT)</td>
<td>1,436</td>
<td>0.3%</td>
<td>2,746</td>
<td>0.5%</td>
</tr>
<tr>
<td>17</td>
<td>*SOFT DRINK BOTTLERS</td>
<td>2,398</td>
<td>0.6%</td>
<td>797</td>
<td>0.2%</td>
</tr>
</tbody>
</table>

PRODUCT/TRADEMARK FRANCHISES: 223,724 (51.5%) 135,097 (25.9%)

BUSINESS/FORMAT FRANCHISES: 210,814 (48.5%) 386,118 (74.1%)

TOTAL: 434,538 (100.0%) 521,215 (100.0%)

Note: (*) Denote product/tradename franchise.
• business aids and services increased from 5.1 percent to 12.4 percent.

As shown in Exhibit 2-9, nearly all sectors of business format franchising (except automotive products and services) experienced growth in the number of establishments, while the three sectors within product/tradename franchising experienced declines. Growth in establishment units among certain sectors of business format franchising was especially significant in:

• educational products and services (862 percent increase in establishments between 1975 and 1990);

• recreation, entertainment and travel (219 percent increase);

• business aids and services (191 percent increase), with particular increases in miscellaneous business services (594 percent), printing and copying services (500 percent), and employment services (332 percent); and

• construction and home improvement (153 percent increase).

4. Overall Growth in Franchise Establishments for All States, but Continued Concentration in Certain States

Establishment data are available on the expansion of business format franchising by state. Although the growth of business format franchising has been a national phenomena, the number of franchise establishments is not evenly distributed throughout the country. As shown in Exhibit 2-10, in 1988, the leading six states (in terms of franchise establishments) were California (31,467 establishments), Texas (22,714), Florida (15,642), Illinois (11,972), New York (11,888), and Ohio (11,495). Together, these six

---

8 More detailed discussion on the many reasons behind the sectoral shifts can be found in Chapter 3.

9 Similar data are not available for product/trademark franchises.
## EXHIBIT 2-9: CHANGE IN THE NUMBER OF ESTABLISHMENTS BY FRANCHISE SECTOR

<table>
<thead>
<tr>
<th>RANK</th>
<th>FRANCHISE SECTOR</th>
<th># OF ESTABLISHMENTS</th>
<th>CHANGE 1975-90</th>
<th>AVERAGE PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1975</td>
<td>1990</td>
<td>NUMBER</td>
</tr>
<tr>
<td>1</td>
<td>EDUCATIONAL PRODUCTS AND SERVICES</td>
<td>1,304</td>
<td>12,539</td>
<td>11,235</td>
</tr>
<tr>
<td>2</td>
<td>RECREATION, ENTERTAINMENT AND TRAVEL</td>
<td>3,410</td>
<td>10,887</td>
<td>7,477</td>
</tr>
<tr>
<td>3</td>
<td>MISCELLANEOUS, OTHER</td>
<td>2,707</td>
<td>8,406</td>
<td>5,709</td>
</tr>
<tr>
<td>4</td>
<td>BUSINESS AIDS AND SERVICES</td>
<td>22,159</td>
<td>66,407</td>
<td>44,248</td>
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<tr>
<td>5</td>
<td>MISCELLANEOUS BUSINESS SERVICES</td>
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<td>23,561</td>
<td>20,167</td>
</tr>
<tr>
<td>6</td>
<td>PRINTING AND COPYING SERVICES</td>
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<td>6,865</td>
<td>5,724</td>
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<tr>
<td>7</td>
<td>REAL ESTATE</td>
<td>3,808</td>
<td>16,440</td>
<td>12,632</td>
</tr>
<tr>
<td>8</td>
<td>EMPLOYMENT SERVICES</td>
<td>2,721</td>
<td>7,508</td>
<td>4,787</td>
</tr>
<tr>
<td>9</td>
<td>BUSINESS AIDS AND SERVICES</td>
<td>7,547</td>
<td>8,295</td>
<td>748</td>
</tr>
<tr>
<td>10</td>
<td>ACCOUNTING, CREDIT, COLLECTION AGENCIES</td>
<td>3,548</td>
<td>1,758</td>
<td>-1,790</td>
</tr>
<tr>
<td>11</td>
<td>CONSTRUCTION, HOME IMPROVEMENT, ETC.</td>
<td>10,821</td>
<td>27,415</td>
<td>16,594</td>
</tr>
<tr>
<td>12</td>
<td>CONSTRUCTION, HOME IMPROVEMENT, ETC.</td>
<td>10,821</td>
<td>27,415</td>
<td>16,594</td>
</tr>
<tr>
<td>13</td>
<td>RESTAURANTS (ALL TYPES)</td>
<td>42,983</td>
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<tr>
<td>14</td>
<td>RETAILING (FOOD/CONVENIENCE STORES)</td>
<td>11,761</td>
<td>24,511</td>
<td>12,750</td>
</tr>
<tr>
<td>15</td>
<td>RETAILING (FOOD/CONVENIENCE STORES)</td>
<td>11,761</td>
<td>24,511</td>
<td>12,750</td>
</tr>
<tr>
<td>16</td>
<td>RETAILING (NON-FOOD)</td>
<td>6,490</td>
<td>10,760</td>
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<tr>
<td>17</td>
<td>CONVENIENCE STORES</td>
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<td>-1,790</td>
</tr>
<tr>
<td></td>
<td>RETAILING (NON-FOOD)</td>
<td>3,548</td>
<td>1,758</td>
<td>-1,790</td>
</tr>
<tr>
<td>18</td>
<td>REAL ESTATE</td>
<td>37,179</td>
<td>54,428</td>
<td>17,249</td>
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<td>19</td>
<td>CONVENIENCE STORES</td>
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<tr>
<td>20</td>
<td>LAUNDRY AND DRYCLEANING SERVICES</td>
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<td>3,196</td>
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</tr>
<tr>
<td>21</td>
<td>AUTOMOBILE AND TRUCK DEALERS</td>
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<tr>
<td>22</td>
<td>AUTOMOTIVE PRODUCTS AND SERVICES</td>
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<tr>
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<td>SOFT DRINK BOTTLERS</td>
<td>2,398</td>
<td>797</td>
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<tr>
<td>24</td>
<td>PRODUCT/TRADEMARK FRANCHISES</td>
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<td>135,097</td>
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<td>25</td>
<td>BUSINESS/FORMAT FRANCHISES</td>
<td>210,814</td>
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<tr>
<td>26</td>
<td>TOTAL</td>
<td>434,538</td>
<td>521,215</td>
<td>86,677</td>
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Note: (*) Denote product/tradename franchise.
<table>
<thead>
<tr>
<th>STATE</th>
<th>TOTAL FRANCHISE UNITS</th>
<th>RELATIVE PERCENT</th>
<th>CUMULATIVE PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>31,667</td>
<td>12.3%</td>
<td>12.3%</td>
</tr>
<tr>
<td>Texas</td>
<td>22,714</td>
<td>8.9%</td>
<td>21.2%</td>
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<tr>
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<td>15,624</td>
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<td>27.3%</td>
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<tr>
<td>Illinois</td>
<td>11,972</td>
<td>4.7%</td>
<td>31.9%</td>
</tr>
<tr>
<td>New York</td>
<td>11,888</td>
<td>4.6%</td>
<td>36.6%</td>
</tr>
<tr>
<td>Ohio</td>
<td>11,495</td>
<td>4.5%</td>
<td>41.1%</td>
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<tr>
<td>Pennsylvania</td>
<td>9,522</td>
<td>3.7%</td>
<td>44.8%</td>
</tr>
<tr>
<td>Michigan</td>
<td>8,703</td>
<td>3.4%</td>
<td>48.2%</td>
</tr>
<tr>
<td>Georgia</td>
<td>7,321</td>
<td>2.9%</td>
<td>51.0%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>6,593</td>
<td>2.6%</td>
<td>53.6%</td>
</tr>
<tr>
<td>Virginia</td>
<td>6,573</td>
<td>2.6%</td>
<td>56.2%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>6,121</td>
<td>2.4%</td>
<td>58.6%</td>
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<tr>
<td>Indiana</td>
<td>5,977</td>
<td>2.3%</td>
<td>60.9%</td>
</tr>
<tr>
<td>Minnesota</td>
<td>5,571</td>
<td>2.2%</td>
<td>63.1%</td>
</tr>
<tr>
<td>Colorado</td>
<td>5,026</td>
<td>2.0%</td>
<td>65.0%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>4,932</td>
<td>1.9%</td>
<td>67.0%</td>
</tr>
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<td>Massachusetts</td>
<td>4,930</td>
<td>1.9%</td>
<td>68.9%</td>
</tr>
<tr>
<td>Arizona</td>
<td>4,888</td>
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<td>70.8%</td>
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<tr>
<td>Wisconsin</td>
<td>4,844</td>
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<td>72.7%</td>
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<tr>
<td>Missouri</td>
<td>4,780</td>
<td>1.9%</td>
<td>74.6%</td>
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<td>Washington</td>
<td>4,561</td>
<td>1.8%</td>
<td>76.3%</td>
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<tr>
<td>Oklahoma</td>
<td>4,170</td>
<td>1.6%</td>
<td>78.0%</td>
</tr>
<tr>
<td>Maryland</td>
<td>4,158</td>
<td>1.6%</td>
<td>79.6%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>4,061</td>
<td>1.6%</td>
<td>81.2%</td>
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<tr>
<td>Kentucky</td>
<td>4,052</td>
<td>1.6%</td>
<td>82.8%</td>
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<tr>
<td>Alabama</td>
<td>3,741</td>
<td>1.5%</td>
<td>84.2%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>3,675</td>
<td>1.4%</td>
<td>85.6%</td>
</tr>
<tr>
<td>Iowa</td>
<td>3,496</td>
<td>1.4%</td>
<td>87.0%</td>
</tr>
<tr>
<td>Connecticut</td>
<td>3,469</td>
<td>1.4%</td>
<td>88.4%</td>
</tr>
<tr>
<td>Oregon</td>
<td>3,005</td>
<td>1.2%</td>
<td>89.5%</td>
</tr>
<tr>
<td>Kansas</td>
<td>2,894</td>
<td>1.1%</td>
<td>90.7%</td>
</tr>
<tr>
<td>Mississippi</td>
<td>2,339</td>
<td>0.9%</td>
<td>91.6%</td>
</tr>
<tr>
<td>Arkansas</td>
<td>2,253</td>
<td>0.9%</td>
<td>92.5%</td>
</tr>
<tr>
<td>New Mexico</td>
<td>2,019</td>
<td>0.8%</td>
<td>93.3%</td>
</tr>
<tr>
<td>Nebraska</td>
<td>1,986</td>
<td>0.8%</td>
<td>94.0%</td>
</tr>
<tr>
<td>Utah</td>
<td>1,640</td>
<td>0.6%</td>
<td>94.7%</td>
</tr>
<tr>
<td>West Virginia</td>
<td>1,551</td>
<td>0.6%</td>
<td>95.3%</td>
</tr>
<tr>
<td>Nevada</td>
<td>1,477</td>
<td>0.6%</td>
<td>95.8%</td>
</tr>
<tr>
<td>Idaho</td>
<td>1,050</td>
<td>0.4%</td>
<td>96.3%</td>
</tr>
<tr>
<td>Montana</td>
<td>1,023</td>
<td>0.4%</td>
<td>96.7%</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>951</td>
<td>0.4%</td>
<td>97.0%</td>
</tr>
<tr>
<td>Maine</td>
<td>930</td>
<td>0.4%</td>
<td>97.4%</td>
</tr>
<tr>
<td>South Dakota</td>
<td>890</td>
<td>0.3%</td>
<td>97.7%</td>
</tr>
<tr>
<td>Hawaii</td>
<td>854</td>
<td>0.3%</td>
<td>98.1%</td>
</tr>
</tbody>
</table>
EXHIBIT 2-10: BUSINESS FORMAT FRANCHISE UNITS BY STATE, 1988
Continued

<table>
<thead>
<tr>
<th>STATE</th>
<th>TOTAL FRANCHISE UNITS</th>
<th>RELATIVE PERCENT</th>
<th>CUMULATIVE PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>North Dakota</td>
<td>789</td>
<td>0.3%</td>
<td>98.4%</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>786</td>
<td>0.3%</td>
<td>98.7%</td>
</tr>
<tr>
<td>Delaware</td>
<td>715</td>
<td>0.3%</td>
<td>99.0%</td>
</tr>
<tr>
<td>Wyoming</td>
<td>660</td>
<td>0.3%</td>
<td>99.2%</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>559</td>
<td>0.2%</td>
<td>99.6%</td>
</tr>
<tr>
<td>Alaska</td>
<td>538</td>
<td>0.2%</td>
<td>99.7%</td>
</tr>
<tr>
<td>Vermont</td>
<td>505</td>
<td>0.2%</td>
<td>99.8%</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>333</td>
<td>0.1%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Other U.S. Possessions</td>
<td>52</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td><em>TOTAL</em></td>
<td>256,141</td>
<td></td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Note: Data available for only 76 percent of business format establishments; geographic detail is not available for the remaining establishments.

states accounted for an estimated 41.1 percent of all business format establishments (while accounting for 39.3 percent of the U.S. population).

An analysis of the distribution of business format franchise establishments by state shows considerable cross-state variation in terms of the concentration of franchise establishments per 1000 residents. The average for the country as a whole (in 1988) was 1.03 franchise establishments per 1000 residents. As shown in Exhibit 2-11, states with greater concentrations of franchising were mostly located west of the Mississippi river, particularly in the plains and mountain states: Colorado (1.52 per 1000 resident population), Arizona (1.40), Nevada (1.40); Wyoming (1.38), Texas (1.35), New Mexico (1.34). Of the top 15 states in terms of franchise units per 1000 resident population, only one (Florida, 1.27) was located east of the Mississippi River. Most of the states with high concentrations of franchise units per capita also had relatively low population densities. For example, only one of the top 15 states (Florida), had more than 65 persons per square mile.¹⁰ States and areas with lower concentrations include a number of northeast and mid-Atlantic states, and outlying areas: Puerto Rico (0.10) and other U.S. possessions (0.18), New York (0.66), Maine (0.66), Hawaii (0.78), Rhode Island (0.79), Pennsylvania (0.83), West Virginia (0.83), Massachusetts (0.84), and New Jersey (0.85).

¹⁰The average for the U.S. was 70.3 percent in 1990. Population per square mile of land area was for 1990. Source: U.S. Bureau of the Census, Current Population Reports, Series P-25, No. 1058.
EXHIBIT 2-11: CONCENTRATION OF BUSINESS FORMAT FRANCHISE UNITS BY STATE, 1988

<table>
<thead>
<tr>
<th>STATE</th>
<th>TOTAL FRANCHISE UNITS</th>
<th>% OF FRANCHISE UNITS</th>
<th>CONCENTRATION (UNITS/1000 POPULATION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>5,026</td>
<td>1.96%</td>
<td>1.50</td>
</tr>
<tr>
<td>Wyoming</td>
<td>660</td>
<td>0.26%</td>
<td>1.44</td>
</tr>
<tr>
<td>New Mexico</td>
<td>2,019</td>
<td>0.79%</td>
<td>1.32</td>
</tr>
<tr>
<td>Arizona</td>
<td>4,888</td>
<td>1.91%</td>
<td>1.32</td>
</tr>
<tr>
<td>Texas</td>
<td>22,714</td>
<td>8.87%</td>
<td>1.32</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>4,170</td>
<td>1.63%</td>
<td>1.30</td>
</tr>
<tr>
<td>Minnesota</td>
<td>5,571</td>
<td>2.18%</td>
<td>1.26</td>
</tr>
<tr>
<td>S. Dakota</td>
<td>890</td>
<td>0.35%</td>
<td>1.25</td>
</tr>
<tr>
<td>Montana</td>
<td>1,023</td>
<td>0.40%</td>
<td>1.25</td>
</tr>
<tr>
<td>Nebraska</td>
<td>1,986</td>
<td>0.78%</td>
<td>1.24</td>
</tr>
<tr>
<td>N. Dakota</td>
<td>789</td>
<td>0.31%</td>
<td>1.24</td>
</tr>
<tr>
<td>Iowa</td>
<td>3,496</td>
<td>1.36%</td>
<td>1.24</td>
</tr>
<tr>
<td>Nevada</td>
<td>1,477</td>
<td>0.58%</td>
<td>1.21</td>
</tr>
<tr>
<td>Florida</td>
<td>15,642</td>
<td>6.11%</td>
<td>1.19</td>
</tr>
<tr>
<td>Kansas</td>
<td>2,894</td>
<td>1.13%</td>
<td>1.15</td>
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<tr>
<td>Georgia</td>
<td>7,321</td>
<td>2.86%</td>
<td>1.11</td>
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<tr>
<td>Delaware</td>
<td>715</td>
<td>0.28%</td>
<td>1.08</td>
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<tr>
<td>Kentucky</td>
<td>4,052</td>
<td>1.58%</td>
<td>1.08</td>
</tr>
<tr>
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<td>5,977</td>
<td>2.33%</td>
<td>1.06</td>
</tr>
<tr>
<td>Virginia</td>
<td>6,573</td>
<td>2.57%</td>
<td>1.05</td>
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<td>1.17%</td>
<td>1.04</td>
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<td>Connecticut</td>
<td>3,469</td>
<td>1.35%</td>
<td>1.04</td>
</tr>
<tr>
<td>Ohio</td>
<td>11,495</td>
<td>4.49%</td>
<td>1.04</td>
</tr>
<tr>
<td>S. Carolina</td>
<td>3,675</td>
<td>1.43%</td>
<td>1.04</td>
</tr>
<tr>
<td>California</td>
<td>31,467</td>
<td>12.29%</td>
<td>1.04</td>
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<td>Idaho</td>
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<td>0.41%</td>
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<td>4,932</td>
<td>1.93%</td>
<td>1.00</td>
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<tr>
<td>Wisconsin</td>
<td>4,844</td>
<td>1.89%</td>
<td>0.97</td>
</tr>
<tr>
<td>Louisiana</td>
<td>4,061</td>
<td>1.59%</td>
<td>0.95</td>
</tr>
<tr>
<td>Arkansas</td>
<td>2,253</td>
<td>0.88%</td>
<td>0.95</td>
</tr>
<tr>
<td>Alaska</td>
<td>538</td>
<td>0.21%</td>
<td>0.95</td>
</tr>
<tr>
<td>Utah</td>
<td>1,640</td>
<td>0.64%</td>
<td>0.94</td>
</tr>
<tr>
<td>Washington</td>
<td>4,561</td>
<td>1.78%</td>
<td>0.92</td>
</tr>
<tr>
<td>Michigan</td>
<td>8,703</td>
<td>3.40%</td>
<td>0.92</td>
</tr>
<tr>
<td>Missouri</td>
<td>4,780</td>
<td>1.87%</td>
<td>0.92</td>
</tr>
<tr>
<td>D.C.</td>
<td>559</td>
<td>0.22%</td>
<td>0.92</td>
</tr>
<tr>
<td>Alabama</td>
<td>3,741</td>
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<td>0.91</td>
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<td>Vermont</td>
<td>505</td>
<td>0.20%</td>
<td>0.91</td>
</tr>
<tr>
<td>N. Carolina</td>
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<td>0.91</td>
</tr>
<tr>
<td>Mississippi</td>
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<td>0.91%</td>
<td>0.89</td>
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</table>

2-22
### EXHIBIT 2-11: CONCENTRATION OF BUSINESS FORMAT FRANCHISE UNITS BY STATE, 1988

Continued

<table>
<thead>
<tr>
<th>STATE</th>
<th>TOTAL FRANCHISE UNITS</th>
<th>% OF FRANCHISE UNITS</th>
<th>CONCENTRATION (UNITS/1000 POPULATION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>W. Virginia</td>
<td>1,551</td>
<td>0.61%</td>
<td>0.86</td>
</tr>
<tr>
<td>Maryland</td>
<td>4,158</td>
<td>1.62%</td>
<td>0.85</td>
</tr>
<tr>
<td>New Jersey</td>
<td>6,593</td>
<td>2.57%</td>
<td>0.84</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>951</td>
<td>0.37%</td>
<td>0.84</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>4,930</td>
<td>1.92%</td>
<td>0.80</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>9,522</td>
<td>3.72%</td>
<td>0.79</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>786</td>
<td>0.31%</td>
<td>0.78</td>
</tr>
<tr>
<td>Hawaii</td>
<td>854</td>
<td>0.33%</td>
<td>0.75</td>
</tr>
<tr>
<td>Maine</td>
<td>930</td>
<td>0.36%</td>
<td>0.73</td>
</tr>
<tr>
<td>New York</td>
<td>11,888</td>
<td>4.64%</td>
<td>0.65</td>
</tr>
<tr>
<td>U.S. Territories</td>
<td>385</td>
<td>0.15%</td>
<td>0.11</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td>256,141</td>
<td>100.0%</td>
<td>1.03</td>
</tr>
</tbody>
</table>

Note: Data available for only 76 percent of business format establishments; geographic detail is not available for the remaining establishments.

C. TRENDS IN EMPLOYMENT

1. The Number of Persons Employed in Franchising Doubled Between 1975 and 1988

Employment in franchising, which includes full-time and part-time employees and working proprietors, has grown faster than the U.S. labor force. As shown in Exhibit 2-12, the total number employed by all companies involved in franchising in 1988 was about seven million persons (including proprietors and part-time employees). This was about double the number employed in 1975 (3.5 million) and was well above the percentage increase in the number of civilians employed within the labor force between 1975 and 1988 (33.9 percent). The 100 percent increase in the number employed within franchising was also well above growth in the number of franchise establishments (10.6 percent between 1975 and 1988) and inflation-adjusted sales (58.7 percent between 1975 and 1988).

2. Ninety Percent of Employment Growth Within Franchising Resulted from Expansion of Business Format Franchising

Given the rapid expansion in the number of business format franchises, it is not surprising that over 90 percent of the net increase in employment within franchising occurred within business format franchises. As shown in Exhibit 2-12, employment in business format franchises grew by 161.5 percent between 1975 to 1988 (from 2.01 million to 5.25 million persons). This compares to a 17.7 percent increase in employment within product/tradename franchises during the same period (from 1.50 million to 1.77

---

11Based on employment status of the noninstitutional civilian population 16 years older and over, from the U.S. Bureau of Labor Statistics, Employment and Earnings, monthly.
**EXHIBIT 2-12: TRENDS IN FRANCHISE EMPLOYMENT, 1975-1990**

### Persons Employed (in Thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Product</th>
<th>Business</th>
<th>Total</th>
<th>Product</th>
<th>Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>1502.6</td>
<td>2008.4</td>
<td>3511.0</td>
<td>42.8%</td>
<td>57.2%</td>
</tr>
<tr>
<td>1976</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>1977</td>
<td>1571.2</td>
<td>2579.6</td>
<td>4150.8</td>
<td>37.9%</td>
<td>62.1%</td>
</tr>
<tr>
<td>1978</td>
<td>1675.7</td>
<td>2820.5</td>
<td>4496.2</td>
<td>37.3%</td>
<td>62.7%</td>
</tr>
<tr>
<td>1979</td>
<td>1617.0</td>
<td>3038.5</td>
<td>4655.5</td>
<td>34.7%</td>
<td>65.3%</td>
</tr>
<tr>
<td>1980</td>
<td>1524.4</td>
<td>3143.7</td>
<td>4668.1</td>
<td>32.7%</td>
<td>67.3%</td>
</tr>
<tr>
<td>1981</td>
<td>1526.4</td>
<td>3353.9</td>
<td>4878.3</td>
<td>31.2%</td>
<td>68.8%</td>
</tr>
<tr>
<td>1982</td>
<td>1418.3</td>
<td>3509.2</td>
<td>4927.5</td>
<td>28.8%</td>
<td>71.2%</td>
</tr>
<tr>
<td>1983</td>
<td>1415.1</td>
<td>3750.6</td>
<td>5165.7</td>
<td>27.6%</td>
<td>72.4%</td>
</tr>
<tr>
<td>1984</td>
<td>1553.8</td>
<td>4118.1</td>
<td>5671.9</td>
<td>27.6%</td>
<td>72.4%</td>
</tr>
<tr>
<td>1985</td>
<td>1630.5</td>
<td>4652.1</td>
<td>6282.6</td>
<td>26.0%</td>
<td>74.0%</td>
</tr>
<tr>
<td>1986</td>
<td>1670.0</td>
<td>4830.8</td>
<td>6500.8</td>
<td>25.7%</td>
<td>74.3%</td>
</tr>
<tr>
<td>1987</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>1988</td>
<td>1769.3</td>
<td>5252.3</td>
<td>7021.6</td>
<td>25.2%</td>
<td>74.8%</td>
</tr>
</tbody>
</table>

Note: Data not available for 1976 and 1987.

million persons). By 1988, there were about three times as many persons employed by business format franchises as product/tradename franchises.

3. Number of Employees Per Establishment Increased for Both Product/Tradename and Business Format Franchises

Exhibit 2-13 also shows that the number of employees per establishment has increased for both product/tradename and business format franchises in recent years. While the average number of employees per franchise establishment was 8.1 in 1975, it increased to 14.6 by 1988. This represented an 80.8 percent growth in average establishment size. This growth is due, in part, to the strong growth in employment in the restaurant and hotel/motel sector. The number of employees per product/tradename establishment increased by 86.6 percent between 1975 and 1988, from an average of 6.7 to 12.5 employees per establishment. The number of employees per business format establishment increased by 63.2 percent during the same period, from 9.5 to 15.5 employees per establishment. The average number of employees per business format establishment remained about three employees above the number in product/tradename establishments throughout the period.

D. TRENDS IN THE NUMBER AND TYPES OF FRANCHISORS

1. Number of Franchisors More than Doubled Between 1975 and 1988

As might be expected given the rapid increase in franchise sales and establishments, there has been a steady increase in the number of franchisors offering their products and services to prospective franchisees. As shown in Exhibit 2-14, there were slightly over 2,200 business format franchisors in 1988. Although comparable data were not available, an estimated 200 additional product/tradename franchisors were also
EXHIBIT 2-13: TRENDS IN FRANCHISE EMPLOYMENT PER ESTABLISHMENT, 1975-1990

Employees per Franchise Establishment

Year
75 76 77 78 79 80 81 82 83 84 85 86 87 88
16 14 12 10 8 6 4 2 0

- Product/Tradename
- Business Format
- Total

Note: Data not available for 1976 and 1987.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>PRODUCT TRADEMARK</th>
<th>BUSINESS FORMAT</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>6.7</td>
<td>9.5</td>
<td>8.1</td>
</tr>
<tr>
<td>1976</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>1977</td>
<td>7.4</td>
<td>10.7</td>
<td>9.2</td>
</tr>
<tr>
<td>1978</td>
<td>8.1</td>
<td>11.5</td>
<td>9.9</td>
</tr>
<tr>
<td>1979</td>
<td>8.1</td>
<td>12.0</td>
<td>10.3</td>
</tr>
<tr>
<td>1980</td>
<td>8.0</td>
<td>12.4</td>
<td>10.6</td>
</tr>
<tr>
<td>1981</td>
<td>8.4</td>
<td>12.9</td>
<td>11.0</td>
</tr>
<tr>
<td>1982</td>
<td>8.1</td>
<td>13.1</td>
<td>11.1</td>
</tr>
<tr>
<td>1983</td>
<td>8.6</td>
<td>13.6</td>
<td>11.7</td>
</tr>
<tr>
<td>1984</td>
<td>9.7</td>
<td>14.5</td>
<td>12.8</td>
</tr>
<tr>
<td>1985</td>
<td>10.6</td>
<td>15.4</td>
<td>13.8</td>
</tr>
<tr>
<td>1986</td>
<td>11.2</td>
<td>15.4</td>
<td>14.1</td>
</tr>
<tr>
<td>1987</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>1988</td>
<td>12.5</td>
<td>15.5</td>
<td>14.6</td>
</tr>
</tbody>
</table>

EXHIBIT 2-14: TRENDS IN THE NUMBER OF FRANCHISORS, 1975-1988

Note: Data not available for 1987.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>NUMBER OF FRANCHISORS</th>
<th>ANNUAL CHANGE</th>
<th>ANNUAL % CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>1,115</td>
<td>64</td>
<td>6.1%</td>
</tr>
<tr>
<td>1976</td>
<td>1,161</td>
<td>46</td>
<td>4.1%</td>
</tr>
<tr>
<td>1977</td>
<td>1,281</td>
<td>120</td>
<td>10.3%</td>
</tr>
<tr>
<td>1978</td>
<td>1,394</td>
<td>113</td>
<td>8.8%</td>
</tr>
<tr>
<td>1979</td>
<td>1,459</td>
<td>65</td>
<td>4.7%</td>
</tr>
<tr>
<td>1980</td>
<td>1,584</td>
<td>125</td>
<td>8.6%</td>
</tr>
<tr>
<td>1981</td>
<td>1,673</td>
<td>89</td>
<td>5.6%</td>
</tr>
<tr>
<td>1982</td>
<td>1,770</td>
<td>97</td>
<td>5.8%</td>
</tr>
<tr>
<td>1983</td>
<td>1,877</td>
<td>107</td>
<td>6.0%</td>
</tr>
<tr>
<td>1984</td>
<td>1,942</td>
<td>65</td>
<td>3.5%</td>
</tr>
<tr>
<td>1985</td>
<td>2,090</td>
<td>148</td>
<td>7.6%</td>
</tr>
<tr>
<td>1986</td>
<td>2,177</td>
<td>87</td>
<td>4.2%</td>
</tr>
<tr>
<td>1987</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>1988*</td>
<td>2,239</td>
<td>62</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

Notes: Table includes business format franchisors only. There are an estimated 200 product trademark franchisors as well. 1988 changes are calculated for two years.

in existence in 1988. Between 1975 and 1988, the number of business format franchisors about doubled (100.8 percent increase). Throughout the period, the number of business format franchisors increased steadily, with annual increases ranging as high as 10.3 percent (between 1976 and 1977).

2. Large Franchising Systems Dominated in Sales, Establishments and Employment; but Dominance Decreased Somewhat Since 1975

Large franchisors, those with more than 500 franchise establishments, dominate business format franchising. Exhibit 2-15 shows data on the number of franchisors, sales, and establishments by size of the franchisor (measured in terms of the number of franchise units) in 1975 and 1986. As shown in these exhibits, while just 5.8 percent of franchisors (a total of 88 franchisors) had more than 500 franchise units in 1986, this group accounted for about two-thirds (65.0 percent) of all franchise sales and establishments. In comparison, while about one-third of all franchising systems had 10 or fewer establishments (33.9 percent), this group accounted for about 1 percent of sales (0.9 percent) and establishments (1.2 percent).

Despite the dominance of large franchising systems, there is some evidence that their dominance has decreased somewhat in recent years. As shown in the exhibits, franchising systems with more than 500 establishments decreased from 7.9 percent of all franchisors in 1975 to 5.8 percent in 1986. This group experienced a slight drop in their percentage of franchising sales (from 67.6 percent to 65.0 percent) and in number of establishments (from 72.2 percent to 65.0 percent). The largest gains were concentrated in the smallest size groups. The number of franchisors in the smallest two groups (1-10

\[12\] Data are not available for product/trademark franchises.
EXHIBIT 2-15: TRENDS IN THE SIZE OF BUSINESS FORMAT FRANCHISE SYSTEMS, 1975 AND 1988

FRANCHISORS BY THE NUMBER OF ESTABLISHMENT UNITS WITHIN THE FRANCHISE SYSTEM

<table>
<thead>
<tr>
<th># OF FRANCHISE UNITS WITH FRANCHISE SYSTEM</th>
<th>NUMBER OF FRANCHISORS</th>
<th>PERCENTAGE OF FRANCHISORS</th>
<th>% CHANGE 1975-86</th>
</tr>
</thead>
<tbody>
<tr>
<td>501+</td>
<td>88</td>
<td>127</td>
<td>7.9%</td>
</tr>
<tr>
<td>151-500</td>
<td>113</td>
<td>204</td>
<td>10.1%</td>
</tr>
<tr>
<td>51-150</td>
<td>205</td>
<td>343</td>
<td>18.4%</td>
</tr>
<tr>
<td>11-50</td>
<td>405</td>
<td>764</td>
<td>36.3%</td>
</tr>
<tr>
<td>1-10</td>
<td>304</td>
<td>739</td>
<td>27.3%</td>
</tr>
</tbody>
</table>
*Total*                                     | 1115      | 2177      | 100.0%  | 100.0%  | 95.2%     |               |

FRANCHISE SALES BY THE NUMBER OF ESTABLISHMENT UNITS WITHIN FRANCHISE SYSTEMS

<table>
<thead>
<tr>
<th># OF FRANCHISE UNITS WITH FRANCHISE SYSTEM</th>
<th>SALES (IN BILLIONS)</th>
<th>PERCENTAGE OF TOTAL FRANCHISE SALES</th>
<th>% CHANGE 1975-86</th>
</tr>
</thead>
<tbody>
<tr>
<td>501+</td>
<td>27.7</td>
<td>101.1</td>
<td>67.7%</td>
</tr>
<tr>
<td>151-500</td>
<td>7.1</td>
<td>29.1</td>
<td>17.4%</td>
</tr>
<tr>
<td>51-150</td>
<td>3.6</td>
<td>14.2</td>
<td>8.8%</td>
</tr>
<tr>
<td>11-50</td>
<td>2.2</td>
<td>9.8</td>
<td>5.4%</td>
</tr>
<tr>
<td>1-10</td>
<td>0.3</td>
<td>1.4</td>
<td>0.7%</td>
</tr>
</tbody>
</table>
*Total*                                     | 40.9    | 155.6   | 100.0% | 100.0% | 280.4%  |               |

FRANCHISE ESTABLISHMENTS BY THE NUMBER OF ESTABLISHMENT UNITS WITHIN FRANCHISE SYSTEMS

<table>
<thead>
<tr>
<th># OF FRANCHISE UNITS WITH FRANCHISE SYSTEM</th>
<th>NUMBER OF ESTABLISHMENTS</th>
<th>PERCENTAGE OF TOTAL FRANCHISE ESTABLISHMENTS</th>
<th>% CHANGE 1975-86</th>
</tr>
</thead>
<tbody>
<tr>
<td>501+</td>
<td>152,311</td>
<td>203,431</td>
<td>72.2%</td>
</tr>
<tr>
<td>151-500</td>
<td>28,363</td>
<td>56,212</td>
<td>13.5%</td>
</tr>
<tr>
<td>51-150</td>
<td>18,108</td>
<td>30,039</td>
<td>8.6%</td>
</tr>
<tr>
<td>11-50</td>
<td>10,422</td>
<td>19,415</td>
<td>4.9%</td>
</tr>
<tr>
<td>1-10</td>
<td>1,610</td>
<td>37,13</td>
<td>0.8%</td>
</tr>
</tbody>
</table>
*Total*                                     | 210,814   | 312,810   | 100.0% | 100.0% | 48.4%   |               |

units and 11-50 units) nearly doubled and their share of establishments and sales also grew from 1975 to 1986. The medium size group (151-500) also had significant gains, growing from 113 to 204 franchisors (80.5 percent increase), while its share of establishments increased from 13.5 to 18.0 percent and its share of sales increased slightly from 17.4 to 18.7 percent. The apparent growth in the medium and smaller franchises is supported by a recent survey which found that franchise systems selling a large number of franchises tended to be somewhat smaller, but able to use aggressive and sophisticated marketing techniques.13

3. Companies that Franchise, Franchise About Four-Fifths of Their Establishment Units; No Apparent Trend Toward Company-Owned Stores

Many companies that franchise also market their products or services directly themselves through company-owned units. The percentage of company-owned units among companies that also franchise can vary widely across sectors and even among companies in the same sector. As shown in Exhibit 2-16, in 1990 franchisors retained 18.6 percent of establishment units as company-owned stores, while franchising the remaining 81.4 percent of establishment units. The level of franchisee-owned stores was virtually unchanged among franchisors from the level in 1975 (81.5 percent). Although not shown in the exhibit, during the period 1975 to 1990, there was a gradual build-up of company-owned stores (to 22.6 percent in 1982), followed by a gradual decrease back to the 1975 level of company ownership by 1990.

13 Boroian, Patrick J. & Helen LaVan, Franchise Marketing and Sales Survey, 1990-91, published by Francorp and DePaul University (Tables 37-38). The survey did not find concentration in any specific sector. In addition, the survey found that faster growing franchise systems did not tend to be cheaper or less particular about their franchisees.


EXHIBIT 2-16: PERCENT OF FRANCHISEE-OWNED OUTLETS, BY FRANCHISE SECTOR, 1975 AND 1990

<table>
<thead>
<tr>
<th>1990 RANK</th>
<th>FRANCHISE SECTOR</th>
<th>% FRANCHISEE-OWNED OUTLETS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1975</td>
</tr>
<tr>
<td>1</td>
<td>*AUTOMOBILE AND TRUCK DEALERS</td>
<td>99.1%</td>
</tr>
<tr>
<td>2</td>
<td>CONSTRUCTION, HOME IMPROVEMENT, ETC.</td>
<td>97.8%</td>
</tr>
<tr>
<td>3</td>
<td>LAUNDRY AND DRYCLEANING SERVICES</td>
<td>95.7%</td>
</tr>
<tr>
<td>4</td>
<td>RECREATION, ENTERTAINMENT AND TRAVEL</td>
<td>98.2%</td>
</tr>
<tr>
<td>5</td>
<td>MISCELLANEOUS</td>
<td>93.5%</td>
</tr>
<tr>
<td>6</td>
<td>EDUCATIONAL PRODUCTS AND SERVICES</td>
<td>76.7%</td>
</tr>
<tr>
<td>7</td>
<td>HOTELS, MOTELS, CAMPGROUNDS</td>
<td>82.3%</td>
</tr>
<tr>
<td>8</td>
<td>BUSINESS AIDS AND SERVICES</td>
<td>79.1%</td>
</tr>
<tr>
<td>9</td>
<td>REAL ESTATE</td>
<td>99.4%</td>
</tr>
<tr>
<td>10</td>
<td>ACCOUNTING, CREDIT, COLLECTION, ETC.</td>
<td>98.3%</td>
</tr>
<tr>
<td>11</td>
<td>PRINTING AND COPYING SERVICES</td>
<td>91.6%</td>
</tr>
<tr>
<td>12</td>
<td>MISCELLANEOUS BUSINESS SERVICES</td>
<td>96.3%</td>
</tr>
<tr>
<td>13</td>
<td>EMPLOYMENT SERVICES</td>
<td>77.1%</td>
</tr>
<tr>
<td>14</td>
<td>TAX PREPARATION SERVICES</td>
<td>50.8%</td>
</tr>
<tr>
<td>15</td>
<td>AUTOMOTIVE PRODUCTS AND SERVICES</td>
<td>89.5%</td>
</tr>
<tr>
<td>16</td>
<td>RETAILING (FOOD/NON-CONVENIENCE STORES)</td>
<td>95.4%</td>
</tr>
<tr>
<td>17</td>
<td>*GASOLINE SERVICE STATIONS</td>
<td>80.0%</td>
</tr>
<tr>
<td>18</td>
<td>RETRALING (AUTO-TRUCK)</td>
<td>71.4%</td>
</tr>
<tr>
<td>19</td>
<td>RENTAL SERVICES (NON-FOOD)</td>
<td>79.0%</td>
</tr>
<tr>
<td>20</td>
<td>RENTAL SERVICES (EQUIPMENT)</td>
<td>91.4%</td>
</tr>
<tr>
<td>21</td>
<td>RESTAURANTS (ALL TYPES)</td>
<td>72.8%</td>
</tr>
<tr>
<td>22</td>
<td>SOFT DRINK BOTTLERS</td>
<td>96.5%</td>
</tr>
<tr>
<td>23</td>
<td>CONVENIENCE STORES</td>
<td>36.4%</td>
</tr>
<tr>
<td>24</td>
<td>PRODUCT/TIMARK FRANCHISES</td>
<td>82.9%</td>
</tr>
<tr>
<td>25</td>
<td>BUSINESS/TMARK FRANCHISES</td>
<td>79.9%</td>
</tr>
<tr>
<td>26</td>
<td>TOTAL</td>
<td>81.5%</td>
</tr>
</tbody>
</table>

Note: (*) Denote product/tradename franchise.
In 1990, 85.4 percent of product/trademark franchise establishments were franchisee-owned, compared to about 80.0 percent of business format franchises. There was relatively little change between 1975 and 1990 in the patterns of ownership in these two major areas of franchising. However, as shown in the exhibit there was considerable variation in patterns of franchisee-owned versus company-owned stores across sectors. The percentage of franchisee-owned units varied from over 40.2 percent in convenience stores, 44.7 percent for soft drink bottlers, 70.7 percent for restaurants and 71.4 percent for rental services, to above 95 percent for automobile and truck dealers (100.0 percent), construction, home improvement, and maintenance (97.8 percent), and laundry and dry cleaning (95.6 percent).

While there has not been an overall shift toward greater company-ownership in franchising, as shown in Exhibit 2-16, there has been a shift away from franchisee ownership (toward company-ownership) in the following franchising sectors over the past 15 years:

- soft drink bottlers (96.5 percent franchisee-owned units in 1975 to 44.7 percent franchisee-owned units in 1990);
- rental service equipment (91.4 to 71.5 percent);
- food/non-convenience stores retailing (95.4 to 86.2 percent);
- non-food retailing (79.0 to 74.0 percent); and
- recreation, entertainment & travel (98.2 to 94.6 percent company-owned units).

At the same time, there has been a shift away from company-ownership (and toward franchisee-ownership, which offers small business opportunity) in the following sectors:

- educational products (76.9 percent franchisee-owned units in 1975 to 91.4 percent franchisee-owned units in 1990);
- business aids and services (79.1 to 88.3 percent);
hotels, motels and campgrounds (82.3 to 88.6 percent); and

automobile/truck rental services (71.4 to 76.9 percent).

At the company-level, the decision to establish company-owned versus franchisee-owned units is related to several factors, including:

- history and management philosophy;
- the company's expansion strategy for raising capital and recruiting managers in varying locations;
- the need to have units to test product or operational innovations; and
- competitive conditions in different sectors.

The data on changes in ownership (i.e., conversion) between company-owned and franchisee-owned establishments shows a slight trend toward franchisee-ownership:

Since 1975, the trend toward conversion of company-owned units to franchisee-ownership has been stronger than buy-backs by the franchisors. In 1986, 1,726 company-owned units were converted to franchisee-ownership while only 827 units were repurchased by the company for various reasons, the least of which was the company's desire to operate these units permanently.14

As shown in Exhibit 2-17, in 1986, about twice as many units were converted to franchisee-ownership as were re-purchased for company-ownership. A recent survey of 265 franchisors controlling 40,000 franchise units also confirmed the trend away from company-owned units, noting that more franchisors are selling company-owned units to franchisees, indicating need for cash or realization that franchisees can manage the units more efficiently.15

According to franchising experts we interviewed, among those companies that operate both franchisee and company-owned stores, there is a tendency to establish and


15Boroian and LaVan, op. cit.
EXHIBIT 2.17: UNITS CONVERTED TO FRANCHISEE-OWNERSHIP VERSUS REPURCHASED FOR COMPANY OWNERSHIP, 1975-1986

<table>
<thead>
<tr>
<th>YEAR</th>
<th>CONVERTED TO FRANCHISEE-OWNERSHIP</th>
<th>REPURCHASED FOR COMPANY-OWNERSHIP</th>
<th>RATIO: CONVERSION TO REPURCHASE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>725</td>
<td>716</td>
<td>1.01</td>
</tr>
<tr>
<td>1976</td>
<td>956</td>
<td>546</td>
<td>1.75</td>
</tr>
<tr>
<td>1977</td>
<td>839</td>
<td>619</td>
<td>1.35</td>
</tr>
<tr>
<td>1978</td>
<td>718</td>
<td>612</td>
<td>1.17</td>
</tr>
<tr>
<td>1979</td>
<td>1,056</td>
<td>710</td>
<td>1.48</td>
</tr>
<tr>
<td>1980</td>
<td>1,012</td>
<td>808</td>
<td>1.25</td>
</tr>
<tr>
<td>1981</td>
<td>1,068</td>
<td>760</td>
<td>1.41</td>
</tr>
<tr>
<td>1982</td>
<td>1,057</td>
<td>707</td>
<td>1.49</td>
</tr>
<tr>
<td>1983</td>
<td>1,069</td>
<td>549</td>
<td>1.94</td>
</tr>
<tr>
<td>1984</td>
<td>953</td>
<td>577</td>
<td>1.65</td>
</tr>
<tr>
<td>1985</td>
<td>1,407</td>
<td>640</td>
<td>2.19</td>
</tr>
<tr>
<td>1986</td>
<td>1,726</td>
<td>827</td>
<td>2.09</td>
</tr>
</tbody>
</table>

retain company-owned units in more densely-populated, higher sales areas (i.e., urban/suburban locations). This general observation is supported by data in Exhibit 2-18, which shows company-owned units have substantially larger sales per unit than franchisee-owned stores in all sectors (and more employees per unit in most industries).

4. Conversions Appear to Be Growing in Importance within Franchising

Conversion franchises are offered to individuals in the same line of business as the franchise who adopt the franchisee's name and system. According to a recent survey of franchisors, the percentage of franchisors offering conversions was 41 percent in 1990. Conversion franchising was originally used extensively in real estate, but it has grown especially in fragmented sectors serving local markets without clear market leaders, such as construction, home repair and remodeling services, employment and other business services, and some non-food retailing. It has also grown in some sectors with high start-up or equipment costs, like restaurants. Conversions enable the franchisor to recruit franchisees who bring experience, facility and equipment, and customer base with them to the start-up of their franchise unit. Franchisees may benefit from their ability to draw upon the experience of the franchisor, a known and tested product or service, stronger marketing and advertising, more economical purchasing, and other assistance:

16According to some experts, companies tended to use franchises in less densely populated areas because it was difficult and costly to supervise managers in such areas. Because franchisees had their own money at stake, and more general knowledge about the local community, they provided more effective management without close supervision.

17Boroian and LaVan, op. cit., p. 11.

### EXHIBIT 2-18: AVERAGE COMPANY-OWNED AND FRANCHISEE-OWNED EMPLOYMENT AND SALES PER UNIT, 1988

<table>
<thead>
<tr>
<th>Franchise Sector</th>
<th>Employees Per Establishment</th>
<th>Sales Per Establishment (in Thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Company-Owned</td>
<td>Franchisee-Owned</td>
</tr>
<tr>
<td>AUTO PRODUCTS &amp; SERVICES</td>
<td>8.2</td>
<td>4.3</td>
</tr>
<tr>
<td>BUSINESS AIDS &amp; SERVICES</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>ACCOUNTING, CREDIT COLLECTION, ETC.</td>
<td>5.8</td>
<td>2.7</td>
</tr>
<tr>
<td>EMPLOYMENT SERVICES</td>
<td>63.3</td>
<td>42.2</td>
</tr>
<tr>
<td>PRINTING &amp; COPYING</td>
<td>5.6</td>
<td>4.1</td>
</tr>
<tr>
<td>TAX PREPARATION</td>
<td>11.8</td>
<td>7.9</td>
</tr>
<tr>
<td>REAL ESTATE</td>
<td>18.2</td>
<td>12.9</td>
</tr>
<tr>
<td>MISC. BUSINESS SERVICES</td>
<td>19.9</td>
<td>2.9</td>
</tr>
<tr>
<td>CONSTRUCTION, HOME IMPROVEMENT, CLEANING, ETC.</td>
<td>22.3</td>
<td>5.2</td>
</tr>
<tr>
<td>CONVENIENCE STORES</td>
<td>10.9</td>
<td>4.9</td>
</tr>
<tr>
<td>EDUCATIONAL PRODUCTS &amp; SERVICES</td>
<td>29.3</td>
<td>3.8</td>
</tr>
<tr>
<td>RESTAURANTS (ALL TYPES)</td>
<td>31.3</td>
<td>29.7</td>
</tr>
<tr>
<td>HOTELS, MOTELS, CAMPGROUNDS</td>
<td>125.2</td>
<td>59.1</td>
</tr>
<tr>
<td>LAUNDRY &amp; DRY CLEANING</td>
<td>7.3</td>
<td>3.8</td>
</tr>
<tr>
<td>RECREATION, ENTERTAINMENT, &amp; TRAVEL</td>
<td>7.4</td>
<td>3.6</td>
</tr>
<tr>
<td>RENTAL SERVICES (AUTO-TRUCK)</td>
<td>13.5</td>
<td>6.3</td>
</tr>
<tr>
<td>RENTAL SERVICES (EQUIPMENT)</td>
<td>5.7</td>
<td>4.8</td>
</tr>
<tr>
<td>RETAIL (NON-FOOD)</td>
<td>7.9</td>
<td>5.3</td>
</tr>
<tr>
<td>RETAIL (FOOD, NON-CONVENIENCE)</td>
<td>9.6</td>
<td>10.7</td>
</tr>
<tr>
<td>MISCELLANEOUS</td>
<td>12.2</td>
<td>6.9</td>
</tr>
<tr>
<td>*AUTO &amp; TRUCK DEALERS</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>*GAS SERVICE STATIONS</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>*SOFT DRINK BOTTLERS</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

Note: (*) Denote product/tradename franchise.
Facing stiff competition from chains and/or franchise systems, more small business owners will purchase a franchise, sacrificing some independence for a more powerful brand image and various forms of support. Many (but not all) franchisors seek such conversions because they require lower start-up costs, permit more rapid expansion, or eliminate a local competitor. This trend will continue and may accelerate.¹⁹

Two illustrations of franchisors we interviewed who used a conversion strategy for recruiting new franchisees follow:

Restaurant Franchisor. We make a strong effort to seek out franchisees who want to convert from another franchise system, either converting after the contract expires or selling and opening our franchise. This allows us to reduce the cost by remodeling an existing facility, not constructing a new one.

Employment Service Franchisor. We try to convert owner-operators of independent employment agencies. Startups in our field are difficult today because it is very competitive. We use telemarketing in specific markets to identify possible prospects. Our franchise is attractive to independents because the employment business is a negative cash flow business. Our backing for payrolls allows the franchisee to overcome a major limitation and to grow the business as much as possible without a big increase in his working capital.

5. Multiple Unit Franchising Appears to be Growing

Although multiple unit franchising and subfranchising are different mechanisms, they both are efforts by the franchisor to grow more rapidly and to economize on locating franchisees by recruiting more highly-qualified franchisees with the capacity to develop a territory. Multiple unit (or area development) franchises give the franchisee the right to open several franchises in a specific territory. According to a recent survey of franchisors, about 55 percent of franchisors offered multiple unit franchises in 1990.²⁰ A Gallup Organization survey of franchises found that 38 percent of franchisees surveyed owned


²⁰Boroian and LaVan, op. cit.
two or more franchises.\textsuperscript{21}

Multiple unit franchises benefit the franchisor because they reduce the cost of recruiting and training franchisees and attract more skilled and financially capable franchisees. Since the cost of recruiting and training a multiple unit franchisee is virtually the same as that for a single unit owner, the per unit cost of a multiple unit owner is lower. In industries with high investment requirements like restaurants, it is often easier for multiple unit owners to get financing in tight markets because they can more readily demonstrate their ability to operate profitably. There are also lower supervision costs on a per store basis for the franchisor:

The multi-unit franchise continues to gain popularity with the franchisor because it is easier and more efficient for a franchisor to deal with a franchise holder who has a major stake in the business.\textsuperscript{22}

The negative side of multiple unit franchises for franchisors is that a specific territory or market may become dependent on the performance of a single or perhaps several multiple unit owners, and that individual unit performance may increasingly be dependent upon store managers who have less of a stake in the profitability or quality of service delivery than an owner-operator.

Some franchisors permit subfranchisors to operate within certain territories. Such subfranchisors recruit franchisees, provide support and training, and generally manage franchisee operations within a designated territory. There is little in the way of reliable data on the extent to which subfranchising is practiced by franchisors. Like multiple unit franchises, subfranchises may benefit the franchisor because they reduce costs associated


with recruiting and training franchisees. However, they also may diminish the level of royalty payments to the franchisor and interpose another layer of management between the national franchisor and the franchisee.

E. TRENDS IN INTERNATIONAL FRANCHISING

A major development in franchising during the past two decades has been the expansion of American franchise companies into foreign markets. As shown in Exhibit 2-19, according to Franchising in the Economy, the number of U.S. business format franchisors with foreign operations increased from 222 in 1975 to 354 in 1986 (the last year for which data were available). The total number of foreign outlets increased by 188.5 percent over that same period, from 10,964 to 31,626 outlets. Franchising in the Economy also reported that an additional 228 franchisors indicated that they were considering extending their operations to foreign countries by 1990. This interest in expanding to additional foreign markets was expressed mostly by small- and medium-sized firms.23

As shown in Exhibit 2-19, U.S. companies that franchise abroad have particularly concentrated on Canada, Japan, Australia, the United Kingdom, and Continental Europe (particularly France, West Germany, the Netherlands, and Belgium). According to Franchising in the Economy, among the reasons that U.S. franchisors have been attracted to these countries are fewer government controls on investment (compared to developing...
EXHIBIT 2-19: INTERNATIONAL TRENDS IN BUSINESS FORMAT FRANCHISING

NUMBER OF U.S. COMPANIES AND FRANCHISE OUTLETS IN FOREIGN COUNTRIES, 1975-1986

<table>
<thead>
<tr>
<th>YEAR</th>
<th># OF U.S. COMPANIES</th>
<th># OF FOREIGN OUTLETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>222</td>
<td>10964</td>
</tr>
<tr>
<td>1976</td>
<td>234</td>
<td>12348</td>
</tr>
<tr>
<td>1977</td>
<td>244</td>
<td>14217</td>
</tr>
<tr>
<td>1978</td>
<td>266</td>
<td>17156</td>
</tr>
<tr>
<td>1979</td>
<td>275</td>
<td>19449</td>
</tr>
<tr>
<td>1980</td>
<td>279</td>
<td>20428</td>
</tr>
<tr>
<td>1981</td>
<td>288</td>
<td>21416</td>
</tr>
<tr>
<td>1982</td>
<td>295</td>
<td>23524</td>
</tr>
<tr>
<td>1983</td>
<td>305</td>
<td>25682</td>
</tr>
<tr>
<td>1984</td>
<td>328</td>
<td>27021</td>
</tr>
<tr>
<td>1985</td>
<td>342</td>
<td>30188</td>
</tr>
<tr>
<td>1986</td>
<td>354</td>
<td>31626</td>
</tr>
</tbody>
</table>

LOCATION AND NUMBER OF U.S. BUSINESS FORMAT FRANCHISE OUTLETS IN FOREIGN COUNTRIES, 1986

Country
- CANADA
- CARIBBEAN
- AUSTRALIA
- ASIA
- EUROPE (CONTINENT)
- UNITED KINGDOM
- JAPAN
- MIDDLE EAST
- MEXICO
- SOUTH AMERICA
- AFRICA
- CENTRAL AMERICA
- NEW ZEALAND


2-41
countries) and generally high levels of prosperity of their citizens. Some trends among countries with the largest number of U.S. franchises follow:

- **Canada** is the leading market for U.S. franchisors. As the nation's largest trading partner, Canada has been receptive to U.S. franchisors and has imposed few legal or regulatory restrictions on franchise operations. In 1986, 29 percent of all U.S. foreign outlets were located in Canada, down from a high of 46 percent in 1971. Canada has also developed a growing franchising sector of its own with some 1,200 Canadian and U.S. companies operating Canadian-based franchise operations with more than 60,000 outlets and annual sales of $67 billion.

- **Japan** continued to be the second largest market for U.S. franchisors (in 1986), with a total of 7,366 units, of which 72 percent represent various food categories such as restaurants, donut shops, ice cream stores, and convenience food stores. Entry into the Japanese market has reportedly been "difficult and costly, with negotiations often extending ten years or more."

- **Great Britain, Australia, and other British Commonwealth Countries** have also provided active and growing markets for U.S. franchises. Australia ranked third in 1986 (behind Canada and Japan) in the number of operating U.S. franchises (2,816), closely followed by Great Britain (2,415).

- **Continental Europe**, with its high standard of living, offers an increasingly attractive and important market for U.S. franchise operations. For example, franchising now accounts for 10 percent of retail sales in France and is increasingly popular elsewhere in Europe. American franchisors are seeking to structure subfranchise arrangements within Europe in anticipation of new barriers to non-European firms and products.

There are a number of ways for U.S. franchisors to enter foreign markets, including franchising directly to individuals, company-owned operations, joint ventures, or master

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franchisors. Many franchisors use more than one method in conducting foreign operations, but the most popular, least expensive, and fastest method is the master license. According the *Franchising in the Economy*, of the 354 franchisors that operated in foreign countries in 1986, 329 sold their units to franchisees -- either directly or through a master licensee who received the right to develop the franchisor's system in a specific country or region -- 42 operated joint ventures, and 39 had some company-owned outlets. 30

Among the problems sometimes confronted by franchisors trying to establish franchise operations in foreign countries are language difficulties, differences in customs, and sometimes unpredictable government decision-making. Franchisors must comply with the same local requirements as other businesses, and the franchise agreements must comply with local contract law, antitrust law, and trademark licensing laws. According to *Franchising in the Economy*, the success or failure of foreign ventures depends "in large measure upon the soundness of the franchisor's domestic market position and on whether or not the franchisor has the capability in terms of its own organization to provide the necessary expertise to others in another part of the world." 31

At the same time that U.S. firms have penetrated foreign markets, increasing numbers of foreign companies have sought out franchise opportunities in the U.S. Patterns of growth of foreign franchisors in the U.S. have closely paralleled U.S. franchise activities abroad, with Canadian, British, and Japanese firms accounting for the largest proportion of all foreign-sponsored franchises. 32

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F. CONCLUSIONS AND IMPLICATIONS

General growth in franchising in the U.S. since 1975 -- particularly within business format franchising -- is reflected in the following changes in sales, establishments, and employment:

- **Overall Sales.** Annual sales through franchises grew (in current dollars) by a total of $528.7 billion between 1975 and 1990, from $185.8 billion to $714.5 billion. This increase represented a 284.6 percent increase for sales over the 15-year period. When adjusted for inflation (in constant dollars), the increase in sales over the period was 58.5 percent. In relative terms, franchising sales increased from 28.2 percent of retail sales in 1975 to 34.0 percent of retail sales in 1990.

- **Sales by Sector.** While product/tradename franchises still account for about two-thirds of all franchise sales, one of the most significant trends in franchising since the 1970s has been the rapid emergence of business format franchising. In inflation-adjusted (constant) dollars, business format franchise sales increased by 115.5 percent between 1975 and 1990, compared to 42.4 percent for product/tradename franchising. Three sectors within franchising -- automobile/truck dealers (48.4 percent), gasoline service stations (18.0 percent) and restaurants (10.9 percent) accounted for over three-fourths (77.3 percent) of all franchising sales in 1990.

- **Overall Establishments.** Between 1975 and 1989, the number of franchising establishment units grew at a much slower pace (13.3 percent over the period) than general growth in establishment units within the U.S. (48.4 percent).

- **Establishments by Sector.** The slow growth in franchising establishments is explained by significant decreases in the number of product/trade name franchises. Between 1975 and 1990, while business format franchising experienced an 83.2 percent increase in establishment units, the number of product/tradename establishments contracted by 39.6 percent. Where product/tradename establishments represented 51.5 percent of all franchise establishments in 1975, by 1990 it accounted for only about a quarter (25.9 percent).

- **Overall Employment.** The total number employed by all companies involved in franchising in 1988 was about seven million persons, about double the number employed in 1975 (3.5 million). This increase was well above the percentage increase in the number of civilians employed within the labor force between 1975 and 1988 (33.9 percent).

- **Employment by Sector.** The following sectors accounted for the largest number of persons employed in franchising: restaurants, auto and truck
dealers, business aids and services, gasoline service stations, and hotels, motels, and campgrounds. Over 90 percent of the net increase in employment within franchising occurred within business format franchises -- employment in business format franchises grew by 161.5 percent between 1975 to 1988, compared to a 17.7 percent increase in employment within product/tradename franchises.

General growth and change in franchising is also reflected at the franchisor level and in the trends in international franchising:

- Between 1975 and 1988, the number of business format franchisors about doubled (100.8 percent increase)

- Large franchisors, those with more than 500 franchise establishments, dominate franchising. For example, just 5.8 percent of business format franchisors had more than 500 franchise units in 1986, but this group accounted for about two-thirds (65.0 percent of all franchise sales and of all establishments).

- There was relatively little change between 1975 and 1990 in the ratio of company-owned to franchisee-owned stores. Companies that franchise units had (on average) about 80 percent franchisee units and 20 percent company-owned units. There was some tendency to establish company-owned units in more densely-populated, higher sales areas.

- The number of conversion franchises and multiple unit franchises appears to have grown in recent years, as franchisors have developed alternative structures to allow them to expand.

- A major development in franchising during the past two decades has been the expansion of American franchise companies into foreign markets. The number of U.S. business format franchisors with foreign operations increased from 222 in 1975 to 354 in 1986. The total number of foreign outlets increased by 188.5 percent over that same period, from 10,964 to 31,626 outlets.

The statistical analysis of trends in franchising suggests the following conclusions for those interested in franchising sales within the small business community:

- The significant growth in inflation-adjusted rates, number of establishments, and employment make it clear that the most important activities in franchising are within business format franchisors' sectors.

- While important and growing, the nation's franchise systems are but one element of the nation's small business community. Franchising is, however, particularly important in retailing.
Franchising has made an important contribution to job growth which should not be overlooked.

While large franchisors are dominant in terms of franchising sales and establishments and the public’s perception of franchising, there are numerous small and medium size franchisors within the franchise sector.
The growth of franchising has occurred because it serves the mutual interest of entrepreneurial franchisors and franchisees. Through franchising, entrepreneurial businesses who have developed a successful business concept can raise capital to finance expansion and recruit talented and motivated owners/managers to operate new establishments. For the franchisee, franchising offers access to an established product or service and an opportunity to operate a small business.  

According to most franchising experts, franchisors, and franchisees, at the heart of franchising's growth in recent decades has been the relative advantages of franchising over other forms of business expansion. In the first part of this chapter, the internal dynamics of franchising are discussed -- that is, relative advantages of franchising from the perspective of franchisors and franchisees and how these advantages helped to fuel the expansion of franchising over the past two decades. The chapter then considers external factors -- broader economic, technological, economic, and social forces -- that may have contributed to the overall growth of franchising and shaped growth within specific sectors.

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1For typical discussions of the motives of franchisors and franchisees, see Greg Matusky and John Hayes, "Franchising's Great Transformations", Inc, April 1990; and numerous articles by Meg Whittemore in the "Franchising" section of Nation's Business.
A. REASONS FOR GROWTH IN FRANCHISING: FRANCHISOR PERSPECTIVE

For a company considering expansion, the franchise option is one of several alternative growth strategies available. Other options include:

- establishment of company-owned units, partnerships, dealerships, and distributorships;
- licensing of the right to use a tradename or product (without specification of a business format);
- recruitment of sales representatives;
- formation of cooperative associations of similar businesses;
- sale of consulting services to set up similar businesses before deciding to franchise;
- establishment of toll free telephone numbers and mail order operations; or
- acquisition of other companies as subsidiaries.²

From the perspective of the franchisor, the decision to franchise a specific product or service does not take place in a vacuum -- it is a strategic business decision with both advantages and disadvantages. Exhibit 3-1 provides an overview of the relative advantages and disadvantages of franchising versus other business expansion strategies.

In this section, we consider some of the key reasons that an increasing number of companies -- both large and small -- have looked to franchising as an expansion strategy. Our interviews with franchising experts and franchisors provide support for many of the reasons identified in the literature on franchising. Where possible, we have tried to include quotes from our interviews to illustrate reasons that franchising has been such an attractive alternative for companies.³

³Quotes from our interview with franchising experts, franchisors, and franchises have been indented and italicized.
### EXHIBIT 3-1: ADVANTAGES AND DISADVANTAGES OF VARIOUS BUSINESS EXPANSION STRATEGIES

<table>
<thead>
<tr>
<th>COMPANY OPTIONS</th>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchisee-owned stores</td>
<td>-May use franchisee’s capital to expand.</td>
<td>-May lose some control.</td>
</tr>
<tr>
<td></td>
<td>-May be able to recruit higher level or more motivated managers.</td>
<td>-May not teach franchisee to operate unit as well as franchisor.</td>
</tr>
<tr>
<td></td>
<td>-May permit more rapid expansion because of greater advertising and broader geographical presence.</td>
<td>-May be difficult to find qualified franchisee.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-May have lower profitability per unit because of franchisee’s share.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-Franchisee may pursue maximum profit as goal whereas franchisor wants maximum sales.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-May generate higher legal costs and lawsuits.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-May have unmanageable growth if franchisor is better at selling franchises than at support.</td>
</tr>
<tr>
<td>Company-owned stores</td>
<td>-Offers direct control.</td>
<td>-Rapid expansion may be limited by capital shortage, personnel availability.</td>
</tr>
<tr>
<td></td>
<td>-Able to change more quickly from top.</td>
<td>-Units may not be run as well because of lack of motivated managers.</td>
</tr>
<tr>
<td></td>
<td>-May have higher potential profit because there is no franchisee share.</td>
<td></td>
</tr>
<tr>
<td>Partnerships</td>
<td>-Defined legal entity with body of law.</td>
<td>-Limited control over partner.</td>
</tr>
<tr>
<td></td>
<td>-Able to recruit complementary partner with skills or capital.</td>
<td>-Possible liabilities, legal/tax regulations.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-Difficult geographical expansion.</td>
</tr>
<tr>
<td>Licensing of right to use name or product</td>
<td>-Allows expansion easily.</td>
<td>-Limited control in how licensee runs business.</td>
</tr>
<tr>
<td></td>
<td>-Low initial cost.</td>
<td></td>
</tr>
<tr>
<td>Sales Representatives</td>
<td>-Direct control over employees.</td>
<td>-May be expensive to train and maintain staff.</td>
</tr>
<tr>
<td></td>
<td>-Less expensive than company office.</td>
<td>-Continued motivation, supervision often difficult.</td>
</tr>
<tr>
<td>Cooperative Association of Similar Businesses</td>
<td>-May allow trade of information.</td>
<td>-May be difficult to form and maintain.</td>
</tr>
<tr>
<td></td>
<td>-Cheaper group purchase of items.</td>
<td>-Has limited function.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-Not designed to promote individual unit growth.</td>
</tr>
<tr>
<td>Mail order/800 Number</td>
<td>-Easy to set up.</td>
<td>-Not suitable for many products or services.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-Offers limited geographical presence.</td>
</tr>
</tbody>
</table>

Note: Table is based on some advantages and disadvantages cited in Boroian, *The Franchise Advantage*, but includes other comments.
1. Franchising Provides Effective Method for Raising Capital to Finance Expansion

One reason often cited in the literature and by franchisors for franchising popularity is that it is an effective method for raising capital to finance expansion:

Franchising enables intensive and rapid development of a regional or national distribution system with far less capital and management than would be required for company-owned facilities, while reserving a level of marketing control over the product or service. It is a particularly useful expansion method in a capital-intensive business. 4

Franchising enables the franchisor -- including small franchisors who may have difficulty in obtaining credit from traditional lending sources (e.g., financial institutions) -- to draw upon the financial capabilities of individual franchisees. For example, if a company was considering expansion from 25 to 50 outlets and it cost $200,000 to acquire, develop, and equip a new outlet, the company would need to raise a total of $5,000,000. As an alternative borrowing on capital markets, through franchising the franchisor shifts much of the start-up (and on-going) capital requirements (e.g., to finance facility, equipment, and labor force) to the franchisee. Hence, in effect, franchising enables the franchisor to secure capital to finance rapid expansion of outlets:

Franchising overcomes capital constraints to expansion because franchisors can use the fees, royalties, and borrowing ability of franchisees to expand more rapidly. 5

Recent research indicates that franchising may be particularly relevant for smaller,


less mature franchisors who may face difficulties in securing financing from traditional lending institutions. 6 While national capital markets may be readily accessible for mature, large, well-established franchisors (e.g., franchisors such as McDonald’s, who have an established product and a track record of success), smaller and less developed franchisors may find it more difficult and expensive to secure credit needed for expansion through these traditional markets. For example, lending institutions or outside investors may be reluctant to invest in new products or services where it is difficult to judge potential risk. It may also be difficult to secure credit in certain sectors, where there may be little in the way of collateral that can be used to secure loans (e.g., franchise outlets where facility and equipment may be minimal). Because franchisees are deeply involved as participants who control use of facilities and equipment, they may view the business risk differently and be more willing sources of capital.

Many of the franchisors we interviewed for this study confirmed that they developed their franchise systems in response to a need for capital to finance expansion. Two examples follow:

**Education Franchisor.** Our company evolved to franchising from a general idea, not a specific plan. Because of our success, we began to be contacted by people who wanted to establish a franchise in other states. We saw the alternatives as company stores or franchising. Franchising allowed us to expand without cash outlay.

**Restaurant Franchisor.** Historically, we’ve been more a restaurant company than a franchisor, although we have been involved in franchising for long a time. About two-thirds of our stores are company-owned and one-third are franchisee-owned.

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The franchisee-owned units are usually in more remote or smaller locations. Our emphasis now is more on franchising. This is partly because the company now has greater debt burden from a leveraged buyout.

2. Franchising Enables the Franchisor to Pool Resources to Advertise and Develop New Products

Advertising represents a major avenue for franchisors to create and reinforce a tangible, positive image to maintain and expand market share. Franchisors will typically use advertising to further consumer recognition of a tradename, trademark, or logo. As the number of franchise units in a system grow, the franchisor can use the pooled resources of the franchisees to expand advertising, thereby strengthening customer recognition of goods or services and fostering growth in sales. Pooled resources enable the franchisor to hire advertising professionals and to utilize sophisticated market research to better target and enhance the effectiveness of advertising. Pooled resources may also be used by franchisors to spread risks (and costs) of developing and testing new product lines.

3. Franchising Provides an Opportunity for the Franchisor to Recruit Talented and Motivated Managers

Our interviews with franchisors indicated that the ability to attract qualified and motivated persons to operate franchise units was a major factor for selecting franchising over company-owned stores as a method of expansion:

Temporary Employment Service Franchisor. A franchisee brings the stability and enthusiasm of owner-operators. This is important because the key factor in our business is the ability to cultivate referral sources through sustained high-quality contact over time. It is very difficult to supervise corporate personnel in the field, especially with turnover. This is not like a retail store where you can drive business into a store by a good location and enough advertising.

Restaurant Franchisor. We acquired another restaurant in a leveraged buyout in the
late 80's because it was complementary in positioning. While the other chain has mostly company-owned restaurants, we want to convert to about 80 percent franchisee-owned because franchisees have a vested interest and do a better job in running a store than a [company] manager.

Employment Services Franchisor. Our owner was previously in another company where he saw that franchisee-owned units produced more sales than company-owned units mainly because of greater sales effort on part of franchisees.

Within any business enterprise, a key (and limiting) resource is the entrepreneur’s time to determine and monitor the use of other key inputs (e.g., labor, capital, equipment, and raw materials) required for the production of the firm’s goods or services. As firms grow, the entrepreneur must spend increasing amounts of time monitoring functions. Supervisory staff may be hired for some oversight functions, but ultimately the entrepreneur must monitor even these supervisors:

All hired factors of production, including hired supervisors or managers, have an incentive to shirk. Therefore, as a firm grows, the entrepreneur must devote increased time to monitoring functions. Hired monitors can replace some of this function, but ultimately the entrepreneur must monitor the monitors. Firm growth and size are therefore constrained by entrepreneur’s monitoring time, an input that ultimately cannot be purchased in the market.7

One solution to the entrepreneur’s problem is a franchising arrangement which shifts substantial risk and responsibility onto the franchisee:

Franchising transfers direct responsibility to the franchisee for the day-to-day details and problems involved in conducting a small business, including staffing, acquiring and developing facilities, paying business taxes, and obtaining permits.8

The franchisee is at-risk not only for an explicit up-front franchisee fee and on-going royalties, but his/her income is dependent upon the success of the franchise unit.


8Alexrad and Rudnick, op. cit., p. 8.
Financial stake is viewed as a strong motivator for the franchisee:

An ownership interest and financial stake in the business usually instills in the franchisee an incentive to work harder and longer than a company-employed manager.\(^8\)

Hence, in comparison to expansion through company-owned units, franchisors can expand through franchising without a large management group to supervise daily operations, can effectively motivate individual managers, and can circumvent the so-called "entrepreneurial capacity" problem that limits firm size.

4. Franchising Provides the Franchisor Control and Consistency Over Goods and Services Produced Without Diminishing Incentives

Among the various options available for expansion, franchising is an arrangement which provides the franchisor with considerable control over the production process to ensure that goods and services meet standards of quality and consistency.

Although less control is possible than in a corporate system, a large amount is still present through the franchise contract that often is heavily skewed in the franchisor's favor... Fairly elaborate procedures and control systems along with training are used to control the way in which the product is 'delivered' to the customer and, in the case of services as the product for sale, the production process.\(^10\)

For example, franchisors typically provide a range of services to ensure that quality standards are maintained: initial and on-going training, operations manuals, regular quality control visits, certification of suppliers, and research and development of new products. According to Cross, et. al., certain attributes of franchising make it an effective method for controlling the production process, even within the service sector:

\(^8\)Axelrad and Rudnick, op. cit., p. 8.

Franchising makes services more tangible through a standardized approach with people, logos and brands. A problem in services is their intangibility which puts a premium on managing customer contacts and perceptions.

Operations are standardized and tightly controlled by the franchisor, which allows good handling of customer contact. Operations are an important part of what a customer buys and experiences in service businesses.

Training, systems, and standardized methods reduce experience deficiencies which evens out personal service quality and allows good service with small, dispersed operations.

Training, systems, and standardized methods also improve labor skill and productivity which controls labor costs.

Franchisors have operational methods to reduce variation in service and promotional appeals which condition customer expectations. Therefore, the customer is more confident about the purchase.\(^{11}\)

Despite these controls, as will be discussed in greater detail later in this chapter (Section B), the franchisee retains strong (profit-based) incentives to both market and efficiently produce the good or service.

5. **Franchising Provides Flexibility for Responding to Changing Consumer Needs and Emerging Markets Within a Wide Variety of Sectors**

Franchising has wide applicability because it is flexible and can be used in many industries and under a variety of conditions. As discussed in greater detail in Chapter 2, the expansion of business format franchising in recent years and the utilization of franchising in a wide variety of industrial sectors attests to the adaptability of franchising. The literature on franchising indicates that the publicized success of franchising and the growing group of professionals experienced in franchising has led to its utilization in new situations where other methods of marketing or distribution have traditionally been utilized:

A new trend is emerging that promises to radically redefine the way we think about

\(^{11}\)J. Cross, et. al., op. cit.
franchising. Franchising is now more than a marketing method. It is a business strategy that can transform the very fiber of a franchisor. Retailers are using franchises to become wholesalers. Manufacturers are cracking the retail market via franchising. Dealerships are turning to franchising to add control and consistency to their marketing networks...Franchising’s adaptability to changing consumer needs, coupled with its flexibility in identifying and capitalizing on new markets, allows businesses to leapfrog down their evolutionary paths.\textsuperscript{12}

Some analysts view franchising as an effective method for companies to adapt to fragmented markets created by rapidly changing consumer tastes and shifting demographic trends. Companies now need to frequently adjust their offerings to include more items, brand names, promotional campaigns, etc., so there is the right combination for local markets or even for one segment of the market. Because franchisees constantly interact with customers within local markets, they can be the source of valuable feedback for franchisors on introducing new products/services or improving existing ones:

Franchisees are more likely than a transient company manager to understand and satisfy local market needs and to communicate suggestions and marketing strategies to exploit local market conditions. Franchisees are frequently the source of new product and service ideas and operating techniques.\textsuperscript{13}

B. REASONS FOR GROWTH OF FRANCHISING: FRANCHISEE PERSPECTIVE

The growth of franchising over the past two decades could not have occurred without the strong appeal of franchising to franchisees who were willing and able to invest both their time and money in franchise units. Most experts agree that the growth of franchising was fostered by both the perceived advantages of franchises over independent businesses and the increasing numbers of persons who had the financial capability, personal background, and desire to acquire franchises. In addition, the growth was

\textsuperscript{12}Greg Matusky and John P. Hayes, \textit{Inc.}, April, 1990, p. 88.

\textsuperscript{13}Alexrad and Rudnick, op. cit., p. 10.
fostered by franchising's wide appeal to persons starting new businesses and its ability to continue to meet the needs of experienced business owners.

Below, we discuss some of the key advantages of franchising from the perspective of the franchisee and provide some illustrations of these advantages from our interviews and the literature on franchising.

1. Franchising Provides a Recognized Good or Service that Attracts Customers

Those entering franchising often emphasize their ability to immediately capitalize on a recognized good or service. Successful franchisors are able to create and reinforce a tangible and positive image by standardized use of trademarks, trade names, and logos. Recognition of a good or service may be further reinforced by uniform appearance, layout, color, materials, decor, fixtures, signs, clothing, typestyles, and/or packaging. For example, as many parents know, even a young child (who cannot yet read) very quickly comes to recognize the "Golden Arches" or "7/11" signs and associates these symbols with certain products or services. In our interviews with franchisors, frequent references were made to the importance of a product or service that is immediately recognizable to the consumer:

**Maintenance Franchisee.** The company doesn't do a lot for me now because I have been a franchisee for 12 years, but their trademark and advertising are very important aspects of the business. The company does national advertising and the trademark symbol is very recognizable and helps me stand out from the competition.

**Cleaning Service Franchisee.** Image gives an edge over competition that the customer is getting value for the money spent, which allows me to charge a little more for service and the system gives me a little better quality than competition. A franchise gives me a big opportunity for relatively small dollars.
2. Franchising Provides Relevant Training and On-going Technical Assistance

Training and on-going technical assistance are often mentioned as an important reason for franchisees choosing to franchise over establishment of an independent business. Most franchisors offer a formal training program for new franchisees that covers management and operations of franchise units. Franchisors also send field representatives to franchisee units to provide additional instruction, technical assistance, and to monitor performance. Training and on-going technical assistance is particularly important for inexperienced business owners or to business persons entering a new field.\(^{14}\) Comments from our interviews illustrate the importance of training within franchising:

**Restaurant Franchisor.** Training is the heart of the franchise business. Our idea is to take a person with restaurant experience and teach him our system in six weeks. It is difficult to train him to do a consistent product each time, but we must equip franchisees to handle the business. Adequate follow-up is where most companies lose it and fail to maintain systems as they planned with all the details. In the beginning when he is on his own, the franchisee is enthusiastic, but hasn’t established all the habits. The franchisor must follow-up regularly to maintain quality in the beginning until the system is established and maintained for a while. Later, retraining is needed for new personnel and to maintain quality control.

**Maintenance Franchisee.** Back at the beginning, the one-week training program was superb, one of the best I had in my life. It was very inclusive and spent time on how to run the business properly. It didn’t try to paint a rosy picture of big "bucks," but instead gave a realistic perspective that a lot of hard work was needed.

**Franchising Expert.** The individual can learn by trial-and-error or can learn from the experienced staff of a franchisor who have done same thing many times. This saves time and money.

\(^{14}\)Chapter 6 provides much greater detail on the types of training and technical services provided by franchisors.
3. Franchising Provides a Tested System, Which Reduces Risk of Small Business Start-up and Enhances Likelihood of Long-Term Survival

The literature on franchising, as well as our interviews with experts and franchisees, stress that franchising enables the franchisee to invest in a business enterprise that has already been tested. For this reason, franchises are often viewed as less difficult and risky than starting a business "from the ground up:"

The biggest positive factor for the purchase of a franchise is the extensive assistance provided by the franchisor. Compared to opening an independent outlet, the comprehensive set of (supposedly) proven business aids comprising the franchising package can reduce the risk of going into business.15

Instead of developing a business concept and testing procedures for implementing that concept through trial-and-error, franchisees begin with operational procedures and systems that have already been fully-tested in other localities and been proven to be effective (and profitable):

Franchising Expert. It is difficult for any business, but especially new businesses, to know what a particular marketing effort will be worth in sales. The franchisor's marketing experience and assistance allows the franchisee to use the effective stuff right away and avoid the ineffective techniques. For example, the franchisor will be able to tell the franchisee if the big cost difference between a line in the yellow pages versus a three inch ad is worth it.

Many of the franchisees we interviewed mentioned the importance of a proven system as an inducement to becoming a franchisee (compared to an independent business):

Restaurant Franchisee. Restaurants have a million little things and they are all important and must be done properly. The reason for my success is that I can take what other people have done successfully and apply it in another situation. I tried to do exactly what the manual said and not be "smarter." Some guys fail when they stray too far from the tried and tested methods.

Construction Franchisee. The existing businesses I saw had gads of problems and none had the market possibilities I saw in this franchise. It had a recognizable niche market which could be profitable for a long time and it was a business that used my sales and other skills.

15J. Cross, et. al., op. cit., p. 3.
Franchisees emphasize that the franchisor's existing business structure and detailed start-up plans offered them a way to rapidly start-up, minimize mistakes, and ultimately save money. As discussed in greater detail in Chapter 6 (Assistance to Franchisees), franchisors typically play a particularly important role at the time of start-up. Among the types of assistance provided are the following: initial site selection assistance, training programs for franchise owners and managers, "grand opening" technical assistance, and a variety of other types of technical support. The existence of a proven system and technical support can make the critical difference between success and failure of a small business. Some comments from our interviews illustrate the ways in which franchising reduces start-up institutions and costs:

**Construction Franchisee.** Starting a franchise was easier than starting a business because there was a method to follow in the operation. The most valuable thing for me was the format or outline of how the business was established and run. The outline could be applied by someone not in that business previously so that a person could start with some personal strengths or experience, apply oneself to the system and make it work. The operations manual was key because it covered the whole system and helped to compensate for areas of personal weakness.

**Maintenance Franchisee.** I had gone through the trials of setting up a business and saw the advantage of franchises. I had the experience of reinventing the wheel and wasting money, so I believed that dollars spent up-front for the franchisor's experience were well spent. The result was that I saved money in setup.

The advantages of franchises are believed to translate into improved prospects of long-term success and continuation. Among many franchisors and franchisees -- as well as a considerable amount of franchising literature -- there is a general perception that franchising lowers the risk of business failure because the franchisee is buying a "proven" system (with a recognizable product or service) and because the franchisee receives ongoing training and assistance. For example, lower risk was frequently cited in our interview with franchisees:

**Cleaning Service Franchisee.** I wanted to use others' personal experiences to make
fewer mistakes and save money. I did research about going into business, read all the publications I could find, and was impressed by the low failure rate of franchising compared to independent business. It’s not just statistics. I talked to a lot of friends and acquaintances, too.

**Construction Franchisee.** I like having the structure of franchising and the rules to work within. I like having the opportunity to network with others in the same business who have experience in similar problems. I like the lower failure rate because of the tested system.

**Temporary Personnel Franchisee.** I had a strong desire to own my own business and have the ability to make more money. I looked at various money-makers over time and I liked the success of franchises generally versus independent businesses. I thought of franchising as having a safety net.

Despite this perception some franchising experts argue that there are simply no valid or reliable data to substantiate claims of lower risk of failure for franchises:

One of the questions I am most frequently asked is "What is the failure rate of small, independent businesses compared to franchisee owned units?" You may have heard some figures, but really there is no good answer to this question. There just is not any data in the federal government’s statistical system which would tell us. Firms continually go in and out of business for many reasons. Failure is only one of them.16

Possibly, the best historical data available -- which deals only with business continuation, not business failure -- shows a relatively high probability of business continuity within franchising. Based on data collected as part of the annual survey of franchisors for Franchising in the Economy, annual discontinuation rates of franchise-owned businesses were low -- 3.2 percent in 1986 for franchisee-owned units. However, it is important to note that businesses may be discontinued for a variety of reasons, including retirement, personal reasons, low profitability, or business failure.17 While there are no comparable data on continuation rates for independent (non-franchised)

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17Franchising in the Economy, op. cit., various years.
establishments, the SBA's Office of Advocacy found in its analysis of changes in the number of U.S. businesses with employees that 14.9 percent of businesses terminated in 1989.\textsuperscript{18}

A recent analysis of the disclosure documents of 584 of the nation's larger franchisors (covering an estimated 212,000 franchise units) indicated that about 4.4 percent of franchisees leave franchise systems annually. Reasons for leaving a system include retirement, passing the franchise on to a relative, health reasons, and repurchase of the franchise by the franchisor.\textsuperscript{19}

A recent study of failure rates on SBA loans in two industries where franchising is common led SBA to conclude that franchisees are less likely to fail than independent businesses:

Participating in a franchise system does increase a firm's likelihood of survival... In two industries where franchising is common, grocery stores (SIC 5411) and eating places (SIC 5812), a comparison of the failure rates on SBA loans unambiguously demonstrates that firms that are franchises perform better than those that are not.\textsuperscript{20}

SBA cited a variety of factors that may explain enhanced survival among franchisees, particularly franchisor assistance in such areas as: location analysis, lease negotiations, store design and equipment purchasing, employee and management training, advertising and merchandising, implementation of standardized accounting and financial management procedures, centralized purchasing, and financial assistance. According to SBA:

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\textsuperscript{18}U.S. Small Business Administration, \textit{The State of Small Business: A Report of the President}, 1990, p. 16. Terminations represent firms that either reported being out of business or reported no employment for two years.


Each new franchisee is the beneficiary of the collective business experience of all previous and current franchisees.  

4. Franchises Are Often Viewed As Better Investments, Which May Be More Easily Expanded or Sold Than Independent Businesses

As a result of the various factors discussed above -- e.g., a proven business system, training and support provided by the franchisor, and the lower perceived risk of failure -- franchises are often viewed by franchisees as better overall investments.

Because a franchise system has an already established brand name product or service, franchise units are often viewed as more saleable than independent businesses:

Restaurant Franchisee. I wouldn’t want to be an independent unless I was a larger restaurant because franchises have so many advantages over independents: marketing muscle, purchasing muscle, and special advantages with vendors, product development, a research and development umbrella, information which helps keep up with national regulations, more efficient design, labor cost controls, better image in hiring employees, and a more saleable entity if you want to sell.

Once within a franchise system, depending upon whether the franchisor permits multiple unit franchises, a franchisee may have a greater opportunity for expansion than would be possible within an independent business. Franchisees often find -- particularly within franchise sectors such as fast food restaurants -- that once they have mastered the operation of one franchise unit that they can easily expand to other nearby territories because of their already established relationship with the franchisor. In addition, well-documented and standardized operational procedures within one unit are often easily applied to other locations. Our interviews with franchisees included a number of multi-unit operators, who discussed the natural progression from ownership of one franchise unit to additional units:

21E. Starr, op. cit., p. 23. However, it is important to note that SBA conclusions are based on analyses of failure rates on SBA loans within two industries and not across all sectors.
Maintenance Franchisee [3 Units]. I bought the first territory and my husband and I ran it part-time. It didn’t grow as much as we hoped, but we bought a second nearby territory when the owner had a heart attack because it was a very attractive opportunity. Then we bought a territory in between the two so that we could expand.

Restaurant Franchisee [25 Units]. I began as a franchisee in Kentucky, then expanded to Georgia. I wanted to expand more, so I sold my units back to the company and bought units in California where I could have a major market.

Restaurant Franchisee [50 units]. I initially bought the franchise because I liked the food and thought it would do well in my home town. When it did well, I bought other units about every one to two years. After about the fourth one, I sold my other business to concentrate on managing the fast food operations. I found that acquiring several units at the same time to cover a major market was a better approach to expansion because I could supervise them better and advertise more effectively.

C. ECONOMIC, DEMOGRAPHIC, AND APPLIED TECHNOLOGICAL FACTORS AFFECTING RECENT FRANCHISING TRENDS IN THE U.S.

While the internal dynamics of franchising were important to its growth over the past two decades, a variety of economic, demographic, and technological factors have been cited as affecting franchising trends. Below, leading factors that shaped the changes in franchising over the past two decades are highlighted.

1. Economic Factors

A number of economic factors played an important role in shaping not only the overall growth of franchising, but influencing growth and contraction of certain franchising sectors. The most important of these factors are discussed below.

a. General Economic Growth and Cycles Has Substantially Affected Extent of Franchising Growth

As might be expected, general growth (and contraction) in the economy affects growth in franchising sales, establishments, and employment. For example, between
1975 and 1989, the U.S. Gross National Product (GNP) grew by 52.7 percent in constant (inflation-adjusted) dollars.\textsuperscript{22} During this same period, franchising sales in inflation-adjusted dollars expanded by 58.4 percent. The number of franchise units also increased (by 13.3 percent between 1975 and 1989), as did employment within franchising (doubling between 1975 and 1988).

The expansion and contraction of franchising sales seemed to closely follow general trends in the U.S. economy. As shown earlier in Exhibit 2-1 (see Chapter 2), franchising sales declined in inflation-adjusted dollars between 1979 and 1982 as the economy went through a prolonged recessionary period. For example, franchising sales decreased (in inflation-adjusted dollars) by 2.8 percent between 1981 and 1982, at the same time that the nation’s GNP decreased 2.5 percent (in inflation-adjusted dollars).\textsuperscript{23} However, as the U.S. economy recovered during the mid-1980s, franchising sales grew rapidly. For example, franchising sales grew by 11.5 percent in inflation-adjusted dollars between 1983-84, when GNP annual growth reached its high during the decade of 6.8 percent. Levels of sales within franchising began to moderate again (in inflation-adjusted terms) near the end of the 1980s as overall economic growth began to slow again (e.g., franchising sales decreased by 0.2 percent in 1988-89, as GNP growth slowed to 2.5 percent in inflation-adjusted dollars).

b. Franchising Has Been Supported by the Downsizing of Major Corporations

According to the literature on franchising and our interviews with franchisors and

\textsuperscript{22}U.S. Bureau of Economic Analysis, The National Income and Product Accounts of the United States, 1929-82.

franchise experts, downsizing of corporations in the 1980s (and into the 1990s) has led to an increased availability of well-trained corporate executives to both start-up franchising systems and to operate franchise units. Layoffs, limited prospects for promotion and offers of early retirement increased the number of former corporate executives looking for new career opportunities in the 1980s. Former corporate executives have proven to be fertile recruiting grounds for franchisors because they often have:

- the necessary financial resources (e.g., personal savings or golden parachutes);
- experience in development and management of businesses; and
- strong interest in owning and operating their own businesses.

c. Consolidation of Gasoline Service Stations Resulted in an Overall Decline in Product/Tradename Franchising

As a result of the Arab oil embargo of 1973 and resulting shortages in gasoline supplies, an estimated 32,000 franchised gasoline service stations closed between 1973 and 1976. After 1976, the closing of gasoline service stations continued due to restructuring and consolidation within the industry, including (a) consolidation of petroleum companies (leading to disappearance of some brands), (b) emergence of larger, self-service gasoline stations, (c) changes in the marketing techniques of gasoline retailers, and (d) increasing complexity of automobile servicing. By the end of the decade, a total of 51,000 gasoline service stations had closed. During the 1970s, gasoline service stations decreased from about 55 percent to 36 percent of all franchises. This decline in gasoline service stations had a direct and substantial affect on the decline of product/tradename franchising.
2. Demographic Factors

A variety of factors encouraged increasing numbers of persons who had the financial capability, personal background, and desire to acquire franchises. Demographic trends also seemed to create generally strong demand for new products and services which could be provided through franchise outlets. Some of the most important demographic factors affecting franchising during the 1970s and 1980s are discussed below.

a. Franchising Has Been Supported by an Increase in Workers in the Prime of Their Business Careers Due to the "Baby Boom"

Throughout the 1970s and 1980s there was a surge of persons born following World War II, (i.e., "baby boomers") who were beginning to enter their prime earning years. For example, the percentage of the U.S. resident population between the age of 30 and 49 years of age increased from 23 percent to 29 percent between 1970 and 1989. A growing number of these baby boomers -- with financial capability, business backgrounds, and a desire to own their own business -- decided to enter franchising. According to one study, over 60 percent of franchise buyers were between 36 and 45 years of age.24 The baby boom also meant a growing and increasingly diverse base of consumers to purchase products and services.

b. A Highly-Mobile U.S. Population Has Embraced Franchising

U.S. Census data (for 1987-88) indicated that 17.6 percent of the U.S. population moved to a different house in the U.S., with 6.4 percent moving to a different county and 2.7 percent moving to a different state.25 Franchising's ability to offer recognizable

brand names -- reinforced through national advertising campaigns and other means -- has strong appeal to a highly mobile population:

When one travels or moves, new services will be sought (e.g., gas station, dry cleaner, bank). Multi-unit franchise systems make it possible for the consumer to merely patronize a different location of the same system they previously utilized.\(^{26}\)

For example, a family or individual moving from one region of the country to another region can often easily identify the types of products available through a franchising chain and be generally confident of a certain level of quality and cost of items purchased within a franchise unit. A recent report by the SBA cited greater geographic mobility as a factor behind the success of regional and national chains and systems of franchises:

Greater geographical mobility of Americans, for both recreational and relocational purposes, helps retail outlets that have familiar names. Providing uniform levels of product/service quality and standardized prices in familiar surroundings eliminates a measure of uncertainty from the shopper's decision-making. The success of regional and national chains and systems of franchises is predicated on lowering customer risk regardless of where purchases are made.\(^{27}\)

c. Growing Affluence and Education Has Boosted Consumer Demand for New Franchised Products and Services

Between 1970 and 1989, the percentage of the U.S. population (age 25 or older) completing four or more years of college increased from 10.7 percent to 21.1 percent.\(^{28}\) During this same time span, median income in constant 1989 dollars (i.e., inflation-adjusted) for all families increased from $31,534 to $34,213. In addition, between 1970 and 1989, the percentage of families with income $50,000 or more (in constant 1989

\(^{26}\) J. Cross, et. al., op. cit., p. 10.

\(^{27}\) E. Starr, op. cit., p. 13.

dollars) increased from 19.6 percent to 29.0 percent. Growing affluence and educational levels of the American public during the 1970s and 1980s boosted retail sales and seemed to spur consumer interest in specialized niche products and services. Franchise systems have been able to adapt well to changing consumer demands over the past two decades because of their ability to pool product research and marketing costs across franchise outlets and gain feedback from franchisees spread across the country serving diverse markets.

d. Increases in Working Women Has Provided a Source of New Franchisors and Franchisees and Stimulated New Consumer Needs

The civilian labor force participation rate of women in the U.S. increased from 42.6 percent in 1970 to 57.2 percent in 1989. Overall, the number of women within the civilian labor force increased from 27.5 million in 1970 to 47.4 million in 1989. This rapid expansion in the number of working women increased the supply of women available to start up new franchise systems and new franchise units. It also created increased demand for existing and new products/services that could meet the needs of increasing numbers of working women and two-wage earner families (e.g., day care services, educational products, home cleaning services, and fast-food and home-delivery food services).

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31More detail about the role of women in franchising can be found in Chapter 5, Characteristics of Franchisees.
3. Technological Factors

A variety of technological changes during the past two decades has spurred the expansion of franchising in the U.S. and supported the development of new products and services. Several of the key developments are discussed below.

a. Changes in the Technology of Retailing Have Been Conducive to the Expansion of Franchising

Changes in the technology of retailing have contributed to franchising success. According to a recent draft report by the SBA, the decline of small business in retailing is linked (in part) to the diffusion of new technologies:

Changes in the technology of retailing have favored larger retail establishments and larger agglomerations of multi-establishment firms. A revolution in retailing has been driven by the diffusion of applications of electronic data processing and materials handling technologies.\(^{32}\)

The diffusion of new electronic processing and materials and handling technologies has created economies of scale in managing larger, multi-unit retailing operations. For example, Universal Product Codes (UPC), which provides every item with a unique identifier, has made it possible to closely document product movement and sales:

The UPC makes possible point-of-sale documentation of product movements, and has led to greater economies of scale in the management of retail operations. In addition to speeding up the check-out process, electronically-scanned purchase information is used to automatically monitor inventories, generate purchase orders, match purchase orders against invoices for auditing and security purposes, and quickly track consumer trends.\(^{33}\)

Electronic systems such as the UPC have high initial capital costs which fall rapidly as they are spread over more establishment units and customers -- as is the case in larger franchise systems. In comparison to small independent businesses, it is also often easier

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\(^{33}\)E. Starr, op. cit., p. 15.
for franchisees to adapt to technological advances because franchises are part of a larger network. Technological changes can be fully tested out in several locations (as part of Research and Development) before being disseminated to all franchising units.

b. **Emerging New Technologies Have Created New Opportunities and Niche Markets for Franchising**

With the ability to spread research and development costs across franchise units, franchising has reached into new markets and developed new services and product offerings that were not possible even a decade ago. For example, the rapid diffusion of facsimile machines and computer modems have been instrumental in the development of employment service agencies within franchising. Franchising has been able to adapt rapidly to both emerging technologies and the new consumer preferences they have spawned:

Who would have thought that video yearbooks, housesitting services, environmentally safe cosmetics, home inspections, and house calls by physicians would be sold through franchises, as they all are now?34

c. **Expanding Television Viewership Has Enabled Franchisors to Effectively Market Goods and Services to National Audiences**

During the 1970s and 1980s, there was a continued growth in the number and percentage of households with television sets. For example, the number of households with television sets increased from 59 million in 1970 to 92 million in 1990, while the percentage of households with television sets increased from 95.3 percent to 98.2 percent for the same time period.35 However, perhaps the most important change during this period was in the area of cable television viewership. The number of households with


3-25
cable television grew by more than tenfold, from 4 million in 1970 to 52 million in 1990. The percentage of homes with cable television climbed from 6.7 percent in 1970 to 56.4 percent in 1990.\(^{38}\)

The rapid dissemination of cable television was important because many more television stations became available to the American public -- and with these stations came much greater levels of expenditures on advertising and better ability to target advertising on specific consumer groups. For example, estimated expenditures on advertising increased from $3.6 billion in 1970 to $26.9 billion in 1990.\(^{37}\) Franchisors -- especially large national chains -- seemed to be well-positioned to take advantage of increased levels of national television viewership and expanding numbers of stations. Franchisors could easily reach out to national audiences through network and cable television advertisements to promote their brand name products and services. As discussed in Chapter 6, certain uniform features of franchises make them particularly suitable to national advertisement, such as standardization of a franchise system’s appearance, layout, color, materials, decor, fixtures, and signs. Further, the costs of mounting such advertising campaigns could be spread across franchise establishments through advertising royalties.

D. CONCLUSIONS AND IMPLICATIONS

Franchising is one of several alternative growth strategies for companies considering expansion. Among the key reasons for franchising (over other forms of business expansions) from the perspective of the franchisor are the following:


\(^{37}\)McCann-Erickson, Inc., New York, N.Y. Compiled for Crain Communications, Inc., in *Advertising Age.*
Franchising provides an effective method for raising capital to finance expansion. Franchising may be particularly advantageous for the smaller, less mature franchisor who lacks ready access to traditional capital markets.

Franchising enables the franchisor to use the pooled resources of franchisees to advertise, thereby strengthening customer recognition and fostering a rapid growth in sales.

Franchising provides an opportunity for the franchisor to recruit talented and motivated managers, and to expand without a large management group. Franchising transfers substantial risk and responsibility to the franchisee whose income is dependent on the success of the franchise unit.

Franchising provides the franchisor control and consistency over goods and services produced. Franchising's emphasis on standardized operations and methods is particularly applicable for managing service sector operations.

The growth of franchising over the past two decades could not have occurred without the strong appeal of franchising to franchisees who were willing and able to invest both their time and resources in franchise units. Among the key reasons that individuals and small businesses are attracted to franchising are the following:

- Franchising provides a recognized good or service that attracts customers. In contrast to an independent small business, franchising offers the new franchisee a way to begin his/her business with a product or service which is well-known to potential customers.

- Franchising provides relevant training and on-going technical assistance. Training and assistance is particularly important for inexperienced business owners or persons entering a new business field.

- Franchising provides a tested system, which reduces risk of small business failure. The franchisee's business concept and procedures are typically fully-tested and proven in other locations, which enables the franchisee to avoid mistakes during start-up.

In addition to these internal factors, a host of external economic, technological, and demographic factors influenced overall growth of franchising and shaped trends within individual sectors of franchising. Among the key external factors were the following:

- **Economic Factors:** General economic conditions (e.g., recession and growth) substantially influenced franchising's rate of growth over the period 1975 through 1990. In addition, corporate downsizing increased the
availability of well-trained corporate executives. Consolidation and market changes within the gasoline market led to the closure of many service stations, which in turn, led to a substantial decline in the number of product/tradename establishments.

- **Demographic Factors:** The "baby boom," resulting in an increase of persons in their prime working years, provided a steady source of persons interested in purchasing and operating franchise units between 1975 and 1990. Other demographic factors that may have contributed to franchising's growth were:

  -- The recognizable products/services sold by franchises -- along with the ability of franchises to advertise nationally -- seemed to have strong appeal to the highly mobile U.S. consumer.

  -- The growing affluence and education of the American consumer seemed to boost demand for niche products to serve different lifestyles.

  -- Increases in the number of working women both created markets for new products and increased the number of potential new business owners.

- **Technological Factors:** Changes in the technology of retailing and the emergence of new products/services that were well-suited to franchising seemed to foster the expansion of franchising, particularly within business format franchising.

Hence, a variety of factors fueled and shaped the growth of franchising over the past two decades. Many of these same factors -- particularly general economic growth -- are likely to continue to shape growth in the future.
CHAPTER 4:  
FRANCHISEE INVESTMENT AND COSTS

Investment and operating costs of franchising play an important role in determining the types of individuals who enter the field of franchising and the particular sector that they choose to enter. Costs also are important determinants of the relative success of a particular franchisee and levels of profitability. There is some concern within the small business community that the growing start-up costs and total investment requirements in certain franchising sectors may be pricing franchise units out of the reach of many individuals or small businesses who in the past may have been able to gain entry. There is also some concern about the level of some fees paid by franchisees to franchisors, such as franchise fees, royalties, advertising fees, and required purchases from the franchisor. This chapter examines investment levels and specific types of payments made by franchisees to franchisors.

A. FRANCHISEE INVESTMENT

One way of examining the costs of franchising is to analyze the investment that is necessary to start-up and maintain a franchise unit. When assessing a franchisee, a franchisor will closely examine the financial resources of the potential franchisee in terms of:

- **initial cash investment**, which essentially means that the franchisee will be required to make a cash investment of a specified amount at the time the franchise is opened; and

- **total investment**, which estimates the likely total investment, including cash and debt, that the franchisee can expect to devote to the operation of the franchise.
Data available from Franchising in the Economy shows the substantial variation in estimated start-up costs and average total investment across sectors. As can be seen in Exhibit 4-1, median start-up costs for most sectors were in the range of $25,000 to $50,000. However, while most sector's initial start-up costs were in this range, there was considerable variation between the sectors, ranging from tax preparation ($4,000) to hotels, motels, and campgrounds ($425,000). Within sectors there was also a considerable range of initial investment required -- for example, lower quartile start-up costs for convenience food stores were $28,750 versus costs of $92,500 for the upper quartile.

A recent study of 265 franchisors by Boroian and LaVan found that the median total investment was $98,000 and the mean total investment of $148,848, with a high of $4.2 million.¹ A sizeable portion of the franchisee's investment is needed to cover start-up costs. About 40 percent of the franchisors required the franchisees to have more than half of the required capital investment in cash or in liquid assets.² A Gallup Survey of 994 franchisees in November and December 1991, found that on average franchisees reported investing $147,570 (see Exhibit 4-2), which is very close to the amount reported in the Boroian/LaVan survey.

Exhibit 4-3, shows that the average total investment for franchise units varied substantially not only across sectors, but within sectors. The median total investment was less than $150,000 for all sectors except hotels, motels, and campgrounds ($1,350,000), restaurants ($250,000), and convenience stores ($180,000). But there...

¹ P. Boroian and H. LaVan, op. cit., Table 9, p. 12.

²Herbert J. Rust, Owning Your Own Business, 1991, discussing a survey of typical costs and terms of International Franchise Association franchisors (pp.13-15).
## EXHIBIT 4-1: START-UP COSTS FOR FRANCHISEE-OWNED UNITS, 1988

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>LOWER QUARTILE</th>
<th>MEDIAN</th>
<th>UPPER QUARTILE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Products &amp; Services</td>
<td>$25,000</td>
<td>$40,000</td>
<td>$73,750</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>15,000</td>
<td>25,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Accounting, Credit Collection</td>
<td>11,250</td>
<td>20,000</td>
<td>24,750</td>
</tr>
<tr>
<td>Employment Services</td>
<td>22,750</td>
<td>28,500</td>
<td>50,000</td>
</tr>
<tr>
<td>Printing &amp; Copying</td>
<td>30,000</td>
<td>47,500</td>
<td>73,000</td>
</tr>
<tr>
<td>Tax Preparation</td>
<td>N/A</td>
<td>4,000</td>
<td>N/A</td>
</tr>
<tr>
<td>Real Estate</td>
<td>9,000</td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Misc. Business Services</td>
<td>15,000</td>
<td>25,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Construction, Home Improvement, Cleaning, &amp; Maintenance</td>
<td>15,000</td>
<td>25,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>28,750</td>
<td>46,500</td>
<td>92,500</td>
</tr>
<tr>
<td>Educational Products &amp; Services</td>
<td>15,000</td>
<td>25,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>50,000</td>
<td>80,000</td>
<td>125,000</td>
</tr>
<tr>
<td>Hotels, Motels, Campgrounds</td>
<td>200,000</td>
<td>425,000</td>
<td>575,000</td>
</tr>
<tr>
<td>Laundry &amp; Drycleaning</td>
<td>20,000</td>
<td>50,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Recreation, Entertainment, &amp; Travel</td>
<td>30,000</td>
<td>49,500</td>
<td>57,500</td>
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<tr>
<td>Rental Services (Auto-Truck)</td>
<td>25,000</td>
<td>30,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Rental Serv (Equipment)</td>
<td>30,000</td>
<td>40,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Retail (Non-food)</td>
<td>40,000</td>
<td>50,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Retail (Food, Non-convenience)</td>
<td>40,000</td>
<td>50,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>N/A</td>
<td>30,000</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Note: N/A indicates no data in cell. Tax Preparation and Miscellaneous sector data were not available for 1988; data are for 1986. Data was not available for product and trademark franchises.

EXHIBIT 4-2: ESTIMATED TOTAL INVESTMENT COST

Total Estimated Investment

<table>
<thead>
<tr>
<th>Total Estimated Investment</th>
<th>Percent of Franchisees</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000 or less</td>
<td>10%</td>
</tr>
<tr>
<td>$10,001-20,000</td>
<td>10%</td>
</tr>
<tr>
<td>$20,001-30,000</td>
<td>9%</td>
</tr>
<tr>
<td>$30,001-40,000</td>
<td>7%</td>
</tr>
<tr>
<td>$40,001-50,000</td>
<td>9%</td>
</tr>
<tr>
<td>$50,001-60,000</td>
<td>3%</td>
</tr>
<tr>
<td>$60,001-70,000</td>
<td>2%</td>
</tr>
<tr>
<td>$70,001-80,000</td>
<td>2%</td>
</tr>
<tr>
<td>$80,001-90,000</td>
<td>2%</td>
</tr>
<tr>
<td>$90,001-100,000</td>
<td>8%</td>
</tr>
<tr>
<td>$100,001-200,000</td>
<td>8%</td>
</tr>
<tr>
<td>$200,001-300,000</td>
<td>6%</td>
</tr>
<tr>
<td>$300,001-400,000</td>
<td>4%</td>
</tr>
<tr>
<td>$400,001-500,000</td>
<td>2%</td>
</tr>
<tr>
<td>$500,001 or more</td>
<td>7%</td>
</tr>
</tbody>
</table>

Percent of Franchisees by Total Estimated Investment Cost

<table>
<thead>
<tr>
<th>Total Estimated Investment</th>
<th>Percent of Franchisees</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000 or less</td>
<td>10%</td>
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<tr>
<td>$10,001-50,000</td>
<td>5%</td>
</tr>
<tr>
<td>$50,001-100,000</td>
<td>20%</td>
</tr>
<tr>
<td>$100,001-300,000</td>
<td>35%</td>
</tr>
<tr>
<td>$300,001 or more</td>
<td>40%</td>
</tr>
</tbody>
</table>

### EXHIBIT 4-3: AVERAGE TOTAL INVESTMENT, 1988

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>LOWER QUARTILE</th>
<th>MEDIAN</th>
<th>UPPER QUARTILE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Products &amp; Services</td>
<td>$75,000</td>
<td>$100,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>30,000</td>
<td>59,500</td>
<td>100,000</td>
</tr>
<tr>
<td>Accounting, Credit Collection, etc.</td>
<td>20,000</td>
<td>39,000</td>
<td>55,000</td>
</tr>
<tr>
<td>Employment Services</td>
<td>51,250</td>
<td>70,000</td>
<td>98,000</td>
</tr>
<tr>
<td>Printing &amp; Copying</td>
<td>91,500</td>
<td>113,500</td>
<td>148,500</td>
</tr>
<tr>
<td>Tax Preparation</td>
<td>N/A</td>
<td>10,000</td>
<td>N/A</td>
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<tr>
<td>Real Estate</td>
<td>20,000</td>
<td>25,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Misc. Business Services</td>
<td>30,000</td>
<td>50,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Construction, Home Improvement, Cleaning, etc.</td>
<td>25,000</td>
<td>40,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>100,000</td>
<td>180,000</td>
<td>450,000</td>
</tr>
<tr>
<td>Educational Products &amp; Services</td>
<td>25,000</td>
<td>50,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>130,000</td>
<td>250,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Hotels, Motels, &amp; Campgrounds</td>
<td>425,000</td>
<td>1,350,000</td>
<td>4,125,000</td>
</tr>
<tr>
<td>Laundry &amp; Drycleaning</td>
<td>125,000</td>
<td>150,000</td>
<td>191,250</td>
</tr>
<tr>
<td>Recreation, Entertainment, &amp; Travel</td>
<td>70,000</td>
<td>100,000</td>
<td>125,000</td>
</tr>
<tr>
<td>Rental Services (Auto-Truck)</td>
<td>73,750</td>
<td>150,000</td>
<td>275,000</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
<td>100,000</td>
<td>130,000</td>
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<td>Retail (Non-food)</td>
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<td>100,000</td>
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<td>175,000</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>N/A</td>
<td>80,000</td>
<td>N/A</td>
</tr>
</tbody>
</table>

**Note:** N/A indicates no data in cell. Miscellaneous sector data was not available for 1988; data was for 1986. Data was not available for product and trademark franchises.

were very significant differences in total investment levels within most franchising sectors. For example, the lower quartile total investment for convenience stores was $100,000 versus a total investment of $450,000 for the upper quartile.

The level of initial and total investment are important because they can serve as significant barriers to entry into franchising by individuals and small businesses. There has been some concern in recent years that the cost of entry for some types of franchises -- notably fast food restaurants -- have increased to the point where only wealthy individuals and larger business enterprises can gain entry. The data on initial cash investment and on total investment which are presented in this chapter tend to confirm that franchisees in most sectors must have sizeable financial resources to establish a franchise unit. However, there are some sectors where franchisees to not need to have significant personal assets. Moreover, it must be noted that opening and operating any successful business requires access to adequate funds and it may be the case that operating a franchise requires no more funds than a comparable independent business in the same sector. In addition, it may be easier to secure financing for franchise units because of financial backing provided by the franchisor (e.g., the franchisor may secure a loan) and because the product or service provided by the franchisor has already been proven to be successful in other settings. For example, a franchised restaurant which generated $1,000,000 to $1,500,000 in gross sales and required $300,000 in personal assets might be more easily funded than a similar independent restaurant in part because franchisors often help franchisees to raise need capital.

Our interviews with franchisors and franchisees confirmed the considerable range of

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3Data on franchise buyers presented in Chapter 5 and interviews we conducted with franchisors and franchisees indicated that the "average" franchise buyer was relatively affluent (compared to the population as a whole), but not necessarily extremely wealthy.

4See Chapter 6 for additional details on franchisor financial assistance.
initial and on-going investment levels across franchising sectors and systems:

**Maintenance Franchisor.** Most franchisees are attracted to our system because it is affordable and reasonably safe. The amount required is only $25,000 to $30,000 overall and there is virtually no overhead, no office required initially, and no long term leases. People look at our franchise as a good opportunity within their cash limits. The amount people are prepared to risk on a business is their real limit, which is not necessarily their financial limit.

**Employment Service Franchisor.** Potential franchisees have the money or not. We want $100,000 in liquid assets. Most franchisees have saved the money and have assets such as a house. We might help in preparing a loan, but we don’t like franchisees borrowing if it is avoidable.

**Restaurant Franchisor.** We want franchisees to own at least 25 percent of the equity of an operation. The minimum cash required is $150,000, with sufficient net worth to borrow an additional $125,000 to $150,000.

**Restaurant Franchisor.** Since most of franchisees are multiple unit owners, we want financial capability as well as restaurant/retail experience. We emphasize financial capability because a restaurant requires $700,000 to $800,000 of investment and $300,000 in liquid assets is needed.

In our interviews, we found that the size of the required investment in sectors such as the restaurant and food retail industries were of concern both to franchisors and franchisees who view escalating start-up costs and total investment requirements as a potential barrier to continued growth and profitability. Several of the franchisors that we interviewed were particularly concerned about the rising costs of land, especially for what were regarded to be the "best locations:"

**Restaurant Franchisor.** The availability of reasonably priced real estate has been a serious impediment to our growth. Our normal concept for one-half acre of good land is $250,000; in California, some mediocre sites are $700,000.

**Restaurant Franchisee [With 7 Units].** I wouldn’t consider building new units unless the economics change because it is so costly to build new. The volume level must be pretty high from the start to justify costs of $600,000, and there is a lot of danger of misjudging the volume going into a new location.

Other interviewees indicated that in addition to the cost of land, that equipment and furnishings could be a major cost item, and one in which the franchisor and the franchisee did not always view in the same light:
Restaurant Franchisee. The franchisor and franchisee have different points of view on the initial set-up. The franchisor wants the nicest possible store and image, and he is often not well-schooled in construction techniques for adapting existing locations or purchase of used equipment. On the other hand, the franchisee watches the dollars and wants to get in business as cheaply as possible and to save money for other problems. You can buy used equipment for ten to twenty cents on the dollar which results in big savings for $180,000 to $200,000 worth of new equipment in store. You need some negotiations and compromise in start-up.

Some franchisees also indicated that they have simply become more cautious about buying additional units and new equipment.

Ice Cream Franchisee. I know now that I should not have bought all new equipment when I set up. I have seen a lot of good used equipment at one-third the new price. I could have set up at $70,000, not $130,000 to $160,000.

These concerns have forced franchisors to look at less expensive alternatives for sites and equipment, and to focus on conversions of independent or other units. One approach cited in our interviews was to look for non-traditional sites to bring down the initial and overall investment levels:

Ice Cream Franchisor. We don’t want a $400,000 to $500,000 investment level for our units. One of our future priorities is to explore non-traditional avenues like modular or mobile sites to lower investment costs and to remedy the shortage of good sites.

B. MAJOR TYPES AND AMOUNTS OF FRANCHISEE PAYMENTS/FEES

Types and amounts of payments made by franchisees to franchisors vary substantially across industrial sectors and according to the specific stipulations of each franchising agreement. Below, major types of payments made by franchisees are discussed, including initial franchise fee, royalties, advertising fees, and payments for products and services sold by the franchisor to the franchisee.

1. Franchise Fee

Typically, franchisees pay an initial franchise fee to the franchisor to become a
licensed franchisee. This front-end payment (usually in cash) is a non-recurring expense to reimburse the franchisor for costs associated with locating, qualifying, and training new franchisees. This initial fee may also cover such items as:

- start-up training, tuition, room, board, and travel;
- site selection and construction assistance;
- signs and fixtures; and
- on-site pre-opening and grand opening assistance, opening promotional and advertising help, and opening inventories and supplies.

The most recently available data on single unit franchising fees is from a study by Boroian and LaVan. According to this study, the median single unit franchise fee in 1990 was $20,000 and the mean franchise fee was $21,202. The range of most fees was relatively narrow with the lower quartile at $12,900 and the upper quartile at $25,000; the reported high figure was $100,000.

Franchising in the Economy provides more detailed data on the level of franchising fees by industrial sector for 1988. As shown in Exhibit 4-4, the median franchise fee (for single unit franchises) ranged from a low of $5,000 in the area of tax preparation to a high of $24,000 for printing and copying franchisees. The typical initial fee was in the range of $15,000 - $20,000. In addition to showing the median initial fee, this table also shows the range between the lowest and highest quartiles for franchising in each sector.

According to both the literature and our interviews with franchisors and experts on franchising, the philosophy of most franchisors in setting initial franchise fees was to try to meet three objectives: (1) cover the costs of recruiting and training franchisees; (2) maintain a competitive fee structure with others in the same industry so that a pool of qualified potential franchisees is attracted; and (3) screen potential franchisees for financial

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5P. Boroian and H. LaVan, op. cit., Table 9, p.12.
6The arrangements for multiple unit fees varied.
## Exhibit 4-4: Franchise Fees (Single Unit), 1988

<table>
<thead>
<tr>
<th>Sector</th>
<th>Lower Quartile</th>
<th>Median</th>
<th>Upper Quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Products &amp; Services</td>
<td>$15,000</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>10,000</td>
<td>15,500</td>
<td>25,000</td>
</tr>
<tr>
<td>Accounting, Credit Collection, etc.</td>
<td>12,000</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Employment Services</td>
<td>15,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Printing &amp; Copying</td>
<td>18,150</td>
<td>24,000</td>
<td>34,750</td>
</tr>
<tr>
<td>Tax Preparation</td>
<td>2,750</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Real Estate</td>
<td>7,500</td>
<td>10,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Misc. Business Services</td>
<td>10,000</td>
<td>17,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Construction, Home Improvement, Cleaning, etc.</td>
<td>10,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Convenience Store</td>
<td>7,125</td>
<td>7,500</td>
<td>39,725</td>
</tr>
<tr>
<td>Educational Products &amp; Services</td>
<td>12,000</td>
<td>18,750</td>
<td>26,125</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>15,000</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Hotels, Motels, Campgrounds</td>
<td>13,125</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Laundry &amp; Drycleaning</td>
<td>N/A</td>
<td>16,500</td>
<td>N/A</td>
</tr>
<tr>
<td>Recreation, Entertainment, &amp; Travel</td>
<td>10,000</td>
<td>22,500</td>
<td>27,500</td>
</tr>
<tr>
<td>Rental Services (Auto-Truck)</td>
<td>3,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
<td>12,750</td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Retail (Non-food)</td>
<td>15,000</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Retail (Food, Non-convenience)</td>
<td>15,000</td>
<td>19,500</td>
<td>22,500</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Note: Data was not available for product and trademark franchises.

capability. Most franchisors do not view initial fees as a major revenue source. As reflected in the comments below (from our interviews), setting initial fees is an "art rather than a science," which takes into consideration a variety of factors:

**Franchising Expert.** There is no scientific method for setting fees. It depends on what the fee will accomplish and what the market will bear competitively. The initial cost used to be a profit center, but now most franchisors are expecting to offset the cost of acquiring a franchisee. The costs include support of advertising and finding prospects, evaluation, training, and opening the operation.

**Franchising Expert.** Setting fees is an art, not a science. The philosophy of franchise fees is that they should cover costs and make a little. Some fee considerations include: what kind of services are needed at what cost, the length of term and size of territory, the competition and whether the franchisor has a "hot" franchise, the overall profit potential, other "upfront" charges, and renewal charges.

**Franchising Expert.** The setting of fees and royalties is largely a marketing decision by the franchisor. The franchisor should consider the cost of providing services that are needed by the franchisee and should breakeven on providing the services. He should consider comparative offerings which more or less establish ceilings. The franchisor should also consider his competitive position in the industry to determine whether to establish initial fees position and at the top or bottom of the range.

### 2. Royalty Payments

A second major area of franchise costs for the franchisee are continuing fees or royalties. Royalty payments both compensate the franchisor for ongoing support and technical services and serve as a principal source of revenues and profits for the franchisor. According to one expert we interviewed, royalties might be best characterized as lease payments or a way of amortizing the cost of developing the franchise so that franchises can appeal to a wider market of potential franchisees:

**Franchising Expert.** People talk about "buying" and "selling" a franchise, but since a franchise can be terminated, it is really not owned. What is happening is that the franchisee really leases the franchise, and gets the right to use it within certain limitations. Like a lease, the franchisee can transfer it. So a royalty fee is really a lease payment and payment for some services over time, but the payment is due for use irrespective of services. A second view follows from the formal definition of a franchisee which includes: a) a registered trademark; b) a payment; and c) a controllable format relating to training, control over practices, and a marketing
program. The franchisor is the person who has spent time and money to develop the franchise program. He may have spent several hundred thousand dollars, but he doesn't know in advance how many franchisees he will have to amortize cost, or he may feel the full cost may be too high to charge people in advance. The royalty is a financing method -- a way of dividing the cost between an initial fee and a percentage of sales over time in order to make the franchise affordable to a greater number of people.

In most instances, royalty fees are based on gross sales of the franchisees. With some variation by industry, over 90 percent of franchisors calculate their royalties as a percentage of gross sales; less than 10 percent base royalties on fixed rates, percentage of purchases from the franchisor, or other arrangements. The fact that most royalty payments to the franchisor are based on the franchisee’s gross sales rather than on the franchisee’s profits creates a slightly different financial perspective and incentive structure for franchisors and franchisees: franchisors tend to be more focused on building sales and market share while franchisees typically are more aware of the cost of sales. According to Boroian and LaVan’s recent survey of franchisors, the median royalty charged by franchisors in 1990 was 5 percent of gross sales. As shown in Exhibit 4-5, almost half (47.9 percent) of franchisors had royalties between 4.1 percent and 6.0 percent and more than 86 percent had royalties between 2.1 percent and 8.0 percent.7

Franchisors are typically very careful and systematic in their approach to establishing royalties, in comparison to establishment of initial franchise fees. One reason for this care is that royalties are usually the major form of on-going revenue paid to the franchisor. Another reason is that once established, the royalty rate is much more difficult to change than the initial fee. This is because existing franchisees typically have long-term contracts and charging new franchisees different royalties can cause a public relations problem or stir up resentment among franchisees.

7P. Boroian and H. LaVan, op. cit., Table 9, p. 12.
EXHIBIT 4-5: ROYALTIES AND ADVERTISING FEES AS A PERCENTAGE OF GROSS SALES

<table>
<thead>
<tr>
<th>PERCENTAGE OF GROSS SALES</th>
<th>PERCENTAGE OF FRANCHISORS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ROYALTIES</td>
</tr>
<tr>
<td>0.0 - 2.0%</td>
<td>3.3%</td>
</tr>
<tr>
<td>2.1 - 4.0</td>
<td>25.1%</td>
</tr>
<tr>
<td>4.1 - 6.0</td>
<td>47.9%</td>
</tr>
<tr>
<td>6.1 - 8.0</td>
<td>13.7%</td>
</tr>
<tr>
<td>OVER 8.0%</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

A royalty rate that is not set at an appropriate level can become a continuing point of controversy between the franchisor and franchisee. For example, a royalty rate which is too high can make the franchising system unattractive to potential franchisees and contribute to discontent and lack of profitability for existing franchisees. The possibility of franchisees’ resentment of royalty payments is reflected in this comment from one of the franchising experts that we interviewed for this study:

*Franchising Expert. The royalty area is a problem because of human nature. Royalties gnaw at franchisees because they are a major, ongoing, never-ending expense. Franchisees begin to resent the expense and feel that they’re not getting enough help. This may be accentuated when a franchisor slacks off help to the established franchisees who are paying the highest royalties to help new franchisees.*

A royalty rate which is too low can mean inadequate profit levels for the franchisor and that the franchisor is unable to provide an effective level of support services for franchisees.

The following comments from our interviews with franchising experts reflects basic strategies in setting royalties and the care that must be employed by franchisors in setting such fees:

*Franchising Expert. Royalties are real income to franchisors and need to be carefully evaluated since they fall to the bottom line. The amount of royalties generally relates to the franchise fee amount and is based on similar factors. The competition in the industry is important because franchisees will compare different systems. The royalty must relate to overall franchisee profitability so that decent profitability is maintained. The extent of field supervision needed must be covered as well. An allowance or provision for the loss of franchisees must be included. The franchisee should understand that fees and royalties are generally not a negotiable area.*

*Franchising Expert. As a starting point, the franchisor needs a careful analysis of the various costs of what he needs to be successful, including fixed costs, indirect costs and overhead. The franchisor must also look on how costs relate to and change with additional stores. The minimum royalty requirement is 3-4 percent to survive, including profit.*

*Franchising Expert. The royalty level depends on the specific industry spread between gross sales and profit. An industry with a high cost of goods sold would have a rate of 2-6 percent while an industry with a lower cost of goods sold would
be in the 10-15 percent range. The level also depends on a view of what is franchisee's legitimate profit and what the franchisor can take away, and what competitive franchise systems are doing.

3. Advertising Fees

Another continuing cost to franchisees is advertising fees. Many franchisors charge an advertising fee, which they apply directly to their company's national or regional advertising efforts or to the development of promotional materials that can be used in franchisee operations. This royalty can also take the form of a requirement that the franchisee spend a certain amount on their own marketing campaign. In some cases, the franchisee may pay both an advertising royalty to the franchisor and spend an additional amount on local promotions.

As shown in Exhibit 4-5, in 1990, according to a survey of franchisors by Boroian and LaVan, the required national advertising fee averaged 2 percent of gross sales, with three-fourths of all franchisors having advertising contributions under 2.1 percent. The national advertising funds were typically administered by the franchisor, although many franchisors involved franchisees in the planning and development of advertising and marketing. The funds were used for activities such as the design and production of advertisement and marketing materials; the placement of TV, radio, or print media advertising; and the preparation of videos. In addition to the national advertising contribution, franchisees in some industries were required to spend an additional amount on local advertising and marketing, either individually or in cooperation with other local franchisees.

The development of effective national advertising and marketing which reinforces a common identity and/or permits special promotions is very important in some industries, such as fast food restaurants, food retailers, and other retailers:
Restaurant Franchisee. A good advertising program is important in the fast-food business because it's so competitive. You need to keep the name before the public through advertisements with eye appeal.

Both franchisors and franchisees benefit through strong, professional advertising programs. However, because advertising involves significant costs and a number of highly subjective, personal judgements about different themes, timing, and placement, it can be also an area of friction between franchisors and franchisees. Comments from our interviewees concerned promotional strategies for franchisees and ways in which advertising fees are typically used:

Franchising Expert. The basic royalty should include the payment for managing advertising/marketing efforts. The franchisor must focus on what is needed to make franchisees successful quickly so that more advertising funds are better if they give franchisees a quick start.

Restaurant Franchisor. The franchisees make a 3 percent required contribution to the fund and the company decides what would benefit the system as a whole the most. Generally, we allocate 1 percent to local radio, 1 percent to regional television (or to radio if there is no television), 0.5 percent to production of commercials, and 0.5 percent to administrative and other costs.

Restaurant Franchisee. The franchisees must rely on the professionals in the company even though they will make mistakes in marketing. There is an art to creating material, buying ad time, and deciding when and where to run advertisements. I learned as a new franchisee that I didn’t know much about what would work in advertising because what appealed to me didn’t appeal to customers. It took me 15 years to get the experience to understand what drives the market.

4. Payments for Products and Services Sold to the Franchisee

Another area of franchise costs -- determined by the franchise agreement and competitive conditions in different industries -- are payments for products and services sold by the franchisor to the franchisee. An estimated one-third of franchisors sell or lease items to franchisees. As shown in Exhibit 4-6, the total estimated sales of products and

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EXHIBIT 4-6: TOTAL SALES OF PRODUCTS AND SERVICES
BY FRANCHISORS TO FRANCHISEES, 1988

<table>
<thead>
<tr>
<th>SECTOR</th>
<th>TOTAL (Dollars in Millions)</th>
<th>MERCHANDISE (NON-FOOD) FOR RESALE</th>
<th>SUPPLIES (PAPER GOODS, ETC.)</th>
<th>FOOD INGREDIENTS</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Products &amp; Services</td>
<td>2,383.1</td>
<td>2,318.8</td>
<td>38.2</td>
<td>0</td>
<td>26.1</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>202.3</td>
<td>93.7</td>
<td>42.9</td>
<td>0</td>
<td>65.6</td>
</tr>
<tr>
<td>Construction, Home Improvement, Cleaning, etc.</td>
<td>325.9</td>
<td>178.5</td>
<td>15.0</td>
<td>0</td>
<td>132.4</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>276.7</td>
<td>.1</td>
<td>.1</td>
<td>272.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Education Products &amp; Services</td>
<td>35.8</td>
<td>3.2</td>
<td>4.2</td>
<td>28.1</td>
<td>.2</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>2,289.0</td>
<td>220.6</td>
<td>533.5</td>
<td>1,467.8</td>
<td>67.0</td>
</tr>
<tr>
<td>Hotels, Motels, Campgrounds</td>
<td>33.9</td>
<td>15.5</td>
<td>15.4</td>
<td>.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Laundry &amp; Drycleaning</td>
<td>20.3</td>
<td>0</td>
<td>.1</td>
<td>0</td>
<td>20.2</td>
</tr>
<tr>
<td>Recreation, Entertainment, Travel</td>
<td>3.5</td>
<td>.6</td>
<td>1.2</td>
<td>0</td>
<td>1.7</td>
</tr>
<tr>
<td>Rental Services (Auto-Truck)</td>
<td>2.7</td>
<td>0</td>
<td>2.7</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
<td>51.6</td>
<td>38.4</td>
<td>1.8</td>
<td>0</td>
<td>11.5</td>
</tr>
<tr>
<td>Retail (Non-food)</td>
<td>5,079.9</td>
<td>5,024.6</td>
<td>46.6</td>
<td>0</td>
<td>8.6</td>
</tr>
<tr>
<td>Retail (Food, Non-convenience)</td>
<td>1,037.8</td>
<td>161.1</td>
<td>27.7</td>
<td>832.9</td>
<td>16.1</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>64.0</td>
<td>47.5</td>
<td>5.2</td>
<td>0</td>
<td>11.3</td>
</tr>
<tr>
<td>TOTAL</td>
<td>11,806.4</td>
<td>8,102.8</td>
<td>734.6</td>
<td>2,601.6</td>
<td>367.5</td>
</tr>
</tbody>
</table>


Note: Data for product and trademark franchising was not available. Components may not add to totals because of rounding.
services by franchisors to franchisees was $11.8 billion in 1988. Unfortunately, there was no available data indicating what percentage of the franchisees’ total operating costs this amount represented. As shown in this table, there was considerable variation in the types of products and supplies sold by franchisors to franchisees across various sectors. Overall, non-food merchandise represented about two-thirds (68.7 percent) of all products sold; followed by food ingredients (22.0 percent), supplies (6.2 percent), and other goods (3.1 percent). In addition to the direct sales of products and services sold by franchisors, franchisors exercise substantial influence over the type and quantity of other items purchased through approved supplier lists, quality control standards, cooperative purchasing councils, and nationally-negotiated arrangements with suppliers. Several examples of practices of franchisees with respect to the purchase of goods and services through franchisors are reflected in the following comments from our interviews:

**Ice Cream Franchisor.** Franchisees purchase some items through the company, like uniforms, where our philosophy is to provide supplies mostly as a service to franchisees and to make a small margin. Generally, important purchases go through a franchisee’s purchasing cooperative which is separate and sets up national purchasing agreements.

**Construction Franchisor.** Our franchisees support software development, a new electronic data transfer program, quality control audits, and a national marketing program through monthly charges, but our philosophy is to have ongoing programs decided on by a franchisee council and funded by franchisees. We’re able to do a lot cooperatively and maintain franchisee involvement.

**Ice Cream Franchisee.** I buy 95 percent of my supplies from approved suppliers, very little from the franchisor directly. The franchisor usually negotiates a national contract for equipment. I can get the price from the franchisor and have them order and ship it, or I can order myself. Usually their prices are better than what I can do by myself.

**Restaurant Franchisee.** I’m not required to buy much except for the proprietary food items which are special, but generally it’s not smart to buy outside the system. In our system, we’re required to meet strict quality control standards in purchasing outside because the whole deal in our product is quality -- it’s not like hamburger where you can buy everywhere. I can purchase through the system which is a little more expensive but quality and delivery are always okay, so store
managers don’t have to worry. It used to be more of a problem because the company tried to make more money off supplies to franchisees which I don’t think is right. Maybe some outside purchases are good to make sure prices are competitive and to keep the company on its toes.

C. CONCLUSIONS AND IMPLICATIONS

There is concern within the small business community that the start-up costs and total investment requirements in certain franchising sectors may be pricing franchise units out of the reach of many individuals who in the past may have been able to gain entry. On average, franchisees reported investing a total of about $150,000 in their franchise unit, with median start-up costs ranging from $25,000 to $50,000 in most franchising sectors. However, across sectors and individual franchise systems there are wide disparities in both start-up and overall investment levels. For example, 20 percent of franchisees reported total investment levels greater than $200,000, with 7 percent in excess of $500,000. Investments levels reaching these levels -- together with difficulties of locating financing -- indicates that some areas of franchising (e.g., some fast-food restaurants, hotels and motel chains) have moved beyond the reach of many individuals. However, dynamic growth of franchising (which has led to a steady flow of new franchisors) along with the flexibility of franchising (which has made it applicable to a wide variety of industrial sectors) also has meant that there are still many franchise opportunities available involving less than $25,000 in start-up costs and $50,000 in total investment.

There is also some concern that on-going fees charged by some franchisors (e.g., royalties, advertising fees, and payments for products and services) are not reasonable. Royalty payments seem to be a particular source of tension -- as franchisees mature and gain experience they may find that franchisor support is less important or relevant, yet
they must continue to pay royalties. Advertising fees can also be occasionally a source of controversy because advertising requires subjective judgements and the difficulty of mounting advertising campaigns that are effective in all local markets.
CHAPTER 5: 
CHARACTERISTICS OF FRANCHISEES

This chapter focuses on the characteristics of franchisees. It begins with an assessment of the role that franchisees are expected to play in the operation of franchise units. It then considers basic characteristics of franchisees, including financial capacity and some basic demographic characteristics. The chapter concludes with a discussion of the role that women and minorities are playing within franchising.

A. THE TYPICAL FRANCHISEE: ACTIVE AND INVOLVED AS MANAGER

In addition to providing capital, most franchisors expect franchisees to take an active role in managing franchise units -- recruiting and supervising personnel, overseeing day-to-day operations, and ensuring that quality standards are met. According to a 1990-91 survey of franchisors by Boroian and LaVan, only about one percent of franchisors were looking for absentee investors. About 52 percent of franchisors expected their franchisees to provide labor and hire workers, and another 18 percent expected their franchisees to hire managers to help run the business. A number of franchisors (29 percent) were looking for franchisees to provide most of the labor in the franchise.¹

The active role of franchisees in the operations of franchise units is borne out by evidence from a recent survey of franchisees. A 1991 Gallup survey of franchisees found that 85 percent of respondents said they were actively involved with their franchise units on a day-to-day basis. Almost 96 percent of the respondents said they were either actively or moderately involved in their business’ day-to-day operations.

¹P. Boroian and LaVan, op. cit., Table 18, p. 21.
Most franchisors and franchisees interviewed for this study emphasized the active, managerial role that franchisees play in day-to-day operations of the franchise units. Typically, the franchisor is viewed as providing a structured and supportive business system, while the franchisee accepts on-site responsibility for managing a gradually increasing range of costs, customer contacts, and personnel. Comments from two franchisors we interviewed illustrate the important role of franchisees:

**Ice Cream Franchisor.** The franchisor gives franchisees the tools, but the franchisor cannot implement the program in the local store. The franchisee has to take responsibility for his part of the operation and go out and do it with the tools. A franchisor can take away some problems, but cannot make a store successful.

**Employment Service Franchisor.** Like most systems, we want active managers, although the level can go down after the first few years. We want people to roll up their sleeves and be involved themselves, not just be investors.

Even those who enter franchising as an investor, may soon find that they must play an active role, as was the case with one franchisee that we interviewed:

**Restaurant Franchisee.** I got involved through a loan to an individual who was to manage three stores. I checked that the loan was well-collateralized by the stores, but I didn’t check that the manager was well-qualified to run the operation and I had to step in. Outside investment doesn’t work well. The financial partner is in effect an absentee owner too dependent on the manager to run the operation profitably.

The point that is emphasized by both franchisors and franchisees is that the relative success or failure of the local franchising unit is closely linked to the efforts and managerial skills of the franchisee:

**Ice Cream Franchisee.** The most common reason for failure is that people think they can expect business to come to them. People think that having a franchise means that they can open the doors and then sit back and count the money coming in. The fact is that it requires a lot of hard work. You have to give people a reason to come in the store and it’s mainly up to the store owner. It’s kind of amazing that some people won’t hustle even when their money is on the line.

**Restaurant Franchisee.** I see unsuccessful or struggling franchisees sit back and look to the franchisor to do the things that would make them a success or failure. There is a fine line on how far the franchisor can go today because of the legal risk
of doing too much and giving too much advice. In addition, the help may be counterproductive and discourage the franchisee from assuming responsibility and taking charge of operations.

**Maintenance Franchisee.** We look for a desire to make money, Number 1. The goal of our franchisee should be primarily income. Successful franchisees also need heart, persistence, and the willingness to work with customers.

**B. FRANCHISEES' FINANCIAL CHARACTERISTICS**

With the substantial initial investment and working capital required for many franchises, the financial resources of the franchisee are an important element of the franchisee's profile. As discussed in greater detail in Chapter 4, the financial resources of the franchisee are important from the standpoint of whether an individual qualifies to purchase a franchise unit. Particularly in certain sectors (such as restaurants, hotels, and motels), substantial resources and working capital are needed to establish and sustain franchisee operations. Our discussions with experts and franchisors indicated that undercapitalization was one of several factors that affected both short- and long-term success of franchisees:

**Franchising Expert.** Avoiding problems requires careful qualification by the franchisor. The franchisee must have strong financing and a good business plan to survive, particularly in the current economic climate which makes it tougher for weak, poorly planned franchises to survive.

**Franchising Expert.** The franchisee may say he has enough capital, but he may misstate or overestimate his capital availability because of optimism. In addition, the franchisee may run short of capital because he doesn’t control his costs well enough.

**Construction Franchisor.** Many failures may be due to lack of money needed to start the business. We try to evaluate this, but individuals misrepresent their financial position on the statements we receive.

Discussions with franchisees also underscored the importance of capital adequacy because of the uncertainties inherent in starting a business:
Employment Service Franchisee. The main difficulty we had in evaluating the capital needs of the franchise was in projecting the revenue buildup. We didn’t really have a clue because it was a result of the sales effort and the franchisor couldn’t give us any help. It’s not like a retail store to project because there are really no statistics to look up.

Restaurant Franchisee. The franchisee needs to have enough cash and cushion for realistic start-up because it will take time to penetrate a market in different neighborhoods. The franchisee has the responsibility to recognize the trade-offs and limit the total expense in start-up at a site so that he has the right mix of cost and quality at a particular location.

Construction Franchisee. Many franchisees fail because they don’t have adequate dollars needed to weather the storm. They must have adequate money behind them to finance working capital needs. The amount needed depends on an individual’s management of the business and on the economy of the area.

The average franchise buyer uses his or her own personal assets and those of his family to purchase a franchise unit. According to one study, about 71 percent of franchise buyers pledged personal assets and about 52 percent used home equity to finance franchises. About a quarter (23 percent) received financial assistance from other family members.² In our interviews, we found that many franchisees relied upon personal saving and other assets to raise funds needed to start-up their franchise unit:

Educational Franchisor. Franchisees are attracted to our system because of its low cost and low overhead. A second loan on a home is a common source of funding for our franchisees.

Employment Services Franchisee. Both my partner and I were executive recruiters before we bought this franchise. We bought the franchise out of money we had saved while we were employed.

Available data suggest that existing franchisees have achieved income levels well above those found in the general population. According to a national telephone survey of franchisees by the Gallup Organization, the average annual gross income for franchisee owners was $124,570 in 1991. This is well above the median U.S. gross family income

²Boroian and LaVan, op. cit.
in 1991, which was $39,939.\(^3\) As shown in Exhibit 5-1, approximately half of the respondents (48 percent) reported gross income under $100,000, with about one-quarter (26 percent) reporting incomes less than $50,000. Slightly more than one-third (36 percent) reported gross income over $100,000.

The Gallup survey also found a positive correlation between the respondents' number of years in the franchise business and their estimated annual gross income. The longer the respondents had been in business, the higher was their average reported annual gross income: franchisee owners with five or fewer years in franchise business had gross income of $112,430, versus $136,820 for owners with 6 to 10 years of experience and $142,760 for franchisees with 11 or more years.\(^4\)

C. FRANCHISEES' BUSINESS EXPERIENCE AND EDUCATION

Exhibit 5-2 displays the findings from a recent Gallup survey on the number of years franchisees have been in business as franchise owners and as franchise owners of the franchises they are currently operating. Slightly less than half (44 percent) of franchisees said they had been a franchise owner for more than five years; about one-quarter (24 percent) had been a franchise owner for more than 10 years. On average,

\(^3\)U.S. Bureau of the Census, *Current Population Reports*, series P-60, Table No. 180. While income levels for franchisee owners may be well-above those reported generally for U.S. families, the more relevant comparison may be with income levels of independent business owners. While we would expect that the distribution of income for franchisee owners would be comparable to independent business owners, comparable data were not available for such analyses.

\(^4\)Unfortunately, no data were available on the relationship between number of years of ownership of franchise units and likelihood of failure. However, a recent Gallup survey found that franchisee owners with more years of in business were more likely to rate their franchise operation to be very successful -- 57 percent of franchise owners with 11 years or more of experience as a franchise owner rated their franchise operation as very successful compared to 43 percent of franchise owners with 5 or fewer years of experience.
EXHIBIT 5-1: ESTIMATED ANNUAL GROSS INCOME BEFORE TAXES

Gross Income

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Percentage of Franchisees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $25,000</td>
<td>11%</td>
</tr>
<tr>
<td>$25,000-$49,999</td>
<td>19%</td>
</tr>
<tr>
<td>$50,000-$99,999</td>
<td>27%</td>
</tr>
<tr>
<td>$100,000-$149,999</td>
<td>14%</td>
</tr>
<tr>
<td>$150,000-$199,999</td>
<td>9%</td>
</tr>
<tr>
<td>$200,000-$299,999</td>
<td>7%</td>
</tr>
<tr>
<td>300,000 or More</td>
<td>13%</td>
</tr>
</tbody>
</table>

EXHIBIT 5-2: NUMBER OF YEARS IN BUSINESS AS A FRANCHISE OWNER

### # OF YEARS AS A FRANCHISE OWNER --

<table>
<thead>
<tr>
<th># OF YEARS</th>
<th>IN TOTAL</th>
<th>IN THIS PARTICULAR BUSINESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;1</td>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>1</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>2</td>
<td>11%</td>
<td>12%</td>
</tr>
<tr>
<td>3</td>
<td>15%</td>
<td>16%</td>
</tr>
<tr>
<td>4</td>
<td>11%</td>
<td>11%</td>
</tr>
<tr>
<td>5</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>6-10</td>
<td>20%</td>
<td>21%</td>
</tr>
<tr>
<td>11-15</td>
<td>12%</td>
<td>10%</td>
</tr>
<tr>
<td>16-20</td>
<td>6%</td>
<td>4%</td>
</tr>
<tr>
<td>21+</td>
<td>6%</td>
<td>6%</td>
</tr>
</tbody>
</table>

respondents indicated that they had been in the business as a franchise owner for slightly more than seven years (7.4 years). As also shown in the exhibit, 40 percent of respondents indicated that they had been a franchise owner of a particular business they were being interviewed about for more than five years. Approximately one-fifth (19 percent) had been owners of that business for more than 10 years. On average, respondents had been owners of their particular business for about seven years (6.8 years).

The literature on franchising indicates relatively high levels of "white collar" involvement in franchising and the need for greater levels of sophistication, business experience, and education among those entering franchising today:

Franchisees are becoming more sophisticated and have greater expectations about being involved because they come from management backgrounds where they are used to giving ideas, being involved and contributing to organizations. In the sixties and seventies, franchising was mostly a legal relationship and franchisees were not as involved in franchise management policy. Now, franchising is a broader business relationship where the franchisee has been delegated much of the responsibility for customer contact and sometimes has a lot more direct customer contact and experience than the franchisor. The franchisor and franchisee are more like partners in need of common strategies to keep customers.5

A 1990-91 survey by Boroian and LaVan asked franchisors to profile characteristics of today's franchise buyer. The results of this survey indicated the following:

...They indicate that franchisees are generally affluent, mature, experienced, and well-educated. However, they also indicate that the door has by no means closed on the lower segments of the population, with almost 13 percent of franchisees still being sold to blue-collar workers and 59.8 percent to people without college degrees. The 'mom-and-pop' franchise team is still very much alive, as well; of course, 'mom' may very well be a CPA and 'pop' a corporate marketing executive who is tired of corporate life.6

6Boroian and LaVan, op. cit., p. 19.
In this survey, franchisors indicated that a majority of new franchisee buyers came from white collar, professional, or managerial positions. Franchisors also indicated increasing involvement among "corporate dropouts." When asked to compare characteristics of new franchisees today with those typical five years ago, over 80 percent of franchisors saw more corporate dropouts, almost two-thirds saw more buyers with business experience, and over half saw better education in buyers over the past five years.7

Franchisors that we interviewed generally felt that because franchise operations were becoming increasingly more complex and sophisticated, entrants to most fields of franchising had to have higher levels of education and stronger business experience than in the past:

Restaurant Franchisor. Franchisees are becoming more upscale and sophisticated. They seem to have more business experience and be less risk-takers. In my previous franchise, we used a classic approach with franchisees where we found an unexperienced franchisee and gave him complete training, and the systems and controls needed to put him in business. Our current strategy in this franchise is to look for a narrower profile, a more experienced franchisee. We require some restaurant experience because we believe that having a feel for what the restaurant business is will help. The complex situation now requires a more sophisticated franchisee. We want the franchisee to understand the system, the need for continuous quality, the responsibilities, and the need for franchisor royalties. The negative side is that the past experience means that there may be some resistance to the system and training.

Restaurant Franchisor. Retail experience is important. We want to see a three-year history of a successful owner of another retail business because there are similar principles in dealing with the public, inventory, and cost control.

D. THE ROLE OF WOMEN IN FRANCHISING

According to Women in Franchising, Inc., an industry association devoted to the professional interest and advancement of women in franchising, there are a number of

7Boroian and LaVan, op. cit.
factors that make franchising a logical choice for women:

- owning a franchise seems to be a less risky method of getting into business -- someone has done it before;
- initial training in all aspects of running the business is provided along with continuous technical and managerial support;
- owning a franchise provides instant credibility with consumers; and
- there is a network of individuals that a franchisee can turn to for support -- peer support, home office support, supplier support -- as he/she goes about the daily responsibility of running a small business.\(^8\)

Additionally, women may be attracted to certain fields within franchising because of greater flexibility in scheduling (e.g., which responds to child care needs). Professional or skilled women already in the workforce, similar to their male counterparts, may enter franchising to gain more control over their work. Finally, some women may enter franchise markets that are dominated by women as customers.\(^9\)\(^10\)

Despite the relative advantages of franchises for women and the rapid growth of women as business owners, there is little evidence that women have disproportionately entered franchising. A 1987 study by Women in Franchising found that 10.9 percent of all franchised outlets were owned solely by women. An additional 18 percent of franchisee-owned outlets were owned by women in partnership with men. Hence, an estimated 30 percent of the nation's franchised outlets were owned by women either alone or in partnership with men. This was nearly identical to the 30.0 percent of women-

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\(^10\)G. Matusky and J. Hayes, op. cit., pp. 96-98.
owned firms reported in the U.S. in 1987.\textsuperscript{11} A 1990 follow-up survey by Women in Franchising, Inc. showed that women’s ownership of franchises remained at about the same level as 1987 -- 11.1 percent of all franchised outlets were owned solely by women.\textsuperscript{12}

A 1991 survey of franchisees by the Gallup Organization found franchise ownership by women to be at 18 percent. The difference between the Gallup survey and the Women in Franchising, Inc. estimates appear to result from the fact the Gallup survey asked for the gender of the franchise owner who was being interviewed, while the Women in Franchising survey obtained data on the gender of all owners of the franchise unit (e.g., where women were sole owners or partners). No separate data were available from the Gallup survey on the gender of other owners in multi-owner franchise units (36 percent of franchises were multi-owner units). However, the two surveys together suggest that slightly less than one-third of franchise units are owned solely or jointly by women.

Women in Franchising, Inc. identified several types of problems encountered by women purchasing franchises:

\begin{itemize}
  \item the franchisor’s home office not taking them seriously as prospective business purchasers,
  \item the low percentage of franchisors who provide lawful earnings claims,
  \item the unwillingness of franchisors to release the names of all of the current franchise owners, and
  \item the unwillingness of franchisors to disclose long-term success or failure of
\end{itemize}


\textsuperscript{12}Susan Kezios, p. 114.
In our interviews with several women franchisees we found evidence of both some of the advantages of franchising for women, as well as some of the difficulties that women experienced in entering franchising systems:

**Ice Cream Franchisee [Woman-owned].** Franchise businesses have some advantages for women. It was easier for me to get financing because the bank viewed my application as a franchise as stronger than as an independent business. My bank said that it preferred to finance franchises for women because franchises were better than starting a business from scratch and the bank had seen fewer failures. I think that my business ownership allows flexible hours for meeting my family responsibilities as a single mother with a daughter to care for. My store is a block from home and I'm able to work some at home.

**Construction Franchisee [Woman-owned].** I wanted my own small business because I was frustrated working for a bank in construction lending. I had some problems at the time because women were not expected to operate a business. Construction is a difficult field for women because it is a business where there are mostly men. The old boy network of contractors takes time to penetrate. In this field, females are not perceived as having the expertise and experience and there are few women in our system as a result.

### E. ROLE OF MINORITIES IN FRANCHISING

According to the U.S. Department of Commerce, minority entrepreneurs often face multiple barriers in their efforts to operate a successful small business, particularly related to inexperience in business and management, and inadequate financing. The franchising system provides a means for reducing and/or eliminating such barriers to entry. For example, under the franchise system, a franchisor:

- usually provides managerial training and assistance on a continuing basis;
- will finance the purchase of necessary equipment in some cases;

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13Statement of Susan P. Kezios, "Franchising in Hard Times," op. cit., p. 116. It should be noted that with the exception of the first problem, the other problems affect all prospective franchisees during the sales and solicitation process (see Chapter 7).
may arrange for property leases;
• may help obtain loans from the SBA, local banks, or other private investors, and, in some instances, may participate in the venture;
• generally provides such services as locational analysis, advertising and merchandizing, counseling and assistance, standardized procedures and operations.\textsuperscript{14}

Unfortunately, there is little in the way of current reliable statistics on the level of minority ownership of franchises and how minority ownership has changed in recent years. The last reliable figures on minority franchise ownership were collected by the U.S. Department of Commerce in 1986 and published in Franchising in the Economy.\textsuperscript{15} In this report, the Department of Commerce reported that of the 2,177 business format franchisors surveyed, 572 companies reported a total of 10,142 units owned by minorities, while 1,517 reported no minority-owned units.\textsuperscript{16} Hence, about one-fourth (27.3 percent) of business format franchising systems indicated that they had minority franchisees. If non-responses are eliminated from the calculation, a rough estimate of the percentage of minority ownership (in 1986) of business format franchise establishments would be 4.4 percent.\textsuperscript{17}

\textsuperscript{14}Franchising in the Economy: 1986-88, op. cit., p. 10.

\textsuperscript{15}The International Franchise Association resumed publication of "Franchising in the Economy" in 1988, but did not include the question of minority franchise ownership in its survey.

\textsuperscript{16}The remaining 88 companies, mostly large franchisors with a total of 82,526 franchisee-owned units, did not respond because they did not maintain (and are not required to maintain records) identifying such characteristics.

\textsuperscript{17}This percentage is generated by subtracting the 82,526 franchise units (for which data are not available) from an estimated 312,810 business format establishments reported for 1986. This yields a total of 230,284 establishments for which data are available on minority ownership. Of this group of business format franchise establishments, 10,142 units were reported to be owned by minorities.
Data were not collected for product/tradename franchisors (i.e., automobile and truck dealers, gasoline service stations, and soft drink bottlers). However, the Department of Commerce estimated that in 1986 minorities owned 10,000 gasoline service stations and 375 automobile and truck dealerships. Based on estimates of the number of establishments in these two sectors, 8.3 percent of gasoline service stations and 1.4 percent of automobile and truck dealerships were minority owned in 1986. Excluding soft drink bottlers,\textsuperscript{18} a rough estimate of the percentage of minority owners (in 1986) of product/tradename franchise establishment units would be about 7 percent.

Finally, combining available data for business format and product/trademark franchise units generates an overall estimate of 5.4 percent minority ownership in 1986. This figure is well-below the estimated 8.8 percent minority-owned businesses in the U.S. in 1987.\textsuperscript{19} It is also well below the proportion of minorities within the U.S. population -- in 1989, blacks accounted for 12.4 percent of the U.S. population; American Indians/Alaska Natives, 0.7 percent; Asian/Pacific Islanders, 2.8 percent; and hispanics, 8.3 percent. Although the data are somewhat incomplete, the lower representation of minorities within franchising (especially compared to minority firm ownership) may indicate that minorities face greater obstacles to franchise ownership than other types of small business ownership.

As shown in Exhibit 5-3, the Department of Commerce provided some additional analyses of minority-ownership of business format franchises by type of minority group

\textsuperscript{18}Data were not available on minority ownership for the estimated 1,203 soft drink bottlers in 1986.

\textsuperscript{19}U.S. Department of Commerce, Bureau of the Census, Minority-Owned Business Enterprises, Series MB87-1. In 1987, 3.1 percent of U.S. firms were owned by blacks, 3.1 percent by hispanics, and 2.6 percent by Asian/Pacific Islanders and American Indians/Native Alaskans.
### Exhibit 5-3: Minority Ownership by Sector, 1986

<table>
<thead>
<tr>
<th>Sector</th>
<th>Establishments Owned by Minorities</th>
<th>Black</th>
<th>Hispanic</th>
<th>American Indian/Alaskan</th>
<th>Asian/Pacific Islander</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Products &amp; Services</td>
<td>1,467</td>
<td>842</td>
<td>424</td>
<td>26</td>
<td>175</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>1,103</td>
<td>376</td>
<td>424</td>
<td>29</td>
<td>274</td>
</tr>
<tr>
<td>Construction, Home Improvement, Cleaning, etc.</td>
<td>1,364</td>
<td>417</td>
<td>307</td>
<td>18</td>
<td>622</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>1,018</td>
<td>159</td>
<td>169</td>
<td>5</td>
<td>685</td>
</tr>
<tr>
<td>Educational Products &amp; Services</td>
<td>50</td>
<td>6</td>
<td>13</td>
<td>0</td>
<td>31</td>
</tr>
<tr>
<td>Restaurants (All Types)</td>
<td>2,373</td>
<td>854</td>
<td>715</td>
<td>5</td>
<td>799</td>
</tr>
<tr>
<td>Hotels, Motels, &amp; Campgrounds</td>
<td>336</td>
<td>7</td>
<td>28</td>
<td>4</td>
<td>297</td>
</tr>
<tr>
<td>Laundry &amp; Drycleaning</td>
<td>167</td>
<td>64</td>
<td>37</td>
<td>0</td>
<td>66</td>
</tr>
<tr>
<td>Recreation, Entertainment, &amp; Travel</td>
<td>158</td>
<td>69</td>
<td>69</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>Rental Services (Auto-Truck)</td>
<td>144</td>
<td>68</td>
<td>60</td>
<td>2</td>
<td>14</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
<td>19</td>
<td>4</td>
<td>13</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Retail (Nonfood)</td>
<td>695</td>
<td>206</td>
<td>224</td>
<td>8</td>
<td>257</td>
</tr>
<tr>
<td>Retail (Food, Non-convenience)</td>
<td>1,201</td>
<td>525</td>
<td>307</td>
<td>3</td>
<td>366</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>47</td>
<td>18</td>
<td>18</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10,142</strong></td>
<td><strong>3,615</strong></td>
<td><strong>2,808</strong></td>
<td><strong>103</strong></td>
<td><strong>3,616</strong></td>
</tr>
<tr>
<td><strong>Percent</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>35.6%</strong></td>
<td><strong>27.7%</strong></td>
<td><strong>1.0%</strong></td>
<td><strong>35.7%</strong></td>
</tr>
</tbody>
</table>


Note: Of the 2,177 franchisors, 572 reported minority ownership, 1,517 reported no minority ownership, and 88 franchisors with 82,562 franchisee-owned units were unable to respond since they did not maintain such records. Data did not include product and trademark franchisors for which data were not collected.
and by industrial sector for 1986. Of the 10,142 minority-owned business format establishments for which data were available, 35.6 percent were owned by Blacks, 27.7 percent were owned by hispanics, 35.7 percent were owned by Asian/Pacific Islanders, and 1.0 percent were owned by American Indians/Alaska Natives. This distribution is similar to patterns of minority ownership of U.S. firms -- though with slightly higher representation of Pacific Islanders/Asian Americans and lower representation of hispanics. Many of the minority-owned business were concentrated in the most popular franchising sectors, including restaurants (23.4 percent), automotive products and services (14.5 percent), food retailing other than convenience stores (11.8 percent), convenience stores (10.0 percent), and business aids and services (10.8 percent).

Data in *Franchising in the Economy* indicated a steady increase in the number of minority franchisees between 1975 and 1986, although the data were somewhat incomplete because a number of large franchisors did not maintain comparable records. As shown in Exhibit 5-4, the number of minorities entering business format franchising almost tripled between 1975 and 1986, increasing from 3,413 to 10,142. During this period, the increase in the number of minority (business format) franchise establishments (197.2 percent) was well above the general increase in business format establishments (48.4 percent). However, the rate of growth of minorities in franchising (at least since 1982) appears to be about the same as that in businesses as a whole. For example, between 1982 and 1987, the number of U.S. firms owned by minorities increased by an average of 12.7 percent per year, compared to an average annual increase of 13.8 percent.

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20U.S. Department of Commerce, Bureau of the Census, *Minority-Owned Business Enterprises*, Series, MB87-1. In 1987, Blacks owned 35.0 percent of all minority firms; hispanics, 34.8 percent; Asian/Pacific Islanders, 29.3 percent; and American Indians/Alaskan Natives, 1.8 percent.
## Exhibit 5-4: Minority Establishments, 1975-1986

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Establishments Owned by Minorities</th>
<th>Black</th>
<th>Hispanic</th>
<th>American Indian/Alaskan</th>
<th>Asian/Pacific Islander</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>3,413</td>
<td>1,449</td>
<td>1,386</td>
<td>105</td>
<td>473</td>
</tr>
<tr>
<td>1976</td>
<td>4,301</td>
<td>1,894</td>
<td>1,502</td>
<td>135</td>
<td>770</td>
</tr>
<tr>
<td>1977</td>
<td>4,758</td>
<td>2,065</td>
<td>1,637</td>
<td>116</td>
<td>940</td>
</tr>
<tr>
<td>1978</td>
<td>5,859</td>
<td>2,584</td>
<td>2,031</td>
<td>144</td>
<td>1,100</td>
</tr>
<tr>
<td>1979</td>
<td>6,181</td>
<td>2,660</td>
<td>1,998</td>
<td>139</td>
<td>1,384</td>
</tr>
<tr>
<td>1980</td>
<td>6,194</td>
<td>2,632</td>
<td>2,077</td>
<td>143</td>
<td>1,342</td>
</tr>
<tr>
<td>1981</td>
<td>6,093</td>
<td>2,584</td>
<td>1,949</td>
<td>117</td>
<td>1,443</td>
</tr>
<tr>
<td>1982</td>
<td>6,537</td>
<td>2,592</td>
<td>2,013</td>
<td>96</td>
<td>1,836</td>
</tr>
<tr>
<td>1983</td>
<td>7,360</td>
<td>2,825</td>
<td>2,259</td>
<td>118</td>
<td>2,158</td>
</tr>
<tr>
<td>1984</td>
<td>8,116</td>
<td>2,901</td>
<td>2,641</td>
<td>130</td>
<td>2,444</td>
</tr>
<tr>
<td>1985</td>
<td>9,147</td>
<td>3,399</td>
<td>2,709</td>
<td>100</td>
<td>2,939</td>
</tr>
<tr>
<td>1986</td>
<td>10,142</td>
<td>3,615</td>
<td>2,808</td>
<td>103</td>
<td>3,616</td>
</tr>
</tbody>
</table>

**Change (1975-86)**

- Black: 197.2%
- Hispanic: 149.5%
- American Indian/Alaskan: 102.6%
- Asian/Pacific Islander: 296.2%


Note: Numerous large franchisors were not included because they did not maintain such records. Data did not include product and trademark franchisors for which data were not collected.
for minorities of franchise firms for the period 1982 through 1986.\textsuperscript{21}

With minority ownership of franchise businesses lagging somewhat behind general levels of minority ownership of U.S. businesses, some issues have been raised concerning problems that minorities have in both entering and being successful in franchising.

According to a 1990 Interim Report of the U.S. Commission on Minority Business Development, one of the most formidable stumbling blocks to the creation of minority businesses is lack of access to capital. Problems with accessing capital (and credit) was recently cited in testimony before Congress as a particular barrier to entry of minorities into franchising:

Specifically, with respect to the Hispanic community, one of the major barriers to entry into the franchise business is a lack of access to credit and capital. Generally speaking, the Hispanic entrepreneur has essentially no start-up capital aside from personal savings. Banks are less likely to lend money or provide working capital to start-up businesses, particularly in these hard times, and are not willing to risk the potential loss of money on start-up businesses and, therefore, the Hispanic entrepreneur generally starts out small, and then after some success, can develop access to credit and capital, a little at a time. Hispanic entrepreneurs simply do not have the capital necessary to buy into a franchise or a new start-up business franchise.\textsuperscript{22}

Several other issues that have been raised with regard to minority involvement in franchising include the following:

- poor choice of markets and steering of minority franchisees to low-income,

\textsuperscript{21}Data on minority ownership of business franchise establishments, which was available only from 1975-86, is from the U.S. Department of Commerce, \textit{Franchising in the U.S. Economy}. Data on minority ownership of U.S. business firms, which is available only for 1982 and 1987, is from the U.S. Department of Commerce, Bureau of the Census, \textit{Minority-Owned Business Enterprises}, Series MB87-1. Reliable data are not available beyond 1986 to determine whether minority involvement in franchising has increased. However, Boroian and LaVan's 1990-91 survey found that 38 percent of franchisors reported a higher level of minority involvement than five years ago.

depressed urban locations, which suffer from a poorer economic base, higher rents, higher theft rates, and increased security and insurance costs;

- lack of access to capital, which according to a 1990 Interim Report of the U.S. Commission on Minority Business Development is one of the most formidable stumbling blocks to the creation of minority businesses;

- lack of minority recruitment efforts on the part of franchisors;

- lack of legal expertise on franchising available to minorities entering franchising;

- biased selection criteria (both written and unwritten) used by franchisors to choose franchisees;

- initial and ongoing training that may not be appropriate to the needs of the minority franchisee (e.g., urban-based franchises sometimes face different problems than suburban-based franchises, such as zoning requirements, use of union labor, and securing business licenses); and

- fear of retaliation for support of independent franchisee associations. 23

F. CONCLUSIONS AND IMPLICATIONS

Most franchisors expect franchisees to take an active role in managing franchise units -- recruiting and supervising personnel, overseeing day-to-day operations, and ensuring that quality standards are met. This active, managerial role expected by franchisors is borne out by survey data and our interviews with franchisees. For example, in a recent survey, 85 percent of franchisees indicated that they were actively involved with their franchise units on a day-to-day basis. Both the literature and our interviews closely linked success of franchise units (and growth in franchising, in general) to the motivation, efforts, and managerial skills of franchisees.

Initial and on-going investment requirements mean that prospective franchisees

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must bring more than their own time and energy to franchising -- they also need to bring financial resources and, increasingly, business experience and management skills. While there are some areas of franchising where initial and overall cash outlays for franchisees remain low, in most franchise systems and sectors the ability to purchase a franchise unit is tied to the financial capability of the buyer. Increasingly, as franchise systems (and units) grow in their size and complexity, there appears to be a greater emphasis on the business experience and management skills. Perhaps partially as a result of corporate downsizing, franchisors indicate a growing number of their franchisees come from white collar, professional or management positions.

The role of women and minorities appears to have grown in recent years -- though involvement still lags well below what might be expected based on the general labor force involvement of these two groups. About 10 percent of franchise units are owned solely by women, with an estimated 30 percent owned solely or jointly by women. The level of women ownership of franchises is about the same as the level of women ownership of U.S. firms. Data on minority involvement (from 1982) indicates that about 5.4 percent of franchises are owned by minorities, which is well-below the percentage of minorities within the U.S. population and considerably below general levels of minority ownership of U.S. firms (8.8 percent). Relatively low levels of minority involvement in franchising may indicate that minorities face generally greater obstacles to establishment of franchise ownership (especially with regard to raising capital). This would seem to indicate the need for franchisors to reexamine their efforts to recruit minorities and to providing on-going assistance and support services that better relate to specific needs of minority franchise units.
A major aspect of the franchising relationship which differentiates it from independent businesses and conventional supplier-dealer relationships is the provision of support and technical assistance provided by franchisors. When a franchisee enters into a contractual relationship with a franchisor, he or she is purchasing not only a license (or right) to distribute particular goods and/or services, but also the technical knowledge and experience (i.e., "know-how") of the franchisor. The importance of training programs and technical assistance, particularly within business format franchising, was emphasized by most franchisors and franchisees we interviewed:

*Educational Franchisor.* A franchise provides structure to a business which assists in keeping the business on track. In a business by yourself, you have no frame of reference and no one to talk to about a problem.

*Ice Cream Franchisee.* The most important thing for me was that the franchisor gave me a basis for the business. He helped me with the start-up and then allowed me to run the business. The training and marketing supplies are helpful. I also appreciate the fact that the company negotiates good contracts for supplies.

*Construction Franchisor.* Our operating system is the most important aspect to the franchisee. We developed a complete, computerized management system for the various aspects of operations and numerous procedures for other business aspects. At this point, we have a very sophisticated system. We can have 40 jobs running at once and monitor the whole system.

*Construction Franchisee.* I was attracted to this franchisor by an integrated, computerized management system adapted to the unsophisticated profession of construction. It provides a complete system for estimating, job management, costing and invoicing. I can know where every job is every week. As a result, I can provide good service to my customers and control work efficiently so that the business makes a profit.

Typically, the franchisor has a primary responsibility for the development of a franchise program that includes a range of technical support services intended to ensure
high quality products/services, efficient operations and profitability. The types of technical support provided will often vary by industrial sector and in accordance with whether the franchisee is new to the system or is an existing franchisee:

Franchising Expert. The key assistance franchisors offer depends on the size and maturity of both the franchisee and franchisor. Franchisors offer franchisees different things at the beginning versus at maturity. At the beginning, the franchisee is highly dependent on the franchisor and is buying the business know-how, system, and experience in a given field. As a franchisee becomes established, name recognition becomes an important ongoing benefit and advertising becomes more important.

This chapter focuses on the various types of technical support and assistance provided by franchisors for franchisees.

A. SITE SELECTION AND PREMISE DEVELOPMENT

By contract, most franchisors have the right to approve the franchisee’s store or office location, or have the right to set specific criteria if the location is not settled at the time the franchise agreement is signed. However, many franchisors also help new franchisees by providing a range of site selection and facility planning services, including:

- market surveys, including analysis of the demographics within a region to help find the best possible location for the business;
- lease or purchase negotiations;
- provision of outlet plans and specifications for constructing, furnishing, decorating, and equipping the facility;
- construction assistance or actual building/refurbishing of the facility; and
- assistance in ordering and setting up fixtures and equipment.

According to Boroian and LaVan’s 1990-91 survey of franchisors, about one-third of franchisors (33.5 percent) maintain full-time site assistance staffs. This same survey found that about half (52.7 percent) of franchisors get involved with site selection before
the sale of a franchise unit, by helping franchisees to select their own units or by pre-selecting sites for franchisees. Our interviews with franchise experts, franchisors, and franchisees bore out these survey results:

_Employment Service Franchisor._ We help set up the franchisee's office because the location and design of our offices is very important. Even though we do a lot of selling over the phone, the office cannot be in just any standard office building. The office must be attractive and convenient to nurses. In addition, it must be very secure for women, and it must allow extended hours.

_Ice Cream Franchisor._ We work closely with a number of developers to secure the location in a mall in about 70 percent of the cases, then advertise in a local area for franchisees. In about 30 percent of the cases, franchisees already have a location.

_Ice Cream Franchisee._ I picked this franchise because the franchisor had the number one location in a large regional mall near my home. The franchisor had the expertise in setting up my kiosk originally. When I remodeled, he got the drawings approved by the mall developer quicker than I could have.

_Restaurant Franchisee._ The franchisee cannot totally rely on the franchisor to select the site because the franchisor may have limited information on some of the specifics of the site. The franchisor can give standard demographics, traffic flows and design help very well, but he needs local input. The franchisee has the responsibility to do his homework on the local particulars of the site because it is too expensive for the franchisor to do that in detail. It is a problem if the local franchisee has his heart set on a local site and won't tell the franchisor complete information or look openly and honestly at the site. For example, I remember a local franchisee across the street from a big post office who failed because he neglected to tell the headquarters that the post office had a subsidized cafeteria in the building.

_B. FINANCIAL ASSISTANCE_

Typically, franchisees' own resources provide a significant source of capital for both start-up and on-going maintenance of franchise units. However, some franchisors do provide direct financial assistance or loan guarantees/commitments to lenders on behalf of franchisees. A recent survey of franchisors by Boroian and LaVan, found that slightly over one-third (36.2 percent) of franchisors provide financing for franchisees either directly or through third parties. Franchisees use such support to meet a variety of needs, such as
purchasing equipment, inventory, building, and land. Such financing may also be used to
offset a part of the initial franchise fee or as working capital. Several franchising experts
that we interviewed indicated that direct financial assistance had become somewhat more
difficult to obtain in recent years because of the recession and tightening of lending
requirements by financial institutions:

*Franchising Expert. Some mature franchisors do provide direct help, but most
don’t. Most franchisors have better uses for available funding, such as marketing
which can help many franchisees. Some will finance some real estate or forestall
initial payment, but this is more rare now.*

Other types of direct financial assistance which some franchisors provide include deferral
of part of the initial franchise fee, equipment financing, and credit for purchases of
supplies by the franchisee from the franchisor.

Franchisors may provide financial assistance for franchisees indirectly through loan
guarantees/commitments to lenders. Franchisors may guarantee the entire loan (for its full
term) or only a portion of the loan amount. Alternatively, the franchisor may agree to
purchase inventory or equipment from a franchisee who defaults on a loan. This type of
agreement may be assigned to the lender as security for the loan or assure the lender of a
market for collateral at full value. The franchisor may also agree to operate the unit or
secure a replacement franchisee should the franchisee fail.

Franchisors may provide franchisees with information and assistance on how to
secure financing and complete a loan application. For example, franchisors will sometime
introduce franchisees to prospective sources of financing (e.g., financial institutions, the
SBA, and/or private investors) and provide assistance on development of loan applications.
Franchisors’ assistance in securing financing for the franchisee is still critical to the
franchisee’s success:

*Franchise Expert. It is important for the franchisor to help get adequate financing*
for his franchisee. Some franchisors assist in identifying sources of specific types of lending, such as hard-asset lending. They may prepare standardized fill-in-the-blanks loan application forms that the franchisee can take to lenders or the SBA, or they can provide specific detail which helps lend credibility to a loan request. Other help may involve breaking down total assets into manageable assets to improve the ability to fund.

**Restaurant Franchisor.** We provide $175,000 of financing to qualified franchisees from an outside source of financing in order to support growth of our company.

**Maintenance Franchisor.** We provide up to $10,000 of direct funding to qualified franchisees for five years at 12 percent because most of our franchisees don’t qualify for direct SBA funding.

**Employment Service Franchisor.** We have a very efficient computerized system which allows us to provide 100 percent financing of the temporary payrolls of our franchisees. In order to fund the system, we negotiated a $20 million national credit line. This is a big plus because it allows the franchisee to run his business with much less working capital. Funding temporary payrolls limits the growth of many independent temporary employment service companies.

Among the sources of funding mentioned within the literature on franchising and by franchisors/franchisees that we interviewed were loans available through the SBA, including loan guarantees and direct loans, as well as financial assistance available through the Department of Commerce’s Minority Business Development Agency. According to a recent survey of franchisors, the median number of franchisees using SBA financing was 15 percent. Franchisors and franchisees that we interviewed typically viewed the process of applying for SBA financial assistance as long and arduous. Franchisors were often reluctant to recommend SBA financing because they felt that the application was unlikely to be successful, particularly for new franchisors or for franchise units with few hard assets. Some franchisors and franchisees reported that they had had unsatisfactory contacts with SBA lending sources in the past or they felt that their prospective franchisees were unlikely to meet lending parameters. Franchisees we interviewed were often unaware of specific SBA programs and not inclined to seek more information. Some examples of comments that we received concerning SBA financing follow:
Restaurant Franchisor. I have used SBA help to finance equipment packages and land and buildings in the past, but I don’t use it as much now. The main problem is that dealing with the SBA is difficult and time consuming. The time for a decision from the SBA is eight to ten weeks versus two weeks from a private source. A lot depends on the individual you’re dealing with and on the SBA office policies in the local area.

Educational Franchisor. We’ve found SBA financing to be a long process, maybe six months plus, and none of our prospects have been successful.

Maintenance Franchisor. The SBA publishes nice brochures, but it doesn’t help the average franchisee. It is time-consuming and totally frustrating because of the forms and paperwork. In any case, the SBA doesn’t want a $30,000 investment; they want to find big guys for loans. The SBA should find a way to fund more valid small business opportunities in franchising. For example, it should have ten standard criteria for the borrower and for the franchisor.

Employment Franchisor. It’s the last resort for financing because we want the franchisee to have personal assets and because the paperwork is out of sight. It depends a lot on bank contacts. I can only recall one franchisee who used the SBA and it took six months to get the loan approved.

Maintenance Franchisor. The problem with the SBA program for minorities is that it’s focused on expensive businesses. The need is to target more the qualified middle range of businesses. Franchising is a very appropriate type of business development for minorities because the controlled format deals with many of the problems that minorities and women have. For example, a good strategy for minority business development would be to focus on lower cost franchise investments, not the McDonald’s, where an experimental pool could be set up.

Restaurant Franchisor. In another franchise system, I was introduced to people who could package SBA loans which was a useful way to finance some operations. The keys to SBA loans were: 1) the state of the franchisor corporation—how good it was doing and how long it was around; 2) how well the corporate stores were doing; and 3) the history of the franchisee individually. Unfortunately, I don’t think SBA programs are usable to me now as an early stage franchisor.

Maintenance Franchisee. The SBA approach is too slow. It takes 8 weeks to apply and then you’re unlikely to succeed. I recall seeing a story that of 15 banks certified to do SBA loans in our area, 80 percent of them have never made a loan.

C. INITIAL TRAINING AND OPERATIONS MANUAL

Most franchise systems provide a formal training program for the new franchisees at their corporate headquarters, the franchisee’s unit, an existing unit, or prototype
locations. The duration and content of training sessions varies considerably across franchising sectors and franchise systems. Topics that are frequently covered include:

- specialized technical/trade knowledge;
- general operations;
- management and administration;
- employee recruitment, hiring, and training;
- accounting and bookkeeping;
- planning and projections;
- inventory control and merchandise ordering;
- sales, merchandising, promotion, advertising;
- customer service;
- credit accounts management;
- insurance; and
- legal issues.\(^1\)

Initial training often varies across franchise systems in terms of:

- whether training is mandatory or optional;
- who provides instruction (e.g., corporate staff, consultants or active franchisees);
- who from the franchisee attends (e.g., management, selected employees, or all employees); and
- whether the training is provided in a classroom or on-the-job.

A high quality initial training program has advantages for both the franchisor and the franchisee. The franchisor often finds that an effective training program can help to further evaluate a franchisee’s potential for success and identify likely areas where a

\(^1\)Constance Jones, *220 Best Franchises*, p. 29.
franchisee may need assistance in the future. Training programs can also contribute to
development of a strong long-term relationship with the franchisee, and reduced quality
control and compliance problems. From the perspective of the franchisee, initial training
can be a very effective method for rapidly drawing upon the "know-how" of the
franchisor, thereby increasing the chances of success and profitability. Participation in a
well-planned training effort is generally mentioned by franchisors and franchisees as very
important to a franchisee’s success. In our interviews, franchising experts, franchisors,
and franchisees often stressed the importance of this training:

**Franchise Expert.** Effective training is a major factor in long-term relationships. The
start-up sessions are best as small one-on-one sessions with the franchisee, not
formal training sessions. Excellent training at this time is important since the
franchisor has the complete attention of the franchisee when he is first coming on
board. This enables the franchisor to mold the trainee to his system and way of
thinking, and to instill a feeling of working together for mutual benefit.

**Maintenance Franchisor.** Our training program is called "Right Start" and lasts for
the first six months of franchisee operations. We have an initial orientation and
training program for five days, then we have the franchisee do a detailed marketing
plan and competitive analysis of the market. We have daily contact by phone and
frequent visits for six months. Our main goal is positive cash flow within six
months, and we are about 90 percent successful.

**Restaurant Franchisor.** The training for the owner/franchisee and three managers is
very extensive and important. It goes into a number of things like operations,
scheduling, recipes, etc. In order to cope with the high turnover in the restaurant
business, it is important to show them how to train new employees in a number of
simple tasks. The tasks are simple, but we use videotape and other techniques
because we need them done right to control our quality. One common training
problem is that franchisees often don’t send the next group of managers for training
when the existing managers leave, so the next group doesn’t follow the recipes or
quality control steps properly.

In addition to providing training, a franchisor usually conveys the business structure
and major systems to the franchisee through an operations manual. The manual provides
step-by-step instructions for operations, and the administrative policies and procedures of
the business. Some of the topics typically covered include company background and
personnel, general operating rules, unit/store operations (including pricing considerations, job descriptions, and opening/closing hours and procedures), management responsibilities, sales operations, inventory control, and maintenance controls.

Franchise Expert. The franchisor needs to provide a thoroughly done operations manual which is customized to the business. It must be based on a completely tested and reliable operating system. It can be a problem if the franchisor has franchised too early with an unsophisticated system.

The operating manual may change over time to incorporate improvements and to provide a clear definition of all the major functions involved in opening and operating the franchise successfully.²

D. PRE-OPENING AND OPENING SUPPORT

Franchisors customarily provide substantial pre-opening assistance for new franchisees, including sending training personnel or field representatives to the franchisee's location to provide "grand opening" support. A variety of types of support may be provided during the period leading up to the grand opening, including:

- assistance in hiring and training employees;
- help with ordering inventory, materials, and supplies;
- assistance with grand opening advertising and promotions; and
- if applicable, provision of a company representative to assist with the first few sales calls.

While the need for "grand opening" assistance varies across franchising sectors, many of the franchisors and franchisees we interviewed felt such assistance was important in creating the best possible impression with customers and ensuring that appropriate

²Rick Rounsborg and Robert T. Justis, Basics of Franchising, University of Nebraska-Lincoln International Center for Franchise Studies, 1984, pp. 53-54.

6-9
expenditures are made during the early stages of a new franchise:

Franchise Expert. The key aspect of assistance to the franchisee is what the franchisor provides initially in the first 90 days. The franchisee must get all the ingredients needed to launch the business successfully. Franchisees need help right at the start and the "upfront" program must be strong enough. Over time, the franchise relationship grows and the franchisee moves from total dependence to more independence and the franchisor needs to develop new programs and products.

Employment Service Franchisor. We get out to the franchisee’s locations and make some initial sales calls with them. We want to build their confidence and make sure they have proper technique. We also bring along standard marketing materials that the franchisee can use.

E. ONGOING OPERATIONAL ASSISTANCE AND TRAINING

Ongoing operational assistance and refresher training is viewed as a very important responsibility of the franchisor in most franchising systems. Such assistance is used to both monitor and enhance the performance of franchise units. For example, there is particular concern among restaurant franchise systems over the quality control and uniformity of food service operations. If a customer has a poor quality meal or is dissatisfied with service at a franchise outlet, he or she does not tend to blame the individual outlet, but rather tends to view the entire franchise system negatively. Hence, within franchise systems, both franchisors and franchisees are typically very concerned about maintaining a high standard of quality in all outlets.

Franchise Expert. There is a trick to a franchise system’s long-term survival. The franchisee’s appreciation will normally decline if franchisor doesn’t keep up a level of ongoing support and maintain the value of the trademark and image of the system. The franchisor must continue to support the franchisee and his success through monitoring operations, quality control, providing refresher training, upgrading systems, conducting research and development, and facilitating networking. It should be a win-win situation if done right. Problems come when either the franchisor or franchisee attempt to get too much for too little.

By using site visits by field representatives, frequent telephone contact, regional meetings, and newsletters, franchisors are able to provide continuous support and
maintain effective communications with franchisees. Technical support and frequent interaction also help to ensure quality control and to improve the operation and profitability of franchises. Among the types of ongoing operational support that are often provided by franchisors are the following:

- regular visits from company representatives;
- technical support staff available by phone;
- revisions to the operations manual;
- a company newsletter, bulletins, and updates to the operational manual;
- accounting systems and bookkeeping materials or bookkeeping services;
- merchandise, materials, and/or supplies;
- a line of credit for purchases;
- inspection of suppliers for quality;
- quality control inspection of franchisee operations; and
- provision of tax preparation assistance, insurance plans, legal advice, and other types of specialty services.³

Some views about ongoing franchisor assistance from the perspectives of franchisors and franchisees follow:

Employment Services Franchisor. We give continual field support, especially specialized clinical support by registered nurses who evaluate difficult cases for the franchisees and help to maintain quality throughout the system. Health care is a highly regulated field with many government policies and procedures. We help our franchisees stay current through operational/business support, regular meetings, and a newsletter.

Maintenance Franchisor. Proper support is a key to success. We try to give two years of concentrated support, then wean franchisees away. We help to focus the franchisee’s effort with short-term (monthly, weekly) targets.

Maintenance Franchisee. Over my year and a half as a franchisee, the support from

³Constance Jones, op. cit., p. 30.
my franchisor has been good. A field representative visits me every six weeks and is like a business consultant on many topics. In addition, I get technical information from the company and I can call the corporate office on an 800 number for any problems I can't handle. The franchisor gets a 10 percent royalty, but their support justifies it since they have done a lot more to date than they have got from me in royalties. Before a franchisee fails, the franchisor tries to help him out.

Restaurant Franchisee. Franchisors understand quality control. I want my employees to follow the system closely and the franchisor's visits help with another set of eyes. And I want strict quality controls over other franchisees because I want them to follow the system too. It is especially important to hold new franchisees feet to the fire on quality.

Restaurant Franchisee. The franchisor helps us keep up with federal regulations and with what's happening nationally. For example, we recently had a seminar on what restaurants must do to comply with the new disability act.

As part of their ongoing supervision of franchisees, many franchisors conduct analysis of each franchisee's accounting, bookkeeping, control systems, and marketing data to give their franchisees a better perspective on their business operations and to attempt to anticipate problem franchises:

Ice Cream Franchisor. We act as a business advisor to our franchisees. We review profit/loss statements and help them to set long-term financial goals for their franchise. Strong operational controls allow the franchisee to run a tight ship. Our approach is to follow the franchisee closely for 12 to 18 months to develop good management practices and good cooperation with us. We focus on areas specifically within management control, like purchasing. We also provide the franchisee with detailed analysis to show costs and try to motivate and convince franchisees to improve businesses. For example, I recently visited a mom-and-pop franchisee in Georgia who were not providing a monthly profit/loss statement to the subfranchisor. To get them to do what was required by contract, I used some information from other franchisees to convince them of the value of financial statements to tell the financial picture. The franchisee needs to know if there is a financial hole, and how deep it is. If he is profitable, he needs to know whether there is a way to make more money, or what his financial goals should be.

Maintenance Franchisor. One of the biggest reasons to be a franchisee is the information and help of the franchisor. The most important ongoing thing we do for the franchisees is to monitor the business weekly on seven critical items (like number of estimates, price per job, turnover of customers and employees, etc). Our management tracking system of all the franchisees gives us a comparative perspective on performance which allows us to spot problems early and give help.

Franchisors and franchisees we interviewed stressed the importance of an effective
network of field representatives to work with franchisee units. Franchisors indicated that field representatives could typically handle about 25-30 units, though this depended upon size of the unit, type of franchise, and geographic location. Typically, such representatives visited a unit about every two weeks immediately after opening. Once established, the time between visits lengthen to perhaps two-to-five visits per year. The field representatives, who act as an intermediary between the franchisor and franchisee, must be well-versed in franchise unit operations. While on-site, the representative will often play several roles -- quality control inspector, trainer, and general business consultant. Many franchisors supplement field assistance with a special technical assistance "hotline," available to the franchisee through a toll-free telephone number.

Franchisors also may provide periodic refresher training for franchisees, as well as conduct national conventions, regional meetings, periodic seminars, or workshops. For example, regional group meetings may be used by franchisors as a forum for distributing new operational, technical, and marketing information, and to provide updates on regulatory issues.

F. ADVERTISING AND MARKETING

Franchisors play a critical role in the development of advertising and marketing campaigns for their franchise units. Because of their experience and the advantage of combined funds, franchisors are able to provide advertising on a scale and with a professionalism that the individual franchisee could not duplicate. Using advertising fees collected from franchisees to defray (wholly or partly) the costs of advertising and marketing, the franchisor is able to give the franchisee an identity which helps it compete with independents in the same industry. Advertising is often used as a vehicle to promote
a franchisee's logo or trademark. Certain uniform features of franchises make them particularly suitable to national advertisement, such as standardization of a franchise system's appearance, layout, color, materials, decor, fixtures, signs, uniforms, typestyles, and packaging. In addition, the franchisor is able to provide the franchisee with proven marketing materials and methods during the critical start-up phase. Our interviews with franchise experts, franchisors and franchisees highlighted the important role that franchisors play in the area of advertising and marketing:

**Ice Cream Franchisor.** Helping the franchisee develop strong local advertising and marketing to promote his store is very important to our franchise because of the number of locations we have in small towns. We provide materials and training to improve the local store's marketing. We work to improve the franchisee's sophistication and understanding of things like ad placement and the value of community involvement to build sales.

**Restaurant Franchisee.** It is a big mistake for the franchisee to depend on the franchisor to do all the marketing and advertising. Each franchisee needs to develop an all-out marketing strategy. The advertising share spent in each local market is too small to have a big impact unless the local units group together to finance more advertising. There are also local promotions that each store must do in their neighborhood which cannot be expected from the franchisor.

**Educational Franchisor.** We support the franchisee in marketing the services on several levels. We show the franchisee how to use some data base programs and other sources to identify day-care professionals and give them introductions and entre through our contacts. We also market to parents and to kids through magazines and public relations. We help franchisees find ways to expand their market through community outreach programs in stores, churches, and community centers.

**Construction Franchisee.** The franchisees in our systems agreed to cooperatively fund and develop a national marketing program five years ago. It's a leading edge program to work with major companies in our industry. It is just now beginning to show results and we're starting to get referrals and contracts.

**Employment Service Franchisor.** We help our franchisees with marketing by developing relationships with national accounts which they can use when they contact the local offices of these companies. The fact that our company is used in another city is very helpful in establishing credibility and rapport.

The advertising and marketing strategies employed by franchisors vary
considerably. A variety of media may be used, including television, radio, magazines, newspapers, direct mail, and outdoor advertising. Advertising campaigns may be mounted nationally, regionally, or locally. Franchisors also typically provide a variety of promotional materials for local use, including brochures, point-of-sale materials, radio spots, and local newspaper and telephone book advertisements. They may also conduct extensive marketing research for franchisees and make telemarketing data bases available to franchise units.

Advertising can be a source of friction between franchisors and franchisees because advertising generally involves substantial expenditures and subjective judgements concerning advertisement themes, timing, and placement. Moreover, it is often difficult and expensive to develop advertising programs which can effectively reach consumers within all markets or to develop marketing materials usable by all franchisees. To overcome this problem, franchisors often establish advertising councils composed of franchisees who review advertising materials and strategies.

G. PURCHASE OF SUPPLIES

Franchisors may play an important role in purchasing and/or providing supplies for franchisees. In some cases, the franchisors sell or lease patented equipment to the franchisees. As discussed in greater detail in Chapter 4, there is considerable variation in the types of products and supplies by franchisors to franchisees. In addition to the direct sales of products and services by franchisors, franchisors exercise substantial influence over the type, quantity, and quality of other items purchased through approved supplier lists, cooperative purchasing councils, and nationally-negotiated arrangements with suppliers. For example, franchisors will sometimes assist franchisees by arranging group
purchasing of supplies and services. In addition, franchisors can control products or services purchased by the franchisee through strict quality control standards.

Franchisors we interviewed indicated that the major motivation of providing supplies and equipment was as a service and convenience to franchisees, and to ensure quality and uniformity of operation, rather than to make money from the sales. Whatever the motivation, franchising experts, franchisors, and franchisees we interviewed agreed on the importance of franchisors assisting franchisees to purchase/lease supplies and/or equipment:

**Franchise Expert.** Franchisors can help identify good sources of supply for numerous items. It can be very helpful for the franchisee to know how to get the best deal on cars or insurance, for example, or how to get proper service on equipment.

**Restaurant Franchisor.** We directly provide some proprietary items such as batters, spices, and seasonings, but for most supplies, we provide quality control specifications, and have three approved national suppliers for most goods. For example, we have three approved cash registers. We also may negotiate a special group price for things like french fries and all franchisees may take advantage.

**Ice Cream Franchisee.** The franchisor helped me with my equipment replacement by contacting the best suppliers, doing paperwork for a new machine, and finding a buyer for my used machine. The franchisor has more experience on the best suppliers and knows who to contact and who has the best prices. It’s time-consuming and difficult for the individual franchisee to know what company to pick because we don’t do it much. The purchase of other supplies, except for imprinted goods, is voluntary. However, we end up buying about 80 percent of our supplies from the subfranchisor because the prices are very competitive.

**Maintenance Franchisee.** I leased some equipment from the franchisor and bought another piece of patented equipment and the prices seemed competitive and fair to me. Since the equipment is kind of expensive, I did a lot of research to find cheaper equipment and tested a number of other machines, but I didn’t find a better one. The other things I buy from the franchisor are usually small things or customized items. I can buy general supplies from other sources, but usually the franchisor is helpful. I buy the mailing brochures prepared by the franchisor directly from the printing company.

**Maintenance Franchisee.** I’m not required to buy anything significant from the franchisor, other than a few unique items like uniforms, fliers and special business forms. The prices are reasonable. One thing that turned me off about another
Franchisor was the requirement to buy a number of things from the franchisor that I thought were overpriced.

Franchisors can also assist franchisees in purchasing more tangential services, such as employee assistance programs:

**Employment Service Franchisor.** We help our franchisees with special programs like drug screening and employee bonding and provide combined benefits like group medical and dental insurance.

**Restaurant Franchisee.** As a franchisee, we have many special advantages over an independent restaurant with our vendors which results in lower costs. For example, we now have a special insurance program for franchisees with Nationwide Insurance.

H. RESEARCH AND DEVELOPMENT

An important advantage of franchising from the perspective of the franchisee is the franchisor’s capacity for research and development. The franchisor’s greater resources and broader viewpoint over the marketplace enable the system to cope with changes in consumer tastes, pricing of supplies and equipment technology. This advantage in the area of research and development was frequently mentioned in our interviews:

**Franchise Expert.** One advantage to franchising is that the quality of products and services can be systematically improved because the franchisor has better market research on trends and can hire better experts to refine improvements. For example, a lot of research goes into menu improvements in restaurant franchises. The ongoing supervision process provides a way for the franchisor to give the franchisee the benefit of knowledge gained from other franchisees. Many franchisees can contribute detailed experience to franchisors so that the franchisor can provide information on operations that an individual guy can’t duplicate.

**Maintenance Franchisee.** We have trained agronomist to look at research and handle technical questions over the 1-800 number. We also have a shop at headquarters which does research for the system. It does experimentation and testing of new equipment and materials.

**Ice Cream Franchisor.** The franchisor has the expertise needed to implement changes in consumer attitudes and to develop new products, programs and concepts. A research and development capability is needed to look into all phases of a program, product or concept, and to get the answers to put it all together. It
requires more than just a product idea like adding chocolate chips; to be successful, the franchisor has to plan the right equipment, suppliers, marketing, and promotion.

Ice Cream Franchisee. I have been a test store when the franchisor has tried new things and tested programs to improve the system. For example, as a result of our test marketing, I now get 25 percent of my revenues from breakfast rolls and coffee which is surprising for an ice cream store.

Restaurant Franchisee. The franchisor has a good research and development capability that serves the entire system. For example, he has fish and food laboratories for studying new products. In addition, because he sees a number of operations, he is able to design more efficient buildings and equipment.

I. CONCLUSIONS AND IMPLICATIONS

A major aspect of the franchising relationship which differentiates it from independent businesses is the provision of support and technical assistance by franchisors for franchisees. Franchisor knowledge and experience is conveyed to the franchisee through a variety of methods, including:

- site selection and premise development,
- financial assistance,
- initial training,
- pre-opening and opening support,
- ongoing operational assistance and training,
- advertising and marketing,
- purchase of supplies, and
- research and development.

Technical assistance and support services are intended to ensure high quality products/services, efficient operations, and profitability. Franchisor efforts are particularly concentrated in the period preceding start-up, but evolve and continue over the life of the franchising relationship. As discussed in greater detail in Chapter 8, recent survey data (as
well as our interviews) suggest that most franchisees are satisfied with the types of technical support and assistance that they receive from franchisors. One area of concern identified in our interviews related to the difficulty that franchisees had in securing SBA loans.
CHAPTER 7: 
SOLICITATION AND SALE OF FRANCHISES

This chapter focuses on the solicitation and sales process within franchising. This chapter begins with an overview of the solicitation and sales process from the perspectives of the franchisor and franchisee. It examines the existing legal and regulatory framework which governs the solicitation and sales process, considering both federal and state regulations. It then considers the solicitation and sales process from the perspectives of the franchisor and franchisee. The chapter concludes with an assessment of franchise sales regulation and how the overall process that might be enhanced to ensure that prospective franchisees are well-informed, to reduce burden and costs of regulation, and to further the overall growth of franchising in the U.S.¹

A. BACKGROUND ON THE SOLICITATION/SALES PROCESS

1. The Franchisor Perspective

The development of a business from a proven concept through to the sale of its first franchise is typically a long, expensive, and risky process for the franchisor.² Even excluding the costs of direct management involvement, the franchisor bears sizeable "upfront" costs for developing a program before it can be marketed to franchisees:

Initial franchise development costs can vary from a low of approximately $50,000 for a very modest franchise expansion program in nonregulatory states to well over $500,000 for an aggressive, national campaign utilizing extensive outside services

¹In Chapter 8, the focus shifts to issues surrounding the maintenance and regulation of franchising relationships.

²See, for example, Axelrad and Rudnick, op. cit., or Andrew J. Sherman, Franchising and Licensing, American Management Association, 1991, p. 81.
and marketing materials.³

Once the franchisor has developed a proven concept, financed a franchise program, and prepared a franchise offering to meet relevant government regulations, the franchisor begins the sales process by creating leads for prospective franchisees. Boroian and LaVan provide an overview of the basic sales process:

The call is taken by the Director of Franchising (in small organizations this may often be the President), and financial qualifications are briefly stated before sending a letter and the franchise brochure. Follow-up calls are then made. Prospects who are interested are scheduled for personal meetings even if they have not sent a formal application (which usually includes financial information). Prospects pay their own travel expenses. Personal meetings are conducted at franchise headquarters, and the offering circular is presented at the end. Leads that do not schedule personal meetings after two to three calls are filed "dead" but contacted again about six months later.⁴

Because franchisors differ in the type of franchisee sought, and often find it difficult to develop an exact profile, there is a lack of consensus among franchisors on the best method to generate qualified leads:

**Employment Service Franchisor.** Our best source of prospects is referrals from existing offices. Prospects see franchisees who are successful and thriving. We encourage referrals by having internal promotions and prizes. Our reputation is growing so we're having more interest by word-of-mouth. We've also used some ads and shows, although the shows are more just for national exposure.

**Construction Franchisor.** We get 80 to 90 percent of our franchisees from advertisements which are run in the Wall Street Journal by our franchise broker. About 10 to 20 percent of our franchisees come from referrals by existing franchisees.

**Ice Cream Franchisor.** We generally find franchisees through business opportunity ads in local papers. We work closely with a number of mall developers and we find the location about 70 percent of time. We have tried psychological profiles but successful franchisees have diverse characteristics and the profile didn't work well.

However, as shown in Exhibit 7-1, most franchisors regard advertising (especially through

³Axelrad and Rudnick, op. cit., p. 57.

⁴Boroian and LaVan, Franchise Marketing and Sales Survey, 1990-91, op. cit., p. 32.
### EXHIBIT 7-1: METHODS FRANCHISORS USE TO GENERATE LEADS

**MOST EFFECTIVE LEAD GENERATION SOURCES ACCORDING TO FRANCHISORS:**

<table>
<thead>
<tr>
<th>LEAD GENERATION SOURCE</th>
<th>MOST EFFECTIVE LEAD SOURCE ( % OF RESPONDENTS )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising (Print, Radio, TV)</td>
<td>38%</td>
</tr>
<tr>
<td>Word-of-Mouth</td>
<td>32%</td>
</tr>
<tr>
<td>Public Relations</td>
<td>9%</td>
</tr>
<tr>
<td>Trade Shows</td>
<td>6%</td>
</tr>
<tr>
<td>Direct Mail</td>
<td>4%</td>
</tr>
<tr>
<td>Sales Seminar</td>
<td>2%</td>
</tr>
<tr>
<td>Other</td>
<td>10%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>100%</td>
</tr>
</tbody>
</table>

**SPECIFIC METHODS OF GENERATING SALES LEADS USED BY FRANCHISORS:**

<table>
<thead>
<tr>
<th>METHOD OF LEAD GENERATION</th>
<th>PERCENT OF RESPONDENTS WHO HAVE USED METHOD IN PAST</th>
<th>PERCENT OF RESPONDENTS WHO USE METHOD NOW OR REGULARLY</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRINT MEDIA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large Metro Papers</td>
<td>60.0</td>
<td>22.3</td>
</tr>
<tr>
<td>Entrepreneur</td>
<td>49.1</td>
<td>20.0</td>
</tr>
<tr>
<td>Small City Papers</td>
<td>41.5</td>
<td>16.6</td>
</tr>
<tr>
<td>Franchise Opportunities</td>
<td>39.6</td>
<td>12.8</td>
</tr>
<tr>
<td>Franchise Directories</td>
<td>30.2</td>
<td>11.3</td>
</tr>
<tr>
<td>Trade Journals</td>
<td>26.8</td>
<td>9.8</td>
</tr>
<tr>
<td>USA Today</td>
<td>23.8</td>
<td>4.2</td>
</tr>
<tr>
<td>Wall Street Journal</td>
<td>21.5</td>
<td>6.0</td>
</tr>
<tr>
<td>OTHER SALES METHODS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Toll Free 1-800 Number</td>
<td>54.7</td>
<td>47.9</td>
</tr>
<tr>
<td>Franchise Brokers</td>
<td>50.4</td>
<td>21.0</td>
</tr>
<tr>
<td>Videos</td>
<td>43.8</td>
<td>-</td>
</tr>
<tr>
<td>Public Relations Agency</td>
<td>27.2</td>
<td>-</td>
</tr>
<tr>
<td>Franchise Advertising Agency</td>
<td>22.3</td>
<td>-</td>
</tr>
<tr>
<td>Sales Seminars</td>
<td>22.3</td>
<td>-</td>
</tr>
</tbody>
</table>

print media) and referral through word-of-mouth (especially by existing franchisees) as the most effective methods.

As shown in Exhibit 7-2, the typical sales process requires several phone contacts and personal meetings which take place over more than two months. According to franchisors, only about 1 in 10 "leads" result in personal meetings. While franchisors use financial criteria and personal profiles as franchisee screening mechanisms, franchisors we interviewed indicated that much of the identification and evaluation of prospects depends upon intuitive or subjective judgements. Success in selling franchise units depends on a number of factors. Boroian and LaVan, in their franchisor survey, found that franchisors who were most successful in selling franchise units:

• tended to be small- to medium-sized companies ($11 to 25 million in sales) who were more attentive to the details of recruitment and more willing to upgrade sales and marketing efforts;
• were willing to pay for qualified leads;
• likely to use direct mail and specialized lead-generation media;
• likely to use sophisticated techniques such as earnings claims and psychological tests;
• more apt to test marketing data; and
• more likely to offer multiple units.⁵

For most franchisors, the process of recruiting franchisees is expensive and time-consuming. The marketing costs for franchises are the heaviest burden for smaller franchisors who have fewer franchises each year over which to spread the costs. As shown in Exhibit 7-3, the estimated mean cost to sell a franchise unit (according to a recent survey of franchisors) was $7,825.

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⁵Boroian and LaVan, op. cit., Tables 37 and 38, pp. 38-39.
### EXHIBIT 7-2: NUMBER OF DAYS AND MEETINGS INVOLVED IN SALES

<table>
<thead>
<tr>
<th>Days from Lead to Personal Meeting (Median)</th>
<th>32.5 Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Phone Calls Needed to Set Up Personal Meetings (Median)</td>
<td>2.0 Calls</td>
</tr>
<tr>
<td>Percent of Leads Which Result in Personal Meetings (Median)</td>
<td>10.0%</td>
</tr>
<tr>
<td>Days from Personal Meeting to Sale (Median)</td>
<td>30 Days</td>
</tr>
<tr>
<td>NUMBER OF PERSONAL MEETINGS NEEDED TO CLOSE THE SALE</td>
<td>Percent of Respondents</td>
</tr>
<tr>
<td>One Meeting</td>
<td>21.5%</td>
</tr>
<tr>
<td>Two Meetings</td>
<td>29.3%</td>
</tr>
<tr>
<td>Three Meetings</td>
<td>27.7%</td>
</tr>
<tr>
<td>Four Meetings</td>
<td>21.5%</td>
</tr>
</tbody>
</table>

Source: Boroian, Patrick J. & Helen LaVan, *Franchise Marketing and Sales Survey, 1990-91*, published by Francorp and DePaul University, Table 30, p. 32.

### EXHIBIT 7-3: COSTS OF RECRUITING FRANCHISEES

<table>
<thead>
<tr>
<th>AVERAGE COST-SELECTED ITEMS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Printing Franchise Brochure (Median)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Producing Videotape (Mean)</td>
<td>13,998</td>
</tr>
<tr>
<td>TOTAL (ESTIMATED) COST</td>
<td></td>
</tr>
<tr>
<td>Total Cost to Sell Franchise (Mean)</td>
<td>7,825</td>
</tr>
<tr>
<td>Total Cost to Sell Franchise (Median)</td>
<td>5,000</td>
</tr>
<tr>
<td>RANGE OF ESTIMATED TOTAL COST TO SELL FRANCHISE (Including media and salesperson’s compensation)</td>
<td></td>
</tr>
<tr>
<td>$2,000 or less</td>
<td>24.0%</td>
</tr>
<tr>
<td>$2,001 - $5,000</td>
<td>31.1</td>
</tr>
<tr>
<td>$5,001 - $10,000</td>
<td>25.7</td>
</tr>
<tr>
<td>Over $10,000</td>
<td>19.2</td>
</tr>
</tbody>
</table>

Source: Boroian, Patrick J. & Helen LaVan, *Franchise Marketing and Sales Survey, 1990-91*, published by Francorp and DePaul University, Tables 26, 28, and 32, pp. 29-30 and 34.
2. The Franchisee Perspective

For the franchisee, the process of investigating various franchise opportunities can vary from an impulsive decision (involving little planning or evaluation of the franchise system) to a lengthy and systematic evaluation of the franchising system with the assistance of several professional advisers. Much depends on the personal style and business experience of the prospective franchisee, as well as the complexity of the franchise system.

The literature on franchising, as well as our interviews with experts on franchising, placed considerable stress on the importance of prospective franchisees using professional advisors (such as attorneys and accountants) to assist in the process of evaluating the franchise disclosure document. Several franchisors we interviewed indicated that they encourage franchisees to consult with attorneys and other advisors because they wanted the franchisee to understand the mutual obligations and develop realistic expectations about the franchise relationship. However, most franchising experts and franchisees that we interviewed indicated that prospective franchisees are often reluctant to use professional advisors to evaluate franchise offerings because of the cost and/or difficulty of identifying an attorney with expertise in the area of franchising. Several franchisees felt that the disclosure provided sufficient information and that they were able to review the disclosure statement well enough on their own and compare it to other offerings. Some franchisees that used an attorney or accountant did not feel that legal and accounting reviews were especially helpful because the terms in the franchise agreement were not negotiable. Exhibit 7-4 presents some views of franchising experts and franchisees that we interviewed regarding the use of attorneys and accountants during the solicitation and sales process.
EXHIBIT 7-4: VIEWS ON THE ROLE AND CONTRIBUTION OF ATTORNEYS/ACCOUNTANTS DURING THE SOLICITATION AND SALES PROCESS

Franchising Expert. It is important for the franchisee to get an attorney who has experience in franchising. A franchisee must ask how many franchise systems the attorney has worked with, not just take the answer at face value. An attorney is there mostly to help the franchisee understand the contract, not to negotiate the contract. Franchisors generally have standard system-wide provisions which they are reluctant to modify. The attorney's role is simply to read the document, meet with his client and explain it, not to propose extensive revisions. The cost should be under $1000. A local attorney may actually be counterproductive if he raises inexperienced questions.

Franchising Expert. Franchisees should not rush into a business opportunity without evaluating the franchisor's financial strength or their own personal interest in the franchise field. Franchisees should budget $1,000 to $3,000 to have an attorney review the offering document. If they don't know a good franchise attorney, they should ask their personal attorney to find an attorney qualified and experienced in franchise law.

Construction Franchisee. It was not easy to find a good franchise attorney. Franchise law is a relatively new field with little case law. It is a specialty with a handful of real experts nationally and most local attorneys don't really have any expertise in area. However, many attorneys are willing to say they're "experts" in anything you pay them for.

Construction Franchisee. My lawyer and accountant looked over the documents and looked at the company's background. The attorney said that the steady growth in the franchisor was a good factor. He explained that the terms in franchise agreement were in favor of the franchisor, but that this was the same in every franchise agreement. He recommended that I call several franchisees listed in the disclosure document for their opinion, so I called up 9 or 10 franchisees who had nothing negative to say about the company.

Construction Franchisee. The attorney hardly did anything for me because I had a lot of experience with franchise agreements and I could interpret the major items. I found that lawyers have a narrow point of view on franchise agreements because they are focused on looking for potential problems. The real help that an experienced franchise lawyer provides is not so much in identifying the potential problems in the agreement, but evaluating the likelihood that the problems will occur based on his experience.

Restaurant Service Franchisee. The legal documents given to you could choke a horse. In most cases, a legal evaluation usually just summarizes limits and the franchisor's controls, but it is not too helpful in understanding how the franchise really works.

Restaurant Service Franchisee. The accountant should work with the franchisee to help him analyze and understand the numbers, whether or not there is an earnings claim. The basic questions are to determine the time needed to turn a positive cash flow and to see if there is enough potential on bottom line quick enough. The average franchisee doesn't understand all of the aspects of financial planning and may underestimate working capital requirements.

Construction Franchisee. My accountant was more helpful than my attorney. He helped me put together figures to analyze my personal and business expenses, and to do proforma projections of the business. My accountant had relevant experience based on other similar businesses in construction and I found that he could give honest and useful advice, and ask pertinent questions.

Restaurant Franchisee. Accountants are conservative by nature. This can be a good offset to an optimistic person, but the value of their evaluations is limited.
In contrast to mixed comments about the value of legal and accounting advice, most franchisees, franchisors, and experts agree and strongly recommend that franchisees interview other franchise owners before purchasing a franchise unit. They stress that there is much to be learned from the experiences of other franchise owners:

**Franchising Expert.** The most important thing for a franchisee to do is to talk to other franchisees. Face-to-face contact is essential, so a franchisee should visit in-person to evaluate the franchise, and to compare their life experience and situation. The point is to evaluate your own beliefs, determine what your goals are and what makes you happy in a business, and then to compare this to other franchisees. For example, the restaurant business takes long hours and the franchisee has to decide if this is OK for him.

Such interviews, which can be conducted over the phone or (if possible) in-person, can provide the types of background information and "real-life experiences" that help prospective franchisees to determine if a franchising opportunity is well-suited and likely to meet their expectations:

**Maintenance Franchisee.** I didn’t use an attorney or accountant, but I talked to a lot of franchisees both in-person and over the phone. I tried to get communities like my hometown so that their experience was relevant to my situation. The franchisees were 99 percent positive about the franchisor. I saw several franchisees in person in order to ask if they had any negatives about the franchisor. I also talked to some ex-franchisees and franchisees in other chains. The ex-franchisees seemed to be people who didn’t follow the program or wanted to do things differently or their own way.

Interviews with existing (and former) franchisees can also be helpful in identifying potential problems (both during start-up and over the long-term) and ways in which franchisees have overcome such problems. Virtually all of the franchisees and experts we interviewed felt that it was vital for prospective franchisees to conduct a series of interviews with existing franchisees prior to purchasing a franchise unit.
B. EXISTING LEGAL/REGULATORY FRAMEWORK GOVERNING FRANCHISE SOLICITATION/SALES

Both federal and state governments regulate the offering and sale of franchises. The main thrust of these federal and state laws is to ensure a complete and honest disclosure of information during the sales process. Below, we discuss how federal and state regulations structure the solicitation and sales process.

1. Federal Regulation

Since the 1960s, federal regulation of franchising has been principally focused on solicitation and sale of franchises. Two factors have encouraged this emphasis:

- First, there is no federal statute broadly authorizing federal intervention into the ongoing relationship between franchisors and franchisees. The two federal statutes that specifically address franchise arrangements have been narrowly defined to address the legal standing of automobile franchisees and to prevent arbitrary termination of gasoline franchises.

- Second, the most serious and widespread abuses in franchising during the 1960s and early 1970s were found to be occurring prior to the initiation of franchise agreements. The most common types of abuses involved misrepresentation or failure to disclose material facts relevant to the true nature or value of a franchise, and use of unsubstantiated earnings claims or deceptive earning representations.

As a result, federal regulation of franchising focuses on the responsibility of the franchisor to disclose specific information during the solicitation and sales process, and the format of that disclosure.

In 1979, in response to perceived "informational imbalances" between the franchisor and prospective franchisee during the offering of franchise units, the FTC issued the Trade Regulation Rule on Franchising and Business Opportunity Ventures (16 CFR 436.1). This rule, which established regulatory procedures governing pre-sale disclosure of information (i.e., "material facts") by franchisors, provided the basis for federal
authority to regulate franchise sales -- and continues to do so today.

For purposes of the FTC rule, franchises are defined as commercial relationships where:

- the goods or services are identified by a trademark or other commercial symbol,
- the seller gives significant assistance or exercises control over the business operation, and
- there is a payment of $500 or more payable within six months.

The rule does not cover pure product distribution arrangements where the purchaser only buys goods at bona fide wholesale prices for resale and also specifies certain other exemptions from coverage. The intent of the rule is two-fold:

- to make sure the prospective buyer receives the information needed to make an informed decision about whether to invest in a franchise unit, and
- to discourage high pressure sales tactics and provide a "cooling-off" time before documents are signed.

The FTC rule requires disclosure of specified categories of information to prospective franchisees during the solicitation and sales process. It also specifies a format for disclosure -- though subsequently, the FTC permitted optional use of the 1986 Uniform Franchise Offering Circular (UFOC) format. Exhibit 7-5 displays the major categories of information covered under the disclosure requirements for franchisors (and their predecessor companies). Information contained in the Offering Circular must be updated annually, or quarterly in the event of any material changes (e.g., changes in the

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7The UFOC was originally developed by Midwest Security Commissioners Association in 1975 and subsequently modified by the North American Securities Administrators Association. Since the FTC format and the UFOC are similar, and numerous states require the UFOC with the states' own modifications, most franchisors have come to use the UFOC format rather than the FTC format for disclosure.
EXHIBIT 7-5: MAJOR CATEGORIES OF DISCLOSURE INFORMATION THAT MUST BE PROVIDED BY FRANCHISORS

1) a description of the franchisor and the franchised business;
2) the background of management personnel;
3) any litigation or bankruptcies by the franchisor or management personnel;
4) fees paid by the franchisee;
5) the investment required in the franchised business;
6) any restrictions on the franchisee’s sources of supply;
7) financing offered by the franchisor;
8) the obligations of the franchisor to supervise and assist the franchisee;
9) the territorial protection of and restrictions on the franchisee;
10) the status of trade and service marks to be used by the franchisee;
11) the obligations of the franchisee to operate the franchised business;
12) the restrictions on goods and services offered by the franchisee;
13) the terms and conditions of termination, renewal, and transfer of the franchise;
14) the rights and obligations of the franchisee upon termination and non-renewal of the franchise;
15) the earnings claims made to prospective franchisees;
16) information about franchises open and operating, terminated, not renewed and re-acquired by the franchisor;
17) audited financial statements; and
18) copies of contracts to be signed by the franchisee.
franchisor's business, terms of sale, or obligations of the franchisee). The franchisor is not required to provide specific information on sales, income, and earnings by specific franchisees, but the regulation prescribes the format to be used if earnings claims are made. Disclosure of earnings claims must be supported by substantiating material that is available for review by the franchisee.8

The FTC rule deals only with full disclosure and does not regulate the terms of the franchise agreement. The rule does not require the franchisor to file disclosure documents with the FTC, nor does it commit the agency to review the disclosure documents prepared by the franchisor. Timely delivery of disclosure documents to appropriate parties is all that is required under the FTC rule.9 For example, the delivery of documents is required at the first personal meeting to discuss the sale of a franchise or 10 business days before execution of a sale or payment.10

The rule gives the FTC the power to take enforcement action against franchisors for providing incorrect or misleading information to prospective franchisees. Failure to comply with the rule may result in an FTC action for injunction, a cease and desist order, monetary damages, and civil penalties. There is no federal private right of action available to an individual for a violation of the FTC rule. The FTC's principal approach to rule enforcement from 1979 to 1987 was to monitor compliance and encourage franchisors to correct potential violations; after 1987, more enforcement actions were taken by the FTC against potential violations by franchisors.11

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8Axelrad and Rudnick, op. cit., p. 69.

9Axelrad and Rudnick, op. cit., p. 68.

10Andrew J. Sherman, op. cit., p. 81.

While the FTC rule offers a minimum level of protection which applies to offers and sales in all states, individual states can enact laws which offer a higher level of protection to franchise buyers. At various times, the preemption of state laws in favor of a uniform national standard has been considered, but not implemented because of disagreements over how strict the federal regulation should be and how it would be enforced.

2. State Regulation

States have laws governing the solicitation and sale of franchises under specific franchising laws and under a variety of other state laws, such as business opportunity and unfair trade practices. State franchising laws generally focus on requiring the franchisor to register with the appropriate state agency prior to the offer and sales of franchise units. Other state laws impacting franchise sales cover a broad array of issues, such as unfair and deceptive trade practices, and fraud and misrepresentation.

a. State Franchising Laws

Additional state laws on franchise sales exist in 15 states. The states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. These states account for one-third of the nation’s population, more than one-third of all

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franchises, and the overwhelming majority of all franchise enforcement actions.\textsuperscript{14}

With the exception of Michigan and Oregon, these states require that the franchisor first register with the appropriate state administrative agency prior to the offer and sale of franchise units within the state.\textsuperscript{15} The registration process is similar to that of a state securities’ offering in that a state administrator reviews the disclosure materials and must be satisfied that adequate and clear disclosure of all material facts called for by state law have been made in the Offering Circular. Registration does not act as a bar to the franchisee (or the state) later suing the franchisor based on information contained in or omitted from the Offering Circular. The offering is usually effective for one year and must be renewed annually by filing an updated Offering Circular with the state.\textsuperscript{16}

All franchise registration states accept an Offering Circular prepared in accordance with the Guidelines for Preparation of a Uniform Franchise Offering Circular. However, most of the franchise registration states have various peculiarities in their laws requiring that certain modifications be made to the UFOC and that a cover page be prepared containing certain state-specific information.\textsuperscript{17} States may also require additional information, documents, or changes. In addition, states may have laws regulating franchise salesmen and brokers, franchise advertising, or capitalization requirements which may result in the franchisor making escrow payments to guarantee performance.

\textsuperscript{14}Franchising in the U.S. Economy: Prospects and Problems, op. cit., p. 27.

\textsuperscript{15}Oregon has enacted specific franchise disclosure requirements without requiring a registration process; Michigan requires disclosure but dropped registration procedures in 1984.

\textsuperscript{16}Axelrad and Rudnick, op. cit., p. 106-107.

\textsuperscript{17}Axelrad and Rudnick, op. cit., p. 107.
b. Other State Laws Governing Franchising

In addition to the 15 states that have enacted statutes specifically regulating franchise solicitations and sales, most states regulate some aspect of franchise sales under a variety of business opportunity laws, unfair trade practices, and industry regulation statutes. All states have enacted some form of laws prohibiting unfair and deceptive practices in trade or commerce (so-called "Baby FTC Acts"). Nearly three-quarters of the states have business opportunity statutes prohibiting fraud and misrepresentation in the sale of franchises and other business opportunities.18 Most states have industry relationship laws regulating automobile dealerships, gasoline franchises, farm equipment dealers, or alcoholic beverage distributorship.19

C. PERSPECTIVES ON IMPROVING THE FRANCHISING SALES/SOLICITATION PROCESS

Despite some concerns about complexity and burden of disclosure, most franchising experts, franchisors, and franchisees appear to be generally supportive of the FTC’s 1979 Franchise Rule. The FTC’s Franchise Rule is generally viewed as necessary, providing a measure of protection against fraudulent offerings and deceptive solicitation practices. It also ensures that franchisees receive at least basic data and documentation that are important to an informed decision about whether to purchase a particular franchise unit and to enable franchisees to make additional follow-up inquiries to validate

18Generally, a state will not regard a franchise as a business opportunity if the franchisor has a federally registered trademark and does not engage in certain proscribed business practices (such as entering into an agreement to buy back the franchisee’s product or inventory). States with both franchise regulation and business opportunity laws require franchisors to comply only with the franchise regulation laws. Axelrad and Rudnick, op. cit., p. 107.

19Franchising in the U.S. Economy: Problems and Prospects, op. cit., p. 27
franchisor claims. Hence, according to the literature and many involved in franchising, the FTC Rule provides an overall structure that fosters the sale of legitimate franchises, without being unduly restrictive for franchisors. Views on state regulation are more varied. Some of the examples of comments we received during our interviews on existing federal and state regulation follow:

Employment Services Franchisor. We don’t have a problem with existing laws. Disclosure doesn’t curtail our sales and it helps keep out scams. However, a drastic change in state laws because of a few abuses is a concern because it could become too restrictive. The result probably would be that more companies would look at alternatives like licensing, restructuring fees for services, and company units.

Restaurant Franchisor. Regulation was needed to curb abuses in the past, but additional regulation is not needed. The FTC regulation is standard, simple, and easiest to meet. State regulations are redundant and expensive, and the result of growing state regulation will be greater concentration of franchising in some states. Franchising gives people an opportunity to be their own bosses and I am concerned that growing government regulation could cut growth of franchising.

Franchising Expert. FTC Rule 436 is generally not hard to comply with once the franchise agreement is worked out. One half of the offering circular just repeats the franchise agreement and much of it is simple information like names and addresses. The problem for many readers is that there is too much repetition. No major regulation is needed, but some modification of disclosure is needed so there is less duplication and repetition. More information is needed on items like the background of the franchisee and franchise system, and system turnover. The stuff is there, but it is hard to read and interpret.

Franchising Expert. There is a fairly high degree of state regulation now that is inconsistent between different states and with federal statutes, and additional state laws would add more complexity and concern about the right law to apply.

Despite general consensus on the need for disclosure requirements (i.e., those embodied in the FTC Franchise Rule), there is much less agreement over the need for additional regulation of the solicitation/sales process at the federal/state levels. Some argue for additional legislation and/or regulation that would strengthen disclosure requirements and enforcement of those requirements. Proposed legislation by Rep. LaFalce -- H.R. 5232, the "Federal Franchise Disclosure and Consumer Protection Act",
introduced in May 1992 -- is a recent example of a legislative initiative to substantially strengthen disclosure requirements for franchisors. According to its sponsors, this legislation is intended to "provide prospective franchisees with information necessary to make an informed decision about the purchase of a franchise opportunity, to protect prospective franchisees from fraudulent practices, to broaden the scope and enhance the availability and utility of common law remedies, and to promote more equitable franchise relationships." However, despite calls for additional regulation of franchise disclosure, there are countervailing arguments that additional regulations are not needed, unlikely to be effective (because of lack of enforcement), and may have a deleterious long-term effect on the growth of franchising. Further, those in opposition to additional regulation argue that franchisors are already overburdened by the disclosure process. The literature on franchising, as well as recent testimony before the House Committee on Small Business, reflects many diverging views on the need for additional regulation and, generally, how the solicitation/sales process can be improved.

Below, we discuss three specific areas of the solicitation/sales process which are frequently mentioned as in need of improvement: (a) reducing the burden of state regulation, (b) enhancing the level of financial information available to franchisees during the solicitation process, and (c) adding resources and strengthening the enforcement process.

1. Views on the Need to Reduce Costs and Burden of State Regulation

As discussed earlier in this chapter, 15 states have enacted laws governing franchise solicitation and sales (in addition to the FTC Rule). Thirteen of these states require franchisors to first register with an appropriate state agency. There are strongly
divergent views concerning both the need for and utility of state regulation.

The proponents of state regulation argue that federal-state cooperation is needed to protect franchisees from fraud and abuse:

In adopting the Franchise Rule, the Federal Trade Commission explicitly endorsed a shared system of state-federal regulation of franchising. The state role in overseeing the burgeoning franchise marketplace is critical to the continued protection of consumers from fraudulent and abusive franchise promoters.20

The argument is made that the FTC has relatively few resources for enforcement, hence, tends to focus limited resources on larger franchisors and the most abusive situations. States, therefore, must play an active enforcement role:

Given its limited resources, the FTC is severely restricted in its ability to investigate and prosecute Franchise Rule violations and, as is the case with most federal regulatory agencies, has tended to concentrate its efforts on cases where substantial losses or widespread fraud has been documented. As a result, state regulatory agencies shoulder the burden to investigate and prosecute the overwhelming majority of franchise fraud and abuse cases.21

Hence, from this perspective, state regulation of disclosure (and registration) helps to ensure that fraudulent or abusive offerings are screened out before they reach the public, and state laws permit stronger enforcement and greater recourse for franchisees through private action:

Thus, the main benefit of registration with a state agency, as opposed to simply requiring disclosure to prospective franchisees, is that it also serves as an enforcement tool -- it is a mechanism for screening out fraudulent or abusive offerings before they reach the public.22

Critics of state regulation (and registration) argue that state regulation provides only


22Debra Bollinger, op. cit., pp. 104-105.
minimal protection to franchisees and adds a level of unwarranted delay and cost to the franchising process.\(^{23}\) The most frequent complaint about state regulation (and registration) relates to high costs imposed upon franchisors:

Compliance with state registration requirements adds substantially to the franchisor's cost of franchise sales. For larger companies, with an in-house staff of lawyers and legal assistants, such costs may be tolerable. For the overwhelming majority of franchisors that are small companies, the cost of compliance can be oppressive. It is not at all unusual for a franchisor to incur tens of thousands of dollars in annual expenses merely to keep state registrations current.\(^{24}\)

The process of compliance can be difficult, time-consuming, and costly especially for national franchising companies, i.e., those with franchise units in more than one state, who must constantly update and maintain a stock of disclosure statements.\(^{25}\) The cost and burden of state registration can also affect expansion plans of smaller franchise systems. It is pointed out that the costs of added regulation are passed on (at least partially) to franchisees and eventually to the consumer. Substantial costs related to separate state filings -- of what is often only marginally different documents -- was frequently mentioned by those that we interviewed:

**Maintenance Franchisor.** In principle, the disclosure regulations and other regulations are excellent because they have a policing effect for legitimate franchisors. In practice, though, government regulation is beginning to go too far with the various state regulations. The problem is that government people don't know the heartache, expense and difficulty of setting up a business and the huge administrative burden that the regulations require in updating all our documents quarterly.

**Construction Franchisor.** A tremendous amount of the current regulation is unfair to the franchisor, but the franchising industry has brought it on itself because of


\(^{24}\)Neil Simon, op. cit., p. 17.

\(^{25}\)Franchising in the U.S. Economy, Problems and Prospects, op. cit., p. 29.
past abuses and ripoffs. The cost of legal work is unbelievable. We spend about $100,000 annually for updating disclosures and we're not a large franchisor. The franchisor should be able to disclose sales and profits more and legitimate franchisors should have less exposure to fraud charges. It is difficult for a franchisor to really "win" a lawsuit even when he wins because of legal expenses.

Education Franchisor. There are many tedious legal restrictions on a state level which require considerable management time and attorney expense. The states make you jump through hoops to provide them with specific documents. There are unnecessary expenses on semantic differences for each state and on revisions due to the individual taste of state employees. I would estimate the cost (of state registration) at state fees plus about $3,000 in legal fees per state if there are no problems at all. Legal costs are a major burden to a small franchisor company like ours with only 50 units. I don't believe that there is a payoff or additional protection for the franchisee from the state laws. In practice, what happens is that when we meet with several franchisees from several states, some prospects get more information than others. The business is the same from state to state and run the same way, but we give some franchisees different descriptions and less information because of the state restrictions.

A second major argument made against state regulation (and registration) is that it substantially increases the complexity of franchise laws and regulations:

...These variations in state law and procedure confront franchising companies with a confusing patchwork of regulatory requirements that can make compliance not only burdensome but potentially hazardous.26

Technical non-compliance with state franchise registration laws can be damaging to a franchise program and delay or discourage franchise sales. Even franchise attorneys complain of the difficulty keeping up with changes in franchising regulations at the state level. Among the difficulties cited by franchise attorneys (that we interviewed) are the following:

- keeping up with changes in state laws, administrative interpretations and procedures, and personnel;
- knowing the proper jurisdiction with certainty; and
- knowing when material changes require updating of the disclosure statements.

26Franchising in the U.S. Economy: Prospects and Problems, op. cit., p. 27.
Attorneys reported, for example, that it is occasionally necessary to meet contradictory requirements between different states when a franchise location is in one state and the franchisee is in another state. In his testimony before the House Committee on Small Business, a representative from the International Franchise Association identified some common registration compliance differences encountered by franchisors across states:

- Minnesota and Indiana place limitations on the inclusion of mandatory arbitration provisions in franchise agreements.
- In Indiana, franchisors cannot place unlawful limits on litigation. This provision has been interpreted by the state to prohibit liquidated damages, a choice of governing law other than Indiana, or a consent to jurisdiction other than Indiana courts.
- North Dakota and South Dakota do not permit a choice of law of jurisdiction other than their own law and courts.
- Maryland and New York impose differing requirements regarding the information to be included under Item XX of the offering circular.
- Minnesota requires an affirmative statement to the effect that the franchisor will protect the franchisee's right to use the franchisor's trademark.
- Virginia requires an estimate of annual costs incurred in operating the franchised business.27

These differences underscore the complexities of regulations across states and the costs of compliance. Critics of state regulation also point to varying interpretations and standards applied by state examiners:

Examiners base their comments on state franchise laws, regulations and administrative policies. However, comments are often based on widely varying standards of review and misinterpretation. States have had extensive turnover in examiners during recent years. The new examiners generally know little, if anything, about franchising and often registration files are ‘lost in the shuffle’ as they pass from examiner to examiner.28

27Neil Simon, op. cit., p. 159.
28Neil Simon, op. cit., p. 158.
The third major argument generally made against state regulation of disclosure and the state registration process is that it adds only a marginal layer of protection against fraud and abuse. Franchisors and experts that we interviewed typically viewed state regulations on disclosure as complex and costly -- offering little additional information or protection to the franchisee to justify the cost:

**Franchising Expert.** I don’t see much that states really do for franchisees because most states are not careful readers of existing filings.

**Restaurant Franchisee.** The legislation on disclosure has an admirable intent, but it doesn’t deal with the cost factor and the diversion of efforts by franchisor. The franchisor would have to charge higher royalty to cover the costs or to reduce the support provided after franchisee starts. It is better for most franchisees to have more support than more regulations. I think that most franchisors don’t intentionally misrepresent the situation. Most items are covered in the existing disclosures, but people don’t read what is there.

2. **Views on the Need for Earnings Claims**

A source of continuing controversy in the area of regulation centers on disclosure of "earnings claims" to prospective franchisees. Earnings claims are estimates or other representations by the franchisor of what a prospective franchisee might expect in terms of sales, income, and potential profit from a franchise investment. In issuing its franchising rules governing disclosure in 1979, the FTC noted that the most common abuses in franchise offerings and sales involved unsubstantiated earnings claims or deceptive earnings representations. In response, the FTC Franchise Rule neither requires nor prohibits furnishing earnings claims at the time of solicitation and sale. However, if earnings claims are made they must conform to specific guidelines in the FTC Rule. Such claims are only permitted where:

- reasonable proof exists to support the accuracy of the claim;
• the franchisor has in his/her possession, at the time the claim is made, information sufficient to substantiate the accuracy of the claim;

• the claim is geographically relevant to the prospective franchisee’s proposed location; and

• the earnings claim is provided to the prospective franchisee at the same time as the other required disclosure documents.  

According to a recent survey of franchisors, only about 20 percent of franchisors used earnings claims in their disclosure documents in 1990. However, the use of earnings claims appears to be growing because procedural changes by the FTC made documentation easier. Some franchisors report that earnings claims are effective in increasing sales without increasing litigation.

Most industry experts and franchisors agree that earnings claims could be improved, although they are concerned that providing more information might reduce the efforts that prospective franchises make in contacting other franchisees to verify franchise claims. Some franchisors and experts also mentioned the need to strengthen disclosure statements to better enable franchisees to evaluate the adequacy of the franchisor capitalization and cash flow to provide the types of services promised in the disclosure statement. Exhibit 7-6 illustrates views of franchisors, franchisees, and franchising experts from our interviews about the utility of earnings claims.

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29Final Franchise Rule, pp. 59617-18; 16 CFR, Chapter 1, 436.1(b).

30Boroian and LaVan, Franchise Marketing and Sales Survey, 1990-91, op. cit., Table 29, p. 31.

31Boroian and LaVan, Franchise Marketing and Sales Survey, 1990-91, op. cit., Table 29, p. 31.
Franchising Expert. Questions regarding earnings are natural and important questions by potential franchisees. Earnings claims are difficult to prepare for most franchisors because they don’t have good documentation. Most franchise attorneys advise the franchisor to avoid earnings claims because of the possible liability. The result is most franchisors say to prospects: 1) we have information on gross sales but don’t have the data to tell you profitability of individual units; 2) here is list of our franchisees, you can talk to them and get information; 3) you can talk to our competitors; and 4) you should have your accountant help you prepare a proforma.

Franchising Expert. The weakest point of the sales and solicitation process is the transmission of earnings claims. I think that most franchisors want to give more information but many are discouraged by the difficulty of preparing valid information and the potential for litigation. They are following the recommendation of most attorneys and consultants, which is to avoid giving earnings claims. The danger is that many people do not understand that an earnings claim is a projection with many factors that cannot be guaranteed for individual franchisees.

Education Franchisor. Our company provides earnings claims because it was suggested by our attorney. We elected to do it because we thought that it was better for our sales process if a person could see the income prospects of a franchisee. By showing what a franchisee would earn, we helped those who were interested and avoided franchisees who had excessive expectations about income. People who join us know what they’re getting into.

Maintenance Franchisor. We would like to provide an earnings claim if it was mandatory for all franchises because we feel that our franchise is successful. We don’t offer them now because our competitors would probably attack them.

Restaurant Franchisor. There is a weakness in the existing financial information in disclosure documents. Earnings claims should be mandatory in my view. It is funny that we provide so much detail on many things but not on the financial history of other franchisees who have made the investment. More financial data on franchisor financial history should also be provided so that the franchisor can be evaluated more thoroughly.

Employment Services Franchisor. We should have further liberalization of earnings claims areas to make it easier to provide information to prospective franchisees. The documentation requirements make it difficult to provide detail. Geographically relevant data is especially difficult to provide.

Ice Cream Franchisee. More information on earnings would probably be helpful as long as the person still looked closely at the individual location. Profit and loss are highly variable because they depend on small location factors, but the franchisor should provide information on what the franchisee might expect to do.

Maintenance Franchisee. It would have been useful to see additional information like an actual financial statement or a proforma for a given franchisee. When one is looking at a franchise, it may be difficult to evaluate a particular franchise location, or to get complete financial information on the initial and current performance of a franchise. If I bought a business that was not a franchise, I could go to the seller, put up a deposit, and expect to see all the information on the business in the due diligence process.

Maintenance Franchisee. Regarding earnings claims, I like it the way it is. It is best to leave it up to the franchisee to research other dealers and find out about the franchise because the information is more honest, accurate, and better able to allow for different franchise locations and circumstances. If the franchisor gave more projections, the franchisee would start expecting one thing without checking and the sales people would exaggerate the numbers.
3. Views on Enforcement of Sales/Solicitation Regulations

There has been some criticism of the lack of federal and state efforts to effectively review disclosure statements by franchisors and to bring enforcement actions against those franchisors that employ deceptive or fraudulent practices. Until a restructuring of enforcement responsibilities within the FTC in late 1987, enforcement actions against franchisors were virtually non-existent:

While claiming this broad authority, the FTC has often been reluctant to use it. For most of the period from 1979 through 1987, the agency's principal approach to rule enforcement involved monitoring compliance and encouraging franchisors to correct potential violations... During this seven-year period, the FTC brought a total of fifteen enforcement actions -- thirteen involving violations of the franchise rule and two involving misrepresentations by franchisors falling outside the scope of the rule.32

The restructuring of FTC enforcement has brought some additional enforcement actions, though the number of these actions remains small (especially compared to actions taken by state regulators). Staff and resources for enforcement within the FTC remains limited, and given these limitations the federal enforcement of the FTC rule continues to be restricted to cases where there is widespread or costly abuses:

The agency [i.e., FTC] is underfunded and understaffed, employing less than half the staff it had when the franchise rule took effect in 1979. Ultimately responsibility for bringing enforcement actions fall upon a core staff of sixteen attorneys, whose efforts must be divided between franchising and numerous other deceptive practices cases. Given these circumstances, the FTC is severely restricted in its ability to investigate and prosecute franchise rule violations and has tended to concentrate its efforts on cases where substantial losses or widespread fraud has been documented.33

As a result of the lack of federal enforcement, most of the burden of investigation and prosecution of franchise rule violations occurs at the state level. States have a variety

33Franchising in the U.S. Economy: Problems and Prospects, op. cit., p. 25.
of enforcement tools which enable them to take enforcement action against franchisors in violation of the law. For example, states may issue orders prohibiting violations of the law, as well as orders denying, suspending, and revoking registration and exemption of franchises. States also have injunctive and criminal referral authority. In contrast to the small number of enforcement actions concluded by the FTC each year, state regulatory agencies commenced 1,026 enforcement actions during the three-year period between 1986 and early 1989. Most of these enforcement actions have come in the 15 states that have enacted statutes specifically regulating franchise solicitation and sales.

Lack of enforcement at the federal level and varying degrees of enforcement activity at the state level has brought complaints that some deceptive and fraudulent practices are not being uncovered, investigated, and/or prosecuted. The result, according to critics, is that franchisors are able to continue to make false claims (some critics say with impunity), and some franchisees who do not carefully check the reliability of franchisor claims enter into franchising relationships based on deceptive or invalid claims of franchisors. Some franchisors and franchising experts claim that because of the lack of enforcement, disclosure requirements (especially state registration) tend to penalize franchisors who are honest and forthcoming by introducing added costs and delays, without adding sufficient protection against scams and deceptive practices. They argue that while the "honest" franchisor is sometimes entrapped by a technicality in state law or the "whim" of a state examiner, the outright fraud and deception goes undetected and/or unpunished:

34Debra Bollinger, op. cit., p. 105.

Franchising Expert. Additional regulation is not an answer. The disclosure regulation solved the problem of providing enough information for the investment. The process now has technical traps for new franchisors because it is easy to make a mistake. We do not need more regulations, but just more enforcement of the existing regulations. Federal rules are not consistently enforced. States don’t have the personnel to enforce properly so they often focus on minutiae rather than on bigger items. The result is that the legitimate franchisor spends money to comply, but he finds his competition is not using the same standards and there is no enforcement.

D. IMPLICATIONS AND CONCLUSIONS

Controversy over the adequacy of existing regulation and need for additional regulation governing solicitation and sales is unlikely to be fully resolved by the enactment of new "tougher" laws or regulations. Because of the costs and burdens already imposed upon franchisors by existing laws and regulations -- and the uncertainty as to whether new laws/regulations would substantially decrease fraud and abuse during the disclosure process -- every effort should first be made on improving the existing framework.

Specifically, efforts should be focused on:

- greater uniformity in disclosure rules across states and reduction in costs and burdens of the state-level registration process;
- more stringent and uniform enforcement of existing disclosure laws at the federal and state levels;
- increased emphasis on disclosure of earnings claims by franchisors and ensuring quality of such claims;
- increased availability of information during the disclosure process that will facilitate prospective franchisees in more effectively validating the reliability of franchisor claims with existing and former franchisees; and
- an increased role for federal (e.g., the FTC and SBA) and state government agencies, as well as private organization (e.g., International Franchise Association), in informing franchisees about the step-by-step procedures for effectively assessing franchise systems prior to purchasing a franchise unit.
CHAPTER 8:
THE FRANCHISE RELATIONSHIP

This chapter focuses on the relationship between franchisors and franchisees. It begins with a discussion of the existing legal and regulatory framework which governs this relationship, considering federal and state regulations as well as common law. It then examines the franchise agreement, which plays a key role in determining the "ground rules" for the franchising relationship within individual franchise systems. Next, the chapter considers general levels of satisfaction among franchisees with franchisors and specific relationship issues that have been sources of controversy between franchisors and franchisees. The chapter concludes with a discussion of steps that can be taken by franchisors and franchisees (outside of the general legal/regulatory framework) that can be helpful in maintaining effective franchisor/franchisee relationships.

A. EXISTING LEGAL/REGULATORY FRAMEWORK GOVERNING FRANCHISE RELATIONSHIPS

1. Federal Regulation

The regulation of the franchise relationship is less well-defined than the regulation of solicitation and sales. There is currently no federal statute or consistent body of federal case law which recognizes or defines the legal rights of franchisees within franchise relationships. As discussed later in this section, the legal/regulatory framework is governed to a large extent by common law and the franchise agreement between the franchisor and franchisee.

At the federal level, Congress has enacted legislation to regulate some aspects of the automotive and petroleum industries. The Automobile Dealer Franchise Act of 1956
provided a right of action for automobile franchises. This right is broadly stated to permit actions to recover damages and court costs relating to any failure of an automobile manufacturer "to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling or not renewing the franchise."

The Petroleum Marketing Practices Act of 1968 provided a more limited right for gasoline franchisees relating to failure by franchisors to comply with appropriate requirements relating to termination or renewal of a franchise.

2. State Regulation

A number of states -- beginning with Delaware in 1970 -- have enacted franchise relationship regulation. A total of 18 states have adopted such legislation:

- Eight states -- Arkansas, Connecticut, Delaware, Iowa, Mississippi, Missouri, Nebraska, and New Jersey -- have fairness statutes only.
- Ten states -- California, Hawaii, Illinois, Indiana, Michigan, Minnesota, Virginia, South Dakota, Washington, and Wisconsin -- have both fairness statutes and franchise disclosure/registration statutes.

The state franchise statutes "incorporate provisions which range from general prescriptions of 'fairness' and 'good faith' in the conduct of franchise operations, to detailed enumeration of prohibited or permitted actions defining good faith or 'good cause' in specific circumstances." Among the activities or circumstances most commonly


3 Franchising in the U.S. Economy: Problems and Prospects, op. cit., p. 52. In July 1992, Iowa became the 18th state with legislation governing 'fairness' in franchise relationships.

addressed in these statutes are the following:

- conditions permitting franchise termination or nonrenewal,
- prohibition of certain purchase requirements,
- minimum requirements for the duration of franchise agreements,
- prohibition of specific acts not necessary for the conduct of business,
- minimum notification for termination or renewal, and
- creation of a duty of franchisors upon termination of a franchise to repurchase certain equipment or reimburse a franchisee for some part of the value of a franchise.5

The most far reaching of these state statutes is the recently enacted legislation by Iowa. Iowa’s new law (effective July 1992) significantly changed rules governing the transfer of the franchises so that:

- franchisees can give or sell a minority interest in a franchise unit to any family member without approval from the franchisor;
- franchisees can sell the business to anyone he or she picks, as long as the new owners meet the minimum standards the franchisor is using in picking other business owners; and
- there is a limit on the fee the franchisor can charge for the transfer -- it cannot exceed the actual cost of doing the necessary paperwork.6

Iowa’s law goes further than other state statutes because it not only specifies how companies must deal with franchisees, but also imposes these new restrictions on existing contracts.7 Several other state legislatures (including Florida and New York) are also considering legislation that could substantially alter the relationship between franchisors

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5Franchising in the U.S. Economy: Problems and Prospects, op. cit., p. 52.
7Daniel B. Moskowitz, op. cit.
3. General Legal Framework

Franchising is covered by a body of law which has evolved over a long period of time, including contract law, common law, laws covering fraud, and trademark and intellectual property law. While this general legal framework is not specific to franchising, it does establish basic ground rules for the business practices involved in franchising and provides basic parameters within which franchisors and franchisees must act. Several of the key aspects of this general legal framework that affect franchising systems include the following:\(^8\)

- **Federal/State Antitrust Laws.** Federal and state antitrust laws are designed to strike down business practices whose intent or effect is to lessen competition. These laws have special significance for franchising because the franchisor usually imposes controls and restraints to ensure that the franchise follows certain methods of doing business. Controls or restraints tend to be viewed as lessening free choice and competition, though the legality of most restrictions is measured by a standard of reasonableness and/or by review of the ways in which they are established or enforced.

- **Trademark Laws.** The Lanham Act provides certain ways of protecting the rights of the owner of a trademark from infringing use by others. It also imposes certain obligations on the owner of a licensed trademark (e.g., the owner is obliged to ensure that the trademark is not used in such a way as to deceive the public). Trademark registrations, issued through the U.S. Patent and Trademark Office, are issued for a period of 20 years and are renewable without limit upon showing that the trademark is being used by the owner in interstate commerce. Such registration protects the owner of the trademark by prohibiting registration of the same or a confusingly similar trademark by others.

- **Securities Laws.** Federal and state security laws may apply to franchise operations where the franchisee does not play an active or substantive role in the operation of the franchise. For example, some states have enacted a "risk capital" test for determining whether a franchise offering constitutes a

\(^8\)See Axelrad and Rudnick, op. cit., for additional detail on federal/state antitrust laws, trademark laws, and state common law.
security.

- **State Common Law.** State common law is a body of judicial interpretations of various fact situations in the context of basic legal principles and judicial precedents. Common law includes contract law, tort law, and agency law. For example, under contract law, "breaches of express contractual agreements between the parties or contracts that may be inferred from the conduct and reasonable expectations of the parties, such as covenants of good faith and fair dealing."9

B. **THE FRANCHISE AGREEMENT**

From a legal standpoint, the franchise agreement sets out the rights, duties, and obligations of the franchise relationship in a binding contract. Franchise agreements vary in length, but most are long and complex. They are designed to detail the entire legal relationship of franchisor and franchisee and handle many contingencies that may arise over a long period of time. The franchise agreement may consist of one big agreement or may include several related supplementary agreements.10 Exhibit 8-1 displays major sections of a typical franchise agreement.

Most franchise agreements have a relatively long initial term. According to *Franchising in the Economy*, the average duration of agreements completed in 1986 (excluding perpetual agreements) was over 12 years, and over 80 percent of franchisors offered agreements lasting ten years or more (see Exhibit 8-2). The duration of franchise agreements depends upon management philosophy, competitive factors, and other factors such as the term of related leases (e.g., in the retail sector), or financing and collateral requirements (e.g., in the restaurant and hotel sectors).

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9Axelrad and Rudnick, op. cit., pp. 71-76.

10Andrew Sherman, *Franchising and Licensing*, American Management Association, 1991, p. 120.
### EXHIBIT 8-1: TYPICAL SECTIONS OF A FRANCHISE AGREEMENT

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1)</td>
<td>Recitals open the document by identifying the scope and purpose of the agreement, including key definitions and such items as the background of the franchisor, the obligation of the franchisee to act in strict accordance with the operating manual and quality control standards of the franchisor.</td>
</tr>
<tr>
<td>2)</td>
<td>The grant of the franchise, which covers the term that the franchise is granted and the renewals.</td>
</tr>
<tr>
<td>3)</td>
<td>Territorial provisions, which identify the size of the area, the number of outlets within the area, and conditions such as exclusivity.</td>
</tr>
<tr>
<td>4)</td>
<td>Site selection, which covers the responsibility of the parties for identifying the specific franchise unit site.</td>
</tr>
<tr>
<td>5)</td>
<td>Services to be provided by the franchisor, which identifies both pre-opening and post-opening services.</td>
</tr>
<tr>
<td>6)</td>
<td>Franchise fees, royalties and other payments (such as advertising fees) to the franchisors.</td>
</tr>
<tr>
<td>7)</td>
<td>Quality control, which describes restrictions on the use of products, supplies, or operational procedures.</td>
</tr>
<tr>
<td>8)</td>
<td>Insurance, record-keeping and other paperwork obligations of the franchisee.</td>
</tr>
<tr>
<td>9)</td>
<td>Protection of intellectual property of the franchise (such as trademarks, tradenames, and trade secrets) and non-compete restrictions.</td>
</tr>
<tr>
<td>10)</td>
<td>Right to transfer the franchise to others, including the rights of heirs.</td>
</tr>
<tr>
<td>11)</td>
<td>Renewal, which covers conditions for renewal of the agreement.</td>
</tr>
<tr>
<td>12)</td>
<td>Termination, which explains what actions may void the franchise agreement before its normal termination date and indicates under what conditions franchisees may lose the franchise license.</td>
</tr>
<tr>
<td>13)</td>
<td>The legal jurisdiction and methods of resolving disputes, such as arbitration, may be included.</td>
</tr>
<tr>
<td>14)</td>
<td>Miscellaneous provisions, such as the right to borrow money against the franchise, may also be covered.</td>
</tr>
</tbody>
</table>
**EXHIBIT 8-2: DURATION OF FRANCHISE AGREEMENTS REPORTED BY BUSINESS FORMAT FRANCHISORS, 1986**

<table>
<thead>
<tr>
<th>LENGTH OF FRANCHISE AGREEMENT</th>
<th>FRANCHISE AGREEMENTS</th>
<th>PERCENTAGE OF TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>UNDER 10 YEARS</td>
<td>283</td>
<td>17.8</td>
</tr>
<tr>
<td>10 YEARS</td>
<td>523</td>
<td>33.1</td>
</tr>
<tr>
<td>15 YEARS</td>
<td>230</td>
<td>14.6</td>
</tr>
<tr>
<td>20 YEARS</td>
<td>309</td>
<td>19.6</td>
</tr>
<tr>
<td>25 &amp; 30 YEARS</td>
<td>22</td>
<td>1.3</td>
</tr>
<tr>
<td>PERPETUAL</td>
<td>197</td>
<td>12.5</td>
</tr>
<tr>
<td>OTHER</td>
<td>16</td>
<td>1.1</td>
</tr>
<tr>
<td>TOTAL BUSINESS FORMAT FRANCHISORS REPORTING</td>
<td>1,580</td>
<td>100.0</td>
</tr>
</tbody>
</table>


Note: Table shows data for the 1,580 of the total 2,177 business format franchisors who reported franchise agreements in 1986. Under 10 years includes agreements for 1, 3, 5 and 7 years; other included agreements for varying terms. Data for product and trademark franchises was not available.
Both the literature and our interviews confirm a general trend toward more complex franchise agreements, as attorneys for franchisors have attempted to anticipate potential legal problems:

One of my colleagues was recently quoted in the New York Times as saying that 'the standard franchising contract he writes is now running 75 pages, triple the size of a few years ago, as franchisors frantically try to 'stay one step ahead of the jury' and cover all legal bases at signing time.'\textsuperscript{11}

The pattern of court decisions has reinforced the trend toward longer, more comprehensive agreements. Courts generally have tended to support the rights, duties, and obligations specifically identified in the agreements, rather than to create uncertain new rights for franchisees through the application of principles of good faith and fair dealing.\textsuperscript{12}

Consequently, franchise attorneys have attempted to reduce litigation by incorporating provisions which could give the courts information on the intent of the parties at the signing. According to some franchising experts, greater specificity within franchising agreements tends to reduce the extent of negotiation between the franchisor and franchisee prior to execution of the agreement:

\textit{Franchising Expert.} The use of acknowledgement clauses and other mechanisms by franchisors is a new attempt to clarify the offer and reduce uncertainties in what is disclosed by the franchisor. The current situation is that negotiation of franchise agreements is limited. There is generally no negotiation of material terms, and limited negotiation of territory is usual. This may be an advantage for franchisees in that it's not 'let's make a deal.'

There is, however, some concern among franchisees and franchising experts that the increasing length and complexity of franchise documents has reduced the franchisee's ability to evaluate the franchise and diminished the rights of franchisees. As noted in Chapter 7, prospective franchisees are often reluctant to use attorneys because of the

\textsuperscript{11}Rupert M. Barkoff, op. cit., p. 126.

cost and difficulty of finding an experienced franchise attorney. The growing length of
documents and the incorporation of specialized clauses increases the franchisee’s potential
legal cost because it takes more time for the franchisee’s attorney to evaluate the
agreement properly.

In addition, some franchising experts argue that contractual limits now included in
franchise agreements, such as jurisdictional limitations, integration clauses, hold harmless
provisions and requirements for arbitration as a method of settling disputes, prevent
franchisees from getting fair access and due process in court. These experts argue that
franchising agreements have become too one-sided (in favor of franchisors):

I fear greatly that the situation has gotten out of hand, and I have been told by
some of my colleagues who represent franchisors exclusively that they share this
fear. As I have noted above, franchise agreements have always been skewed in
the franchisor’s favor. This is not unexpected since they are drafted by the
franchisor’s lawyer, but some of the ‘rights’ granted to franchisors, or obligations
imposed upon, or acknowledgments made by franchisees have gone beyond
reasonable limits.\footnote{Rupert Barkoff, op. cit., p. 126.}

For example, by stipulating the jurisdiction for the dispute within the franchise agreement,
it is said that franchisors can impose a less advantageous and more expensive forum for
the franchisee to mount a legal challenge. The integration clauses (which precludes
litigation over fraud or deception prior to execution of the agreement) and hold harmless
provisions (which limits relief under some state laws) may be used to unduly restrict the
franchisee’s legal courses of action. Finally, it is argued that some franchisors use
arbitration clauses to avoid damages and publicity, extend arbitration to cover matters like
termination or renewals which are inappropriate for arbitration, or impose requirements to
make the arbitration process burdensome on the franchisee.\footnote{Franchising in the Economy: Prospects and Problems, pp. 62-64.}
In contrast, franchisors and those that represent franchisors typically argue that the increasing length and other changes in franchise agreements reflects an attempt by franchisors to spell out clearly the terms of the franchise agreement before the franchisee invests his or her time and money, and to control the costs of litigation. The cost of such litigation is likely to be passed onto the franchisee (and eventually the consumer in the price of products/services) or may be compensated for by a reduction in the level of franchisor support services:

Restaurant franchisee The legislation has an admirable intent, but it doesn't deal with the cost factor and the diversion of efforts by franchisor. The franchisor would have to charge a higher royalty to cover costs or to reduce support provided after franchisee starts. It is better for most franchisees to have more support than more regulations.

It is argued that the franchisee enters into the franchise agreement voluntarily and that the franchisee has hundreds of franchise systems from which to compare:

Proposals to regulate franchise relationships are often based on a perceived inequality of bargaining power between franchisors and prospective franchisees. Nonetheless, it must be borne in mind that a franchisee's decision to enter into a franchise agreement is rarely due to necessity. Indeed, investors have hundreds of franchises from which to choose. If the terms of one agreement are unattractive, the prospective franchisee may look elsewhere or establish his or her own business.15

Essentially, it is argued that over the long-term that general contract law and an efficient "free market" (with many franchise systems from which to select) tends to make those franchise systems which are too one-sided in their franchise agreements less successful in marketing franchise units to prospective franchisees. In addition, during the due diligence process, the prospective franchisee can contact existing franchisees to determine how franchisors have interpreted the terms and conditions set forth in the contract and any potential problems that franchisees have had in the relationship area.

15Neil Simon, op. cit., p. 149.
C. PERSPECTIVES ON KEY RELATIONSHIP ISSUES

1. Franchisee Satisfaction with the Relationship

In reviewing the literature on franchising and recent testimony before Congress, it sometimes appears that franchisors and franchisees are pitted against one another and engaged in continual battle over the fairness of the franchising relationship. While there are certainly disputes between the franchisors and franchisees concerning the extent to which additional regulation is needed in the areas of disclosure and relationship, this acrimony sometimes obscures the strong incentives that both sides have to work together and the positive and supportive relationships that have evolved between franchisors and franchisees within most franchising systems.

A recent survey of nearly 1000 franchisees conducted by the Gallup Organization (for the International Franchise Association) found that most franchisors were satisfied with their franchise and rated their relationship with their franchisor positively.\(^\text{16}\) As shown in Exhibit 8-3, a majority of franchise owners (63 percent) reported they were more satisfied with their franchise than other businesses they have owned or operated, or other jobs they have held. Another 23 percent reported the same level of satisfaction. Only slightly more than one-tenth (13 percent) of respondents said that previous businesses they had owned or operated or jobs they had held proved to be more satisfying than their current position of owning a franchise. The Gallup survey also found that most franchise owners felt that their expectations had been met or exceeded in the following areas:

- personal satisfaction in operating the franchise (76 percent indicated that their franchise operations met or exceed their expectations);

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\(^{16}\)The Gallup Organization, Inc., National Franchise Owner Study. Jan. 1992. The results were from a national survey by telephone of 994 franchise owners; it had a maximum expected error range of 3.1% for the sample at a 95% level of confidence.
EXHIBIT 8-3: FRANCHISEE SATISFACTION WITH THEIR FRANCHISE UNIT RELATIVE TO OTHER BUSINESSES THEY HAVE OWNED OR OPERATED, OR OTHER JOBS THEY HAVE HELD

- More Satisfied: 63%
- About the Same: 23%
- Less Satisfied: 13%
- Don't Know: 1%

EXHIBIT 8-4: FRANCHISE OWNERS' RATING THEIR RELATIONSHIP WITH THEIR FRANCHISOR

- Excellent: 39%
- Good: 40%
- Fair: 14%
- Poor: 6%
- Don't Know/Refused: 1%

• overall satisfaction (73 percent);
• profit (55 percent); and
• level of assistance provided by the franchisor (63 percent).

As shown in Exhibit 8-4, approximately four-fifths (79 percent) of franchise owners rated their relationship with the franchisor company as being either excellent (39 percent) or good (40 percent). Only 6 percent of franchisees rated their relationship as poor. Finally, 75 percent of franchise owners indicated that knowing what they know now, they would purchase or invest in the same franchise business again.

Hence, despite the considerable attention that has been directed at specific areas of franchising relationships (see below) and anecdotal evidence concerning franchisor abuses, both the statistics on growth in franchising (see Chapter 2) and evidence from a recent survey of franchisees suggests a high level of franchisee satisfaction and a strong working relationship between franchisors and franchisees.

2. Key Relationship Issues

Despite generally positive views that franchisees have of their relationship with franchisors, there are a number of areas of the franchising relationship that have been cited as problematic (i.e., subject to abuse) and in need of greater regulation. Below, we provide an overview of key relationship issues.

a. Right of Termination

Franchise agreements typically contain relatively elaborate provisions outlining the franchisor’s authority regarding termination of a franchisee. An agreement will usually set out a fairly lengthy period for the franchise arrangement, but permit early termination by the franchisor upon the occurrence of an event of default. Generally, the franchisee will
be given a cure period -- usually 5 to 30 days in which to correct the default. There are
some circumstances (e.g., bankruptcy, insolvency, unauthorized transfers of ownership,
and violations of public health laws) in which no cure period or an extremely short cure
period (e.g., 24 hours) is customarily granted.

As discussed in Chapter 3, annual rates of discontinuation for franchise units are
relatively low. For example, in 1988, only about two percent of business format
franchises were terminated, with a majority of those contracts terminated at the initiation
of the franchisee. According to Franchising in the Economy, the total number of
terminations (of business format franchises) in 1988 was 8,579 (see Exhibit 8-5). The
total included 4,865 terminations (56.7 percent) made by franchisees for a variety of
reasons, including death, illness, retirement, poor profitability, lack of business interest and
other factors. A total of 3,714 terminations (43.3 percent of the total) were made by
franchisors. About 62 percent of the franchisor initiated terminations were related to
nonpayment or financial default by franchisees. Another 11 percent were for quality
control violations, mostly in the restaurant, non-food retail, hotel, and business service
sectors.17

Despite these relatively low rates of termination, the franchisor’s right to terminate
a franchisee has been a source of continuing controversy and some legislative activity.
From the perspective of the franchisee, the right of the franchisor to terminate the
franchisee can be of paramount concern because it can directly impact upon the ability of
the franchisor to continue his/her franchise unit:

The dominant problem arising between franchisors and franchisees, and the one for
which the principle of good faith and fair dealing is most commonly invoked,
involves the conditions giving rise to the severance of a franchise relationship. This

17Franchising in the U.S. Economy 1986-88, op. cit.
## Exhibit 8-5: Franchise Terminations by Year
Reported by Business Format Franchises, 1977-1988

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Terminations by Franchisor</th>
<th>Terminations by Franchisee</th>
<th>Terminations by Mutual Agreement</th>
<th>Total Terminations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>2,930</td>
<td>2,143</td>
<td>541</td>
<td>5,074</td>
</tr>
<tr>
<td>1978</td>
<td>1,748</td>
<td>3,069</td>
<td>1,152</td>
<td>5,969</td>
</tr>
<tr>
<td>1979</td>
<td>2,634</td>
<td>3,701</td>
<td>1,145</td>
<td>7,480</td>
</tr>
<tr>
<td>1980</td>
<td>2,780</td>
<td>3,546</td>
<td>430</td>
<td>6,756</td>
</tr>
<tr>
<td>1981</td>
<td>3,116</td>
<td>3,597</td>
<td>468</td>
<td>7,181</td>
</tr>
<tr>
<td>1982</td>
<td>2,473</td>
<td>3,097</td>
<td>610</td>
<td>6,180</td>
</tr>
<tr>
<td>1983</td>
<td>2,577</td>
<td>3,861</td>
<td>462</td>
<td>6,906</td>
</tr>
<tr>
<td>1984</td>
<td>2,649</td>
<td>3,661</td>
<td>305</td>
<td>6,615</td>
</tr>
<tr>
<td>1985</td>
<td>2,651</td>
<td>4,348</td>
<td>451</td>
<td>7,450</td>
</tr>
<tr>
<td>1986</td>
<td>3,075</td>
<td>3,914</td>
<td>372</td>
<td>7,361</td>
</tr>
<tr>
<td>1987</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>1988</td>
<td>3,714</td>
<td>4,865</td>
<td>NA</td>
<td>8,579</td>
</tr>
</tbody>
</table>


*Note: Data for product and trademark franchises was not available. Slightly different data collection categories and techniques were used in 1988.*
is perhaps the most crucial issue for franchisees, whose livelihood and capital investment in a franchise are clearly dependent upon the franchisor’s power to terminate, to decline, to renew, or to deny the franchisee the right to sell or transfer a franchise. 18

Beyond its potential to effect the survival of a franchise unit, some analysts argue that the right of termination permeates the relationship between the franchisor and franchisee, swinging this relationship decisively on the side of the franchisor. From this underlying "threat" of termination, it is argued that franchisees feel compelled to comply with the directives of franchisors, even if they are unreasonable or inappropriate. Some abuses (related to the ability to terminate) that have been cited include the following:

1. required purchases of inventory and equipment from the franchisor at above market prices,
2. required testing of unproven products without allowance for potential loss,
3. required investment to alter the design or appearance of the franchise location,
4. "voluntary" contributions for special promotional campaigns, and
5. extension of non-competition agreements to apply to franchise operations or to unrelated business activities of franchisees. 19

In opposing additional regulatory constraints on termination, franchisors typically argue that their right to terminate the franchisee should not be unduly restricted because the capacity to terminate is necessary to enforce quality standards and uniformity of system operations that are critical elements of franchising:

On the franchisor’s side, it is believed that such power is essential to the efficient operation of a franchise system. Legal actions designed to restrict this authority, or to guarantee franchise renewals, are widely viewed by franchisors as tantamount to

sanctioning noncompliance, incompetence, and noncompetitiveness.\textsuperscript{20}

Franchisors note that poor performance on the part of a franchisee can damage the entire franchise network:

A franchise whose performance is below the standards set out in the franchise agreement reduces the value of the trademark as consumers will quickly associate the substandard franchisee's products or services with all outlets in the chain. Where a substandard franchisee is permitted to continue to use the franchisor's accumulated goodwill with the public, the consumer suffers and the investment of all other franchisees is directly impaired.\textsuperscript{21}

Hence, franchisors believe that it is essential to maintain the ability to promptly terminate poor franchisee operations for cause in order to protect both the franchisor and also all other franchisees:

\textit{Franchising Expert}. The franchisor must have the ability to protect the entire franchise system and its image and name for the franchisor and all franchisees. Increased regulation [of the franchising relationship] is likely to protect the five percent of franchisees (who are unsuccessful for many reasons) at the expense of the 95 percent who are successful.

Franchisors point to statistics on termination (discussed earlier) to support their view that the number of terminations is not high and that there is little evidence of systematic abuse of franchisees through termination. Given the expenses of recruitment and intensity of training that is needed for new franchisees -- as well as the possibility of costly litigation -- franchisors argue that it makes little sense terminating franchisees that are performing adequately. Finally, it is argued that the rights to terminate are clearly spelled out in the franchise agreement. If the terms are too one-sided or if there is a pattern of abuse by a franchisor, it is argued that prospective franchisees will be less inclined to join the franchise system.

\textsuperscript{20}Franchising in the U.S. Economy: Problems and Prospects, op. cit., p. 65.

\textsuperscript{21}Neil Simon, op. cit., p. 149.
Some states have enacted legislation intended to more specifically stipulate the franchisor's right to terminate and to reduce the potential for abuse within the franchisor-franchisee relationship. The California Franchise Relations Act of 1980 stipulates that "good cause" is required for the franchisor to terminate the franchise agreement. "Good cause" is defined as including, but is not limited to, "the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure." Under the California statute, notice need not be given in the case of bankruptcy, insolvency, abandonment, material misrepresentation in connection with the acquisition of the franchise, repeated violations, eminent domain seizures, the franchisee's conviction for a felony, or a determination by the franchisor that operation of the franchised business will result in an imminent danger to the public's health or safety. Shorter cure periods are prescribed if the franchisee has failed to comply with applicable laws or failed to make timely payments of amounts due to the franchisor. The Wisconsin Fair Franchise Law and Fair Dealership Law provide less detailed, but equally broad provisions relating to termination. For example, the statutes require a 60-day period in which to rectify any claimed deficiencies and places upon the franchisor the burden of proving good cause.

As a result of reported abuses of termination conditions by franchisors, proposed legislation (the "Federal Fair Franchise Practices Act") was introduced to the 102nd Congress in May 1992. If enacted, this legislation would establish certain restrictions on the franchisor's right of termination and provide (in most cases) for a specified period to

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22California Statutes, 1980, Chapter 1355, Sections 20000-20043.

23Fair Franchise Law, Wisconsin Statutes, 553.01-553.78 (1981-82); Fair Dealership Law, Wisconsin Statutes, 135.01-135.07 91987-88).
cure a default. A key stipulation of this proposed legislation affecting the right to terminate is:

It shall be unlawful for any franchisor or subfranchisor, either directly or indirectly through any officer, employee, agent, representative, or attorney -- to terminate or otherwise cancel a franchise prior to its expiration without good cause for such termination or cancellation.24

b. Right of Renewal

An issue closely related to termination is the right of renewal. Most franchise agreements grant some form of extension rights to franchisees. In some cases, the right to renew may be perpetual, in others there may be a right for one renewal for a term usually not in excess of the initial term. Data available through Franchising in the Economy, suggests that a relatively small percentage of franchisees experience difficulty in renewing their franchise:

- of the franchise agreements up for renewal in 1988, 90 percent were renewed;
- of those not renewed, 84 percent were at the initiative of the franchisee or by mutual consent;
- 96 percent of all franchisors offer franchisees a contractual right to renew their franchise agreements; and
- renewal rates remained at about 90 percent for the period 1977 to 1988 (see Exhibit 8-6).25

Despite the fact that most franchisees are successful in renewing their franchise units, a number of issues have been raised with respect to renewal. Similar to termination, some experts and franchisees argue that franchisor's rights to renewal are

24"Federal Fair Franchise Practices Act," H.R. 5233, 102nd Congress, 2nd Session, May 21, 1992. The proposed legislation provides a restrictive definition of "good cause" which limits the ability of franchisors to terminate a franchise.

**EXHIBIT 8-6: FRANCHISE RENEWALS BY YEAR, REPORTED BY BUSINESS FORMAT FRANCHISES, 1977-1988**

<table>
<thead>
<tr>
<th>YEAR</th>
<th>ELIGIBLE FOR RENEWAL</th>
<th>RENEWED</th>
<th>PERCENT RENEWED</th>
<th>NOT RENEWED</th>
<th>NOT RENEWED BY FRANCHISEE</th>
<th>NOT RENEWED BY FRANCHISOR</th>
<th>NOT RENEWED BY MUTUAL AGREEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>14,122</td>
<td>13,429</td>
<td>95.1%</td>
<td>693</td>
<td>220</td>
<td>208</td>
<td>265</td>
</tr>
<tr>
<td>1978</td>
<td>15,373</td>
<td>14,299</td>
<td>93.0%</td>
<td>1,074</td>
<td>243</td>
<td>483</td>
<td>348</td>
</tr>
<tr>
<td>1979</td>
<td>15,364</td>
<td>14,126</td>
<td>91.9%</td>
<td>1,238</td>
<td>169</td>
<td>615</td>
<td>454</td>
</tr>
<tr>
<td>1980</td>
<td>11,411</td>
<td>10,202</td>
<td>89.4%</td>
<td>1,209</td>
<td>213</td>
<td>536</td>
<td>460</td>
</tr>
<tr>
<td>1981</td>
<td>11,515</td>
<td>10,278</td>
<td>89.3%</td>
<td>1,237</td>
<td>245</td>
<td>737</td>
<td>255</td>
</tr>
<tr>
<td>1982</td>
<td>11,415</td>
<td>10,061</td>
<td>88.1%</td>
<td>1,354</td>
<td>513</td>
<td>404</td>
<td>437</td>
</tr>
<tr>
<td>1983</td>
<td>11,854</td>
<td>10,707</td>
<td>90.3%</td>
<td>1,147</td>
<td>451</td>
<td>380</td>
<td>316</td>
</tr>
<tr>
<td>1984</td>
<td>15,354</td>
<td>13,950</td>
<td>90.9%</td>
<td>1,404</td>
<td>515</td>
<td>547</td>
<td>342</td>
</tr>
<tr>
<td>1985</td>
<td>12,543</td>
<td>11,369</td>
<td>90.6%</td>
<td>1,174</td>
<td>350</td>
<td>402</td>
<td>422</td>
</tr>
<tr>
<td>1986</td>
<td>12,999</td>
<td>12,073</td>
<td>92.9%</td>
<td>926</td>
<td>193</td>
<td>359</td>
<td>374</td>
</tr>
<tr>
<td>1987</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>1988</td>
<td>13,067</td>
<td>11,713</td>
<td>89.6%</td>
<td>1,354</td>
<td>222</td>
<td>479</td>
<td>653</td>
</tr>
</tbody>
</table>


Note: Data for product and trademark franchises is not available.
often one-sided, limiting the bargaining power of franchisees and, in some instances, exposing franchisees to abuses because the franchisee may have few alternatives but to accept the renewal on the franchisor's terms or to close the business. Those calling for greater regulations governing the renewal process argue that the franchisee contributes significant risk capital and labor to the development of the franchise and is therefore entitled to greater protection from unreasonable conditions of non-renewal. In addition, in the event of non-renewal, because of this substantial investment, it is argued that the franchisee is entitled to reasonable compensation (e.g., recovery of fair market value of the accumulated assets).\textsuperscript{28} Other sources of controversy relating to renewal include:

- **Imposition of Significant New Financial Commitments.** Franchisees are sometimes required to execute the "then-current" form of the franchise agreement, which may contain terms substantially different from the terms of the original agreement. Over a 10 to 20 year period (since origination of a particular franchise unit), the franchisor may have substantially changed the franchising concept, perhaps introducing new store designs, new marketing programs, and new products or services. When the franchisee's renewal time comes up, he or she may be faced with the need to make substantial financial commitments and/or change methods of operation -- which may, in turn, cut into the franchise unit's (short-term) profitability.

- **Imposition of Additional Legal Claims.** At the time of renewal, the franchisor may impose additional legal responsibilities or conditions upon the franchisee. For example, the franchisee may be required to execute a general release of claims against the franchisor.

- **Imposition of a Non-compete Clause.** Most franchise agreements contain a post-term covenant that prohibits competition on the part of the franchisee with the franchisor. This means that if the franchisee does not elect to renew the franchise agreement (e.g., because additional terms are too onerous), he or she must close the business, sell it to a third party (subject to approval by the franchisor), or change the business so that it will not be deemed competitive with the franchisor's system.\textsuperscript{27}

\textsuperscript{26}Franchising in the U.S. Economy: Prospects and Problems, op. cit., p. 51.

\textsuperscript{27}Rupert M. Barkoff, op. cit., p. 120.
Franchisors tend to view the franchise arrangement with a specific franchise unit as having a fixed duration, with the terms of renewal set forth in the original franchise agreement. They argue that given the lengthy duration of most franchise agreements, it is vital for the franchisor to maintain flexibility at the time of renewal so that it is possible to change and upgrade franchising units that may have become obsolete. The franchisor has the general responsibility for maintenance of the viability of the franchising system and is in the best position to determine the changes that may be needed. For example, from a practical standpoint, the franchisor has the capacity to conduct market research, maintain system-wide information regarding the market, and test various alternative marketing strategies. To maintain needed flexibility and viability of a franchising system (for the good of the franchisor and franchisees), it is argued that it is essential that the franchisor is able to restructure both the economic and legal terms of the franchise agreement at the time of renewal, as well as to eliminate those franchisees that have performed poorly:

Franchising Expert. The lack of profit in an operation is a fundamental problem in a system. The franchisor must keep the needs and interests of the franchisee in mind and must realize the economic need for profits to the franchisee in order to keep a strong system.

Unprofitable units create a drag on overall profitability of the franchisor and may effect the ability of the franchisor to recruit prospective franchisees and to secure financing from capital markets. It is noted that the franchisor’s ability to expand and support existing franchise units is closely linked to the growth and profitability of the franchising system as a whole. The renewal process is one of several tools that franchisors can use to leverage change in franchise operations and enhance performance (and profitability).

Another important issue affecting renewal (as well as termination and transfer) is the enforceability of non-compete clauses on the franchisee. As discussed above, some franchisees and experts view non-compete clauses as overly restrictive and as
substantially decreasing alternatives available to franchisees at the time of renewal.

Franchisors, however, tend to view non-compete clauses as a vital defense against loss of "intellectual property." Franchisors maintain that the intellectual property of the system is licensed rather than sold to the franchisee for use only during the term of the franchise agreement. In selecting a particular franchise system (versus starting an independent business or joining another franchise system), the franchisee is borrowing on the accumulated experience and goodwill that the franchisor has been building since the inception of the franchise system. Some portion -- franchisors generally argue that this portion is quite large -- of the successful start-up and business development that results within an individual franchise unit is attributable to the experience and the assistance of the franchisor. Therefore, when the term of the franchise agreement is concluded, it is argued that it is unfair for the franchisee to withdraw from the franchise system (taking the business "know-how" and customer base) and enter into competition with the franchisor. The fairness of "non-compete" provisions and their importance to franchisors were addressed by a number of experts and franchisees that we interviewed:

**Franchising Expert.** Our view is that when the franchisee selects a system, he profits from the use of intellectual property, subject to certain limitations he knows in advance. The intellectual property is not a wasting asset which has been transferred and is usually not completely paid for in the term. The franchisor's rights are limited by state court interpretations of non-compete clauses and by common law which says that non-compete clauses must be reasonable in geographical scope and in time.

**Franchising Expert.** Legal problems in the relationship often come from franchisees who violate the non-compete clause. They unilaterally walk away from the contract and say 'sue me.' There is often very flagrant use of confidential information.

**Ice Cream Franchisee.** The franchisor should have some right to keep an existing location when it is built up, unless this results in the franchisee being unable to sell the location for a long period of time.

**Maintenance Franchisee.** The key point is that you must look at the franchisee's
knowledge at the time of setting up. At that time, the franchisee wants the
franchisor’s help in setting up, so it is not fair to the franchisor if the franchisee can
throw away the contract and set up his own company in a few years. I can’t set
up my own company in the adjacent county, but the restriction is fair because I
wouldn’t know how to do it if I weren’t already a franchisee.

To date, there has been relatively little legislative activity to regulate the terms of
renewal. Among the states that have enacted legislation affecting the right of renewal are
the following:

- **Wisconsin.** The Wisconsin Fair Dealership Law provides that no franchisor
  may fail to renew "or substantially change the competitive circumstances’ of
  a franchise agreement without good cause." "Good cause" means either the
  failure to comply with essential and reasonable requirements of the
  franchisor which are non-discriminatory imposed or in bad faith.²⁸

- **Illinois.** The Illinois Disclosure Act prohibits the franchisor from refusing to
  renew the franchise agreement without compensating the franchisee for the
diminution in the value of his or her business if the agreement prohibits the
franchisee from competing after the agreement expires or if the franchisee
has not received six months’ notice of the intended non-renewal.²⁹

- **Iowa.** Iowa enacted new legislation (effective July 1, 1992) that
  substantially affects the terms of renewal (as well as termination and
  transfer). This legislation "basically makes the tie forever if the franchisee
want to continue the relationship," barring mid-contract terminations and
making it "illegal for the franchisor to refuse to renew a contract unless it
can show that the franchisee has not been operating up to snuff."³⁰

Finally, at the federal level, proposed legislation -- the Federal Fair Franchise Practices Act -
- was introduced in May 1992 that is intended to substantially alter the balance between
franchisors and franchisees in terms of renewal and non-compete provisions. For example,
this proposed legislation would "prohibit, or enforce a prohibition against any franchisee
from engaging in any business at any location after expiration of a franchise or after

²⁸Wisconsin Fair Dealership law, Wisconsin Statute 135.01 - .07, 1985.
³⁰Daniel B. Moskowitz, op. cit.
termination of the franchise prior to its expiration for good cause" except where the franchisor offers in writing to purchase the assets of the franchised business for its "fair market value" as a going concern.\(^{31}\)

c. **Right of Transfer**

A third major relationship issue relates to the ability of franchisors to restrict the franchisee’s right to transfer a franchise unit to other parties. Franchise agreements set forth the conditions for transfer should the franchisee die, become disabled, or seek to sell his/her unit for other reasons. Franchisors will usually retain their rights to approve or disapprove transfer (or sale) of a franchise unit:

Typically, a franchise agreement will allow the franchisor the unfettered right to transfer its interest in the agreement to another party. In contrast, the franchise agreement will normally provide that the franchisor has granted the franchise to the franchisee in reliance upon his character, skill, financial resources and so forth, and accordingly, the franchisee may not transfer his interest without the franchisor’s consent.\(^{32}\)

In addition to the right to approve the sale, franchise agreements also may contain a condition that the transferor must execute a general release of claims or that the franchisor must approve the terms of the transfer, including price. Hence, given the franchisor’s right to approve or disapprove the transfer, the franchisee is to a large extent subject to the "good faith" of the franchisor.

Aggregate data available on transfers of franchise units suggests that most

\(^{31}\)"Federal Fair Franchise Practices Act," H.R. 5233, 102nd Congress, 2nd Session, May 21, 1992. "Fair market value" of a franchise unit is to be determined as if the business were to be resold or renewed for a period of years equal to the contract term being offered by the franchisor for new or renewed franchises. Alternatively, the fair market value of a franchise unit may be ascertained by an impartial appraiser, whose appointment is acceptable to both parties. The offer must be submitted to the franchisee not less than 10 days before the effective date of termination or expiration.

\(^{32}\)Rupert Barkoff, op. cit., p. 122.
franchisees are able to transfer their franchise units despite the need for franchisor approval. For example, in 1986 (the last year for which data were made available by the Department of Commerce), 98 percent of franchisees that sought permission to sell their franchises were permitted to do so. The data also indicated, though, that the percentage of transfers approved declined slightly over the period 1977 to 1986 (see Exhibit 8-7).³³

Arguments for and against changes in regulations governing the right to transfer are not unlike those made concerning rights of termination and renewal. Some franchise experts, as well as franchisees, argue that the franchisor’s rights to approve or disapprove a transfer are too one-sided and subject to abuse:

It has been my experience, however, that franchisors frequently abuse their discretion when it comes to transfers. Franchisors often view transfer as an opportunity to exert pressure on the franchisee or his successor. For example, the franchisor may view the existing franchisee’s operations as substandard, and will therefore suggest, either outright or by implied threat, that a transfer will not be approved unless the operation is upgraded. If the transferor has multiple units, the franchisor might suggest that the transfer will not be approved unless the units retained by the franchisee are upgraded. I have also seen instances where it appears that the franchisor will drag its feet in approving a transfer in order to get the franchisee to sell the operation back to the franchisor, or to another favored person, sometimes at a more favorable price.³⁴

With their substantial investments of both capital and time in the development of their franchise units (which may be over several decades), franchisees often feel that they should have the authority to sell their units -- especially in the case of the sale of a unit to family or relatives. Franchisees note that franchisor restrictions make it more difficult to find a buyer and may depress the price which a successful franchise can command.³⁵ A number of franchising experts we interviewed felt that the issues surrounding transfer


³⁴Rupert Barkoff, op. cit., p. 122.

### EXHIBIT 8-7: FRANCHISE TRANSFERS BY YEAR
REPORTED BY BUSINESS FORMAT FRANCHISES, 1977-1988

<table>
<thead>
<tr>
<th>YEAR</th>
<th>REQUESTS FOR TRANSFERS OF OWNERSHIP</th>
<th>REQUESTS APPROVED BY FRANCHISOR</th>
<th>% REQUESTS APPROVED BY FRANCHISOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>2,648</td>
<td>2,623</td>
<td>99.1</td>
</tr>
<tr>
<td>1978</td>
<td>2,786</td>
<td>2,730</td>
<td>98.0</td>
</tr>
<tr>
<td>1979</td>
<td>3,388</td>
<td>3,344</td>
<td>98.7</td>
</tr>
<tr>
<td>1980</td>
<td>3,522</td>
<td>3,426</td>
<td>97.3</td>
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<tr>
<td>1981</td>
<td>2,978</td>
<td>2,878</td>
<td>96.6</td>
</tr>
<tr>
<td>1982</td>
<td>3,082</td>
<td>3,040</td>
<td>98.6</td>
</tr>
<tr>
<td>1983</td>
<td>3,634</td>
<td>3,524</td>
<td>97.0</td>
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<tr>
<td>1984</td>
<td>2,628</td>
<td>2,489</td>
<td>94.7</td>
</tr>
<tr>
<td>1985</td>
<td>3,501</td>
<td>3,380</td>
<td>96.5</td>
</tr>
<tr>
<td>1986</td>
<td>4,202</td>
<td>4,108</td>
<td>97.8</td>
</tr>
</tbody>
</table>


Note: Data for product and trademark franchises was not available.
were more important than either termination or renewal:

*Franchising Expert.* The more significant issue for most franchisees is the refusal to permit transfer. This is often in dispute because big dollars are involved and franchisees have the expectation that the business is theirs and they do not want franchisor's interference in the sale. The franchise agreement used to say that franchisors could not unreasonably withhold consent, but now usually the agreement has many specific conditions. Often the franchisor may have a right of first refusal or require a new, more restrictive franchise agreement as a condition of approval.

Franchisors typically argue that there is a need for franchisors to have considerable control over the ability of franchisees to transfer their franchise units. Because the quality of performance and profitability of individual franchise units can substantially impact the franchisor's image and profitability, franchisors typically argue that it is essential to examine the experience and financial capability of proposed buyers of existing franchise units as they would any prospective franchisee (even when the "proposed buyer" is a family member). Franchisors argue that not only are their own interests served by their ability to approve transfers of franchise units, but they are protecting the interests of all of their franchise units.

With the exception of Iowa's recent enactment of new franchising laws affecting the right of transfer, federal and state governments have generally been reluctant to address the issue of transfer of franchise units (except through more generalized laws governing contracts and fair business practices). However, Iowa's new laws are (comparatively) quite restrictive in the area of the franchisor's right to approve the sale of existing franchise units. As of July 1, 1992, Iowa's law mandates that the franchisee can give or sell a minority interest in a franchise unit to any family member without approval.

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36 The Arkansas Franchise Practices Act sets forth a procedural pattern in connection with franchise transfers; the California Franchise Relations Act protects heirs, spouses, and estates.
from the franchisor. The law also permits the franchisee to sell a franchise unit to anyone he or she selects, as long as the new owners meet the minimum standards the franchisor is using in selection of other business owners. There is also a limit on the fee the franchisor can charge for the transfer – it cannot exceed the actual cost of doing the necessary paperwork.\textsuperscript{37}

d. **Territorial Rights**

Another significant and currently controversial issue relating to franchise agreements is the territorial rights of franchisees. Most franchise agreements are fairly specific in how they delineate what territorial, customer, or product rights are granted to the franchisee. In the case of territory, a franchise agreement may designate a specified area. Alternatively, the agreement may indicate that the franchisee may operate only from a designated location and may acknowledge the right of the franchisor to place additional units in any location it chooses, even though the placement of such units may adversely impact the franchisee. Concerns about territorial rights have three dimensions:

- **encroachment**, when franchisors desire to open additional stores in a market area without necessarily giving existing franchisees first option to purchase the new units;

- **non-traditional means of distribution**, where franchisors seek additional ways of distributing products in a market area beyond franchises and franchisees become concerned that these alternative methods may have a negative impact on their sales; and

- **modification of territories at the time of contract renewal**, where franchisors desire to reduce or eliminate a franchisee’s territorial exclusivity at the time of renewal.

Franchisors generally believe that they should have a broad ability to limit prior geographical exclusivity during the renewal process. Franchisors argue that the

\textsuperscript{37}Daniel R. Moskowitz, op. cit.
appropriate size of a franchisee’s territory may change over time (particularly over a 10-to
20-year period), depending upon changes in traffic patterns, population density, and
marketing strategies. For example, the addition of new office or residential space or
construction of new roads or public transportation within a locality can substantially alter
the number of franchise units that can and should operate within a specified territory.

As a practical issue, franchisors generally feel they are in the best position to
determine when increased units may be needed within a local area because of their
national (or regional) perspective. Franchisors argue that the addition of units to a local
area may actually benefit a local franchise unit by reducing the likelihood of competing
franchise systems entering a local market. The addition of a unit can also have the effect
of expanding advertisement and marketing within a locality, and thereby increase
consumer recognition of a product or service. In many cases, franchisors noted that new
units are first offered to existing franchisees within a territory. Typical of the comments
that we received reflecting the franchisor’s views of territorial issues include the following:

Restaurant Franchisor. Setting a territorial restriction of five miles, for example, is
not good because it really depends on the market. In some areas like the Chicago
loop or areas of New Orleans, we have five company-owned stores within about 1
mile and all are doing over $1 million in sales. In other areas, five miles is too
close. There is no black and white answer to how close is too close; it all depends
on traffic and population density. The problem that territorial limits create is that
another chain will go in and reduce our market penetration because of its presence.
We do not have territorial restrictions in our agreement, but our policy is not to
cannibalize sales of an existing store by putting in another.

As might be expected, franchisees have a somewhat different perspective on
territorial matters than franchisors. Franchisees often acknowledge that defining local
territories is difficult and subject to change over time and that saturation of a local market
(to limit competition) can also be beneficial for both the franchisor and franchisee.

However, franchisees generally feel that franchisors have an obligation to avoid locating
new franchise outlets in a territory that may decrease the sales and/or profitability of existing franchisee. The franchisees we interviewed stopped short of supporting territorial restrictions imposed through regulation. Many franchisees feel that the right of first refusal should be offered to existing franchisees. Some of the views of franchisees we interviewed on territorial issues follow:

**Restaurant Franchisee.** Territorial restrictions are a tough area to develop a fair policy in. The company needs the right to develop a market, but the franchisee needs some protection from stores which cannibalize his sales or cut his territory. I have several stores. In one case, I needed to develop an additional store in my area to reduce the volume of a store which had 'max'd out.' The new store built my sales overall, but it cut the volume at the old store.

**Restaurant Franchisee.** Our system’s expansion policy is generally fair. The franchisor sells an initial area with demographic data on how many stores should be developed in the area and the franchisee commits himself to develop that number of stores in area. If other people want to develop in a nearby area, the company offers the right of first refusal to the existing franchisee if he wants to develop it.

**Restaurant Franchisee.** Defining a territory can be a problem. For example, an area can hit a point of saturation from a profit standpoint, but it may still be an advantage for the corporation to build market share and total sales with more stores. There can be a situation where the site needs to be developed by your company or an existing store will be hurt even more when the competition takes a site because the market is there. It’s very difficult to draw a standard territory because it depends on several factors, including traffic flows and population density.

**Ice Cream Franchisee.** If the franchisee operates a good store and pays his royalties promptly, then he should be protected in his county or immediate area. If another store in a nearby area is needed to build advertising dollars or keep out competition, then the franchisee should have the right of first refusal.

With the exception of recent legislation enacted in Iowa, there have been relatively few attempts at the federal or state levels to address territorial concerns of franchisees. Iowa enacted a new law (effective July 1, 1992) which could substantially affect the ability of franchisors to locate new franchise units in the vicinity of existing franchise units. For example, Iowa’s law gives existing franchisees the right to purchase new franchise units if they are near enough to the existing business to affect competition (e.g.,
within three miles for fast-food outlets). If the franchisor establishes a new unit without giving the existing franchisee the right of first refusal on the location, the franchising company must pay its existing franchisee the profit lost from the business diverted to the new franchise unit. Critics of Iowa’s law suggest that such laws are likely to diminish incentives for franchisors to expand using franchising (e.g., they may choose company-owned stores instead). Additionally, there is difficulty in establishing valid territorial limits for franchise units (especially over time) and fair compensation for lost profits.

D. STEPS THAT FRANCHISORS CAN TAKE TO IMPROVE AND MAINTAIN FRANCHISEE/FRANCHISOR RELATIONSHIPS

Successful franchise relationships often last several decades (or longer), may involve hundreds of thousands of dollars of investment, and require the transfer of extensive business assistance and services between the franchisor and franchisee. Successful franchise relationships must be able to adapt not only to economic cycles, but also to major technological, social and legal changes. In addition, there is a need to overcome what may be (at times) conflicting goals between franchisors and franchisees. For example, while both the franchisor and franchisee generally benefit from higher sales, a franchisor’s royalties typically depend on gross sales, while the franchisee’s income is linked to the profitability of the sales. Given the long-term and interdependent nature of the relationship between franchisors and franchisees, there are many critical points at which a franchising relationship can run into difficulty.

Franchising experts, franchisors, and franchisees that we interviewed stressed that outside of the legal/regulatory framework, that there are a variety of steps that franchisors

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Daniel B. Moskowitz, op. cit.
can take to maintain and improve the relationship between franchisors and franchisees. In addition to maintaining effective franchisor/franchisee relationships, these steps can also improve the overall profitability and viability of franchise systems and reduce costly litigation harmful to both franchisors and franchisees. Below, we highlight some of the key points that our interviewers suggested can be helpful in building and sustaining effective relationships.

1. Maintaining Good Communications Between Franchisor and Franchisee

One consistent message of franchisors, franchisees, and experts alike is that while mutual profitability is a fundamental factor, good franchise relationships require constant and effective communications. Well-established communication channels allow new ideas to be introduced and disputes to be resolved. Some examples (from our interviews) of effective strategies to promote communication within franchising systems are described below.

Restaurant Franchisee. I did not have a good relationship with the previous management because I felt that they did not have a feel for the franchisee’s position or respect for the franchisee as a business partner and they didn’t appreciate the scope of franchisee’s financial investment. I was initially concerned by the leveraged buyout of the franchisor because the new management came from outside the food business. But, I soon found that the new management was outstanding and oriented to having the franchisees grow and make money. By encouraging the franchisees to say what they thought, and permitting them to find out what was going on, the new management created a very positive climate.

Restaurant Franchisor. The key to a good relationship is communication, especially in the development phase. It is important to try to include franchisees in decision-making if possible, and to try to get their ideas and use them if you can. The point is to make the franchisees recognize the value of the system and feel responsible for maintaining the system’s value to the other franchisees.

Restaurant Franchisor. The most difficult thing to organize in a franchise system is the communication between the franchisor corporation and the franchisee’s operational management to make sure all aspects of the program are being implemented. In any company, it is not unusual to have conflict between the
corporate and operations staffs because they have different perspectives and different personalities. In my small system, we have four full-time staff to deal with only four franchisees, but we still find it difficult to get agreement and to maintain a standard approach.

**Franchising Expert.** The franchisee may feel unloved if he is not contacted enough, or feel that the franchisor is not listening. Often the simple solution is open communication. For example, the president of one franchise I know creates a list and calls all franchisees not contacted by the front office during the month.

**Franchising Expert.** A frequent complaint I noticed involved the growth in the size of the franchise system. When it was small, there was personal interaction between the franchisor and franchisee. As the system grows, there is less personal interaction in the big system and, as a result, franchisees often feel that system doesn’t listen to them anymore.

Most of those that we interviewed felt that franchise advisory councils can make a significant contribution toward maintaining effective franchisor-franchisee relationships. Franchise advisory councils provide a forum for sharing information and ideas. Among those we interviewed, there was a consensus that the number and scope of advisory councils appeared to be growing:

**Franchise Expert** Franchisors have found that, from a practical standpoint, they need more than legal power to bring franchisees along on changes. There has been a growing focus on the franchise relationship and franchisor/franchisee consultation because a logical way to address problems is through the franchisee organization. It is mutually beneficial to solve problems together because franchisees have the information, but see the trees rather than the forest, and franchisors have the ability to see the whole system and lead the franchisee to change.

However, there are reports that some franchisors actively tried to discourage the formation of councils or to control their operation.39 Some additional observations from our interviews about the role of advisory councils and their effectiveness are displayed in Exhibit 8-8.

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**EXHIBIT 8-8: VIEWS ON FRANCHISE ADVISORY COUNCILS**

**Franchising Expert.** Franchise advisory councils can be effective if they deal with real problems as an advisory group and have real access to the franchisor. They have a limited role as an advisory group, not a decision group.

**Franchising Expert.** I'm not a strong advocate of formal franchise advisory councils. The main point is for the franchisor to keep the interests and needs of franchisees in mind, and to give attention and consideration to the franchisees as people. If this is done effectively, the formal system is not critical. The major downside of franchise advisory councils is potentially organizing dissenters of the system and giving them a forum for stirring up activity. The tendency in franchise advisory councils is to recruit those who have complaints and the problems may or may not be representative of the system as whole. In any case, the franchisor may end up annoying his supporters with either a response or non-response to the suggestions of the council.

**Hotel Franchisor.** We helped our franchisees set up a franchise council because it was important to our communications to franchisees. It helped communications in both directions and had a number of benefits. The council had the credibility to communicate the reasonableness of what the franchisor was trying to do. It reduced problems with compliance. It gave us more feedback on the bugs in the system and fine-tuned criticism so it was more focused. The result was that it fostered the system to change and become more profitable for both parties. Eventually, we put two members of the franchise counsel on the board of the company.

**Construction Franchisee.** A unique aspect of our franchise is the ability of franchisees to help govern the system and control the future through our franchise councils. Our district councils help make the policies of the company. Our district councils meet twice a year and have real power through a democratic process to set the rules of the system. About a half of the proposed rule changes come from the franchisor, and the rest come from our executive council or individual franchisees. The system uses the experience of everyone to improve our operations. We set up ad hoc committees to do various things like new ventures, new programs or new marketing.

**Ice Cream Franchisee.** I was on our national franchise advisory council and chaired my region for two years. We talked about various topics like problems, upcoming marketing, changes in products, and consumer tastes. I enjoyed it and thought that it kept me on top of the company's situation and on the ground level in trends. As the regional chair, the most difficult part was getting a response from other franchisees. Many owners don't want to get involved, give opinions or make suggestions, but then they complain after the fact.

**Maintenance Franchisee.** I was on the President's Advisory Council for six years. It started with people yelling at the President, but evolved to a problem-solving group which meets regularly twice a year. It covers all aspects of the business like advertising, the five-year plan for the franchisor, suggestions on equipment, and planning for the national meeting.

**Maintenance Franchisee.** We have a franchise advisory council which is elected by the franchisees. They meet quarterly and by conference call. The members call other franchisees to get opinions. It serves as sounding board for new ideas. It is especially useful to new franchisees who are hard-charging and full of ideas since it gives a way to filter ideas using the experience of other franchisees. It doesn't stifle creativity, but it helps focus and direct the input and ideas of new franchisees through the comments of other franchisees.

**Restaurant Franchisee.** I have been on the President's Council and the Ad Council which meet quarterly. I give my input, but I don't believe in franchisees having too great a say in running the system. Franchisees often don't agree on the specific solutions to problems or they invent problems at the meeting because of their need to speak. A committee just can't decide how to go ahead effectively. The best thing is that each franchisee should voice opinions to management himself and not go indirectly through a representative to a franchise advisory council.
2. Maintaining Support Over Time and an Atmosphere of Trust

As discussed in Chapter 6, the assistance that a franchisee values changes as the franchisee gains experience in the business and as market conditions change over time. The franchise relationship needs to evolve so that the franchise system can continue to be important to franchisees and provide the types of assistance and support that is needed. Over time, franchisees tend to be more critical of what they are paying for in terms of royalties and, according to our interviews, problems tend to crop up in certain areas; particularly related to the level and quality of franchisor services, advertising or marketing decisions, and franchisor inspection and quality control. Some observations from our interviews follow:

*Franchising Expert.* The biggest tensions between a franchisor and franchisee depend on how long they have been married. Early stage franchisees tend to be concerned with whether the franchisor delivered what was promised to the franchisee. Mature franchisees are concerned with whether the franchisee is getting full value for his royalty dollar. In addition, tougher economic times have resulted in more irritation and resulting class actions, and increased arbitration, as well as restructured financial arrangements.

*Franchising Expert.* The franchisor must be creative in keeping the support of the franchisee over time. The franchisee may find increasing fault in the franchise program as he learns more. The franchisee may have repeated problems with his supervisor or with standards that are too hard or too lenient. It is normal for the franchisee to become more independent over time, but some franchisors may find it personally difficult to accept this fact and plan for it. Some franchisees who want or expect to be more independent and more respected over time may have a psychological problem in their continued relationship to the franchisor.

As with any long-term business relationship -- particularly one that is as interdependent as the franchising relationship -- interviewees stressed the importance of developing and maintaining an "atmosphere of trust". This atmosphere of trust requires constant attention and reinforcement from both parties, open communication channels, and a willingness to "give-and-take." According to those we interviewed, both franchisors and franchisees need to continually look at the long-term picture and devote time and
energy in developing an atmosphere of dialogue and trust.

E. IMPLICATIONS AND CONCLUSIONS

As reflected in this chapter, the relationship between franchisors and franchisees has been at the center of considerable controversy over the past decade. Franchisors and franchisees, as well as federal/state governments, have struggled with the issue of whether additional laws and regulations are needed to eliminate abuses and enhance the relationship between franchisors and franchisees. Our interviews with franchising experts, franchisors, and franchisees, as well as the existing data on franchising and views expressed within the literature on franchising, suggest that considerable care should be taken in instituting any new regulations that could be harmful to the overall trends of growth within franchising or that might substantially increase costs/burden of franchising. On balance, the following factors argue against substantial change to current law and regulations governing franchising relationships at the federal and state levels:

- **Satisfaction with Franchising Relationships Is High Among Franchisees.** Findings (of a recent Gallup Organization survey) on franchisee overall levels of satisfaction and rating of the franchisor-franchisee relationship suggest that most franchisees are (overall) satisfied with the existing relationship. Only 6 percent of franchisees indicated that their relationship with their franchisor was poor.

- **Feasibility of Implementing Effective and Generally Applicable Relationship Regulation Is Questionable.** Given the diversity of franchising relationships and very differing circumstances of franchisees (even within the same franchise system), the feasibility of enacting regulations that would effectively apply to all franchising situations is uncertain. For example, designation of an appropriate territory for franchise units, to guard against encroachment, is a subjective judgement which depends upon the specific franchise system and the specific location of each franchise unit.

- **Substantial Recent Growth in Franchising Indicates Its Popularity and Acceptability Among Franchisors and Franchisees.** Growth of franchising -- especially within the business format sector -- has outpaced general economic growth over the past two decades. Although it is impossible to
know whether added protections would have increased the growth of franchising (above actual growth levels), the sustained growth that occurred would seem to argue against radical changes that might affect the willingness of franchisors to use franchising as a method of expansion. Such legislation -- if it significantly affected franchisor incentives -- could have a substantially negative effect on future growth of franchising.

- **General Legal Framework and Franchising Disclosure Laws Provide Basic Protections for the Franchisee.** There is an existing body of law (e.g., common law, tort law, securities law, trademark law) which provides a basic level of protection for franchisees against deception and unfair business practices. General legal protections are further reinforced and extended -- to some extent -- by federal and state disclosure pertaining to franchising.

- **Costs and Burdens of New Regulations Could Be Substantial and Effect Willingness of Franchisors to Franchise.** Added regulation of the relationship could have a likely impact of increasing regulatory burden and costs of franchising, which is likely to be passed onto franchisees and then consumers. For example, new regulations and legal restrictions on the relationship would increase legal costs for franchisors (and franchisees) as they cope with understanding the implications of these laws and make necessary changes to franchise agreements. Such laws are also likely to lead to added litigation and legal costs (at least over the short-term). Such added burden and costs may have the effect of pushing franchisors toward establishment of company-owned outlets (rather than franchisee-owned outlets).

Given these factors, the risks of new regulation governing the franchising relationship appear to outweigh the potential benefits. In fact, such regulation, if too onerous on franchisors, could dampen expansion of franchising in the U.S. and create incentives for franchisors to move in the direction of opening company-owned stores rather than franchisee-owned outlets. Given the risks associated with added regulation of the relationship -- and opposition to such legislation among franchisors and, to a some extent franchisees -- regulation of the franchising relationship should be considered as a last option for eliminating abuses within franchising relationships. Other avenues for improving the franchising relationship appear to be more promising and to offer fewer risks in terms of continued growth in franchising, including:

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• Greater Emphasis Is Needed in the Areas of Full Disclosure and Enforcement at the Federal/State Levels. Prospective franchisees need reliable and honest information regarding likely earnings and the structure of the relationship before entering the franchise agreement. At the federal/state levels the review of disclosure statements and greater enforcement concerning deceptive practices could be instrumental in providing greater protection to franchisees against fraud or abusive franchisors.

• Prospective Franchisees Need to Be More Vigilant in Validating Claims of Franchisors with Existing Franchisees, and if Necessary, Federal/State Agencies. Before entering franchising relationships, franchisees need to be more vigilant in contacting franchisee units -- particularly those that have terminated or not been renewed. Franchisees need to enter such relationships with clear expectations.
CHAPTER 9:
THE FUTURE OF FRANCHISING IN THE U.S.

The previous chapters of this report have examined the expansion of franchising in
the U.S. and the many factors contributing to the growth of franchising from 1975 to
1990. This chapter will build on earlier findings, discuss the major trends that are likely to
shape the future of franchising in the coming decade, and present a series of
recommendations on how the growth of the industry may be assisted.

A. PROJECTED TRENDS IN FRANCHISING DURING THE 1990's

In the past, the growth of franchising occurred because it served the mutual
interest of entrepreneurial franchisors and franchisees. Franchising allowed entrepreneurial
businesses who developed a successful business concept to surmount several limitations
and to expand their businesses rapidly and economically. For the franchisee, franchising
offered easy access to an established product and the opportunity to operate a small
business with less perceived risk. The expansion of franchising over the past two decades
occurred in a generally supportive economic, social, and legal environment which fostered
its growth.

The consensus that emerged from the literature on franchising and from our
interviews was that franchising would continue to grow during the 1990s (particularly
business format franchising) unless there was:

- a major and prolonged recession, or
- introduction of legislative or regulatory change that significantly alters the
  underlying incentives of franchising for franchisors or franchisees.

Typical of the viewpoints of most of the franchising experts that we interviewed was the
Franchising Expert. The growth of franchising will continue because it meets the economic needs of both franchisors and franchisees. There will be continued growth because there is no substitute for the franchisee who wants to go into small business easily and no substitute for the franchisor who wants to replicate a concept. However, a major legal change or regulatory effort could hinder growth.

The extent of growth is likely to be shaped by a number of factors -- the most important of which is overall growth of the U.S. economy. This section discusses likely trends in franchising during the 1990s based on recent statistical trends, the literature on franchising, and our discussion with franchising experts, franchisors, and franchisees.

Exhibit 9-1 provides a summary of likely key trends in franchising during the 1990s.

1. Overall, Franchising Sales Are Likely to Continue to Expand and Could Reach a Level of $1 Trillion Dollars by the Year 2000

It is generally expected that franchising sales will continue to expand during the 1990s, barring a prolonged recession or major legislative/regulatory changes. As shown in Exhibit 9-2, if the underlying trend in sales from 1975 through 1990 were extended into the future, franchise sales could be expected to increase to over 1,000 billion dollars by the Year 2000. As shown in Exhibit 9-3, product/tradename franchising could be expected to reach a level of about $750 billion dollars in sales by the Year 2000, while business format franchising could be expected to reach a level of about $300 billion dollars.

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1The estimates for the years 1991-2000 presented in this chapter are derived from a regression of data for the years 1975 to 1990. The future estimates prepared by this method should be interpreted as indicating the broad underlying trend within the data for the future, if major conditions were to remain essentially unchanged. In most cases, the estimated trend fits the actual data quite well, and the future estimates are regarded as reasonable in light of current conditions.
1. Overall, Franchising Sales Are Likely to Continue to Expand and Could Reach a Level of $1 Trillion Dollars by the Year 2000

2. Franchising Sales Are Likely to Continue to Increase as a Percentage of Retail Sales and May Reach a Level as High as 38 Percent of Retail Sales by the Year 2000

3. The Number of Business Format Franchising Establishments Is Expected to Continue to Expand, Reaching an Estimated Level of Over 450,000 by the Year 2000

4. The Number of Product/Trademark Franchising Establishments Is Expected to Decline, but at a Slower Rate Than During the Past Two Decades

5. Overall, Franchising Is Likely to Continue to Be a Source of New Job Growth within the U.S. Economy, with Employment in Franchising Possibly Reaching a Level as High as 10 Million by the Year 2000

6. The Number of Business Format Franchisors Is Likely to Continue to Grow at a Rate of About Four Percent per Year and May Reach a Level of Nearly 3,500 by the Year 2000

7. International Expansion of Franchising Is Likely to Continue at a Strong Pace

8. Franchising’s Flexibility Is Likely to Mean Continued Expansion of Franchising into New Markets, But Growth in Individual Sectors Is Difficult to Predict
EXHIBIT 9-2: FRANCHISE SALES, OVERALL, ACTUAL AND ESTIMATED TRENDS, 1975-2000

Sales ($ Billions)

Year

Actual  Estimated

EXHIBIT 9-3: FRANCHISE SALES, ESTIMATED TRENDS, OVERALL, PRODUCT/TRADENAME, AND BUSINESS FORMAT FRANCHISING, 1975-2000

Sales ($ Billions)

Year

Overall  Product/Tradename  Business Format
2. Franchising Sales Are Likely to Continue to Increase as a Percentage of Retail Sales and May Reach a Level as High as 38 Percent of Retail Sales by the Year 2000

Based on the franchising adaptability to retail trade and recent patterns of growth, most analysts feel that franchising will continue to expand and increase in its share of retail sales during the 1990s. Though increasing somewhat unevenly between 1975 and 1990, franchising sales grew as a share of retail sales from about 28.2 percent to 34.0 percent. This rapid expansion has resulted in some forecasts that franchising could account for as much as half of all retail sales by the end of the 1990s:

Excluding the possibility of a major economic recession, the chances are extremely good that franchising will maintain current levels of growth throughout much of the 1990s... it is likely that annual sales of franchise businesses will exceed half of all retail sales in the economy by the end of the decade.²

To account for one-half of all retail sales, however, franchising would have to undergo a period of unprecedented growth during the 1990s. As shown in Exhibit 9-4, based on patterns of growth over the past 15 years, it seems more likely that franchising’s share of retail sales will increase by three to five percentage points during the 1990s -- possibly reaching a level as high as 38 percent of retail sales by the Year 2000.

3. The Number of Business Format Franchising Establishments Is Expected to Continue to Expand, Reaching an Estimated Level of Over 450,000 by the Year 2000

Between 1975 and 1990, business format franchising grew steadily from a level of 210,814 to 386,111 establishments, while product/tradename franchising declined from 223,724 to 135,097 establishments. As a result, business format franchising grew from slightly less than one-half (48.5 percent) of all franchise establishments to about three-

²Franchising in the Economy: Problems and Prospects, op. cit., p. 16.

EXHIBIT 9-5: NUMBER OF ESTABLISHMENTS, BUSINESS FORMAT FRANCHISING, ACTUAL AND ESTIMATED TRENDS, 1975-2000
quarter (74.1 percent) of franchise establishments. The predominant sentiment among franchisors, franchisees, and experts that we interviewed was that the principal growth in franchising establishments will continue to come in business format franchising. As shown in Exhibit 9-5, the pace of growth in business format franchise establishments since 1975 suggests that business format franchising could reach a level of slightly over 450,000 establishments by the Year 2000. Given the adaptability of business format franchising to high growth service sectors over the past two decades, it is possible that business format franchising establishments may even exceed this level.

4. The Number of Product/Tradename Franchising Establishments Is Expected to Decline, but at a Slower Rate Than During the Past Two Decades

Projecting the pattern of growth for product/tradename franchising is more problematic. This is because of the precipitous decline in the number of product/tradename establishments since the early 1970s. Much of this decline was due to restructuring of the gasoline service station sector -- which resulted in closure and consolidation of many gasoline service stations in the U.S. Few analysts expect the same kind of decline in product/tradename establishments during the 1990s. Hence, it would be unwarranted to use data on trends over the past 15 years to project future establishment trends for this sector. Most analysts that we interviewed indicated that the number of product/tradename franchisees was likely to continue to decline over the next decade, but at a much slower rate than has been experienced since the early 1970s.

\[\text{For example, if trends in product/tradename franchise establishments between 1975 and 1990 continued through the 1990s, by the Year 2000 there would only be an estimated 63,000 product/tradename establishments.}\]
5. Overall, Franchising Is Likely to Continue to Be a Source of New Job Growth within the U.S. Economy, with Employment in Franchising Possibly Reaching a Level as High as 10 Million by the Year 2000

Over the period from 1975 to 1988, employment in franchising doubled from 3.5 million to 7.0 million, with more than 90 percent of the increase coming in business format franchising. This increase resulted both from the growth in the number of franchise establishments and an increase in the number of persons employed per franchise establishment. Significant growth occurred in restaurant and hotel sectors. As shown in Exhibit 9-6, employment within franchising may reach a level as high as 10 million persons by the Year 2000. Much of this growth will continue to come within business format franchising, which could grow to a level of about 8.2 million. While growing at a slower rate than business format franchising, product/tradename franchising could reach a level of about 1.8 million employees by the Year 2000.

6. The Number of Business Format Franchisors Is Likely to Continue to Grow at a Rate of About Four Percent per Year and May Reach a Level of Nearly 3,500 by the Year 2000

As noted in Chapter 2, the number of business format franchisors more than doubled from 1,115 franchisors in 1975 to 2,239 in 1988. Because business format franchising will continue to offer several fundamental advantages for company expansion, experts see a continued growth in business format franchising of about 4 percent per year or a net growth of about 75-100 franchisors per year. As shown in Exhibit 9-7, the number of business format franchisors may reach a level of nearly 3,500 by the Year 2000.

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EXHIBIT 9-6: FRANCHISE EMPLOYMENT, OVERALL, ACTUAL AND ESTIMATED TRENDS, 1975-2000

Persons Employed (Millions)

Note: Data were not available for 1976 and 1987.

EXHIBIT 9-7: NUMBER OF BUSINESS FORMAT FRANCHISORS, ACTUAL AND ESTIMATED TRENDS, 1975-2000

Number of Franchisors

Note: Data were not available for 1987.
7. **International Expansion of Franchising Is Likely to Continue at a Strong Pace**

Although extensive consideration of the international expansion of franchising was beyond the purview of this report, the increased penetration of foreign markets by U.S. franchisors, and the growth of foreign-based franchisors in the U.S. are important trends which are likely to continue during the 1990s. For example, according to *Franchising in the Economy: 1988-1990*, one sixth of all business format franchisors had units outside the U.S. in 1988 and the number of foreign units operated by U.S. franchisors grew by more than 10 percent between 1986 and 1988. A number of factors are likely to provide continued impetus for expansion of foreign units by U.S. franchisors, including:

- saturation of existing domestic markets,
- growing prosperity and expanding demand for consumer goods in many foreign markets,
- increasing emphasis on the global marketplace and reduction in barriers to trade,
- improving international communications and transportation systems,
- growing interest on the part of investors in many foreign countries, and
- lack of specific regulation governing franchising in most foreign countries.

According to a number of recent surveys and most franchising experts, rapid expansion of U.S. franchisors into international markets is likely to be the case throughout the 1990s:

...according to my own recent survey of U.S. franchise systems, almost one-half of the responding franchisors without foreign units plan to initiate such expansion, and more than 90 percent of the systems with foreign units intend to increase their presence in foreign countries.\(^5\)

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\(^6\) B. Walker, op. cit., p. 3.
8. Franchising's Flexibility Is Likely to Mean Continued Expansion of Franchising into New Markets, But Growth in Individual Sectors Is Difficult to Predict

Basic social/economic trends and the introduction of new technologies are likely to continue to define specific consumer groups and niche markets which are suitable for franchising in the 1990s. Over the past two decades, franchising has been proven to be an effective method for businesses to adapt to fragmented markets created by changing consumer tastes and demographics. Franchising has wide applicability as a form of business organization because it is flexible, and can be adapted to many industries and conditions. The publicized success of franchising and a growing group of professionals experienced in franchising will lead to utilization of franchising in new situations where other methods of marketing or distribution have been traditionally used. As in the past, it will continue to be very difficult to predict future applications of franchising:

Who would have though that video yearbooks, housesitting services, environmentally safe cosmetics, home inspections, and house calls by physicians would be sold through franchises as they all now are? Who would have imagined the variety of restaurant menus and formats that are core products for franchises today. Some of the growth will represent logical extensions and mere imitations of an existing offering. However, some new franchisors surely will offer products that are unfamiliar today.7

Beyond the continued broad shift toward business format franchising, it is difficult to predict the specific sectors within franchising that are likely to experience high rates of growth or decline. Among the franchising sectors that have grown the fastest in terms of sales since 1975 are recreation, entertainment and travel (1131.8 percent in inflation-adjusted sales between 1975 and 1990), real estate (996.3 percent), printing and copying services (762.9 percent), miscellaneous business services (634.5 percent), and education products and services (327.1 percent).

7B. Walker, op. cit., p. 3.
9. Other Potential Trends

Some other potential trends identified in the literature and/or during our interviews that are likely to affect patterns of growth in franchising during the 1990s include the following:

- **Increased Emphasis on Profitability of Existing Franchise Units Versus Expansion.** According to some experts, during the 1990s a growing number of franchisors (especially larger and mature franchise systems) will concentrate on generating higher returns from their franchising units. Franchisors may look to generating better returns from existing units as opposed to increasing the number of franchisees. Some possible methods for increasing profitability of franchisees include: (a) dual operations, in which franchisees are permitted to run two franchises from a common area or adjacent area, (b) reduction of operating costs (e.g., downsizing operations to kiosks, sharing common space with complementary outlets, and operating out of mobile units, and (c) increasing ownership of multiple units in order to reduce training and supervisory costs.\(^8\)

- **Likelihood of Stricter Monitoring and Enforcement of Standards, Especially within Larger, More Mature Franchising Systems.** In our interviews, several experts mentioned a recent trend toward stricter enforcement of standards, particularly within larger, more mature franchising systems. This may, in part, be a reflection of the growing ability of franchisors -- through improved computerized systems and telecommunications systems -- to monitor franchisee operations on a daily basis. For example, one franchising expert noted that the increased monitoring capacity may permit companies to substitute company-owned operations for franchisee-owned units through the development of more sophisticated management systems and managerial incentives.

- **A Growing Proportion of New Franchisee Owners is Likely to Come from Three Groups -- Middle Managers, Women, and Independent Small Business Owners.** Trends during the 1980s suggested that three groups -- middle managers, women, and independent small business owners -- were increasingly attracted to franchising as a method for opening and operating small businesses. According to most experts, these three sources will continue to provide a disproportionate share of new franchisees. For example, corporate restructuring and downsizing will continue to provide a source of experienced, middle managers who have the necessary resources and skills to operate franchise units. While rates at which women entered franchising slowed somewhat in the late 1980s, a number of analysts argue that the role of women in franchising is likely to grow (at least modestly) as

\(^8\)B. Walker, op. cit., p. 3.
women re-enter the business world after raising a family, leave the corporate world to operate businesses of their own, or form partnerships with their husbands. Finally, a number of factors have been cited as likely to increase the role of independent small business owners in the field of franchising: "Facing stiff competition from chains and/or franchise systems, more small business owners will purchase a franchise, sacrificing some independence in return for a more powerful brand image and various forms of support."9

- Small- and Medium-Size Franchisors Likely to Grow in Their Importance. According to franchising experts we interviewed and recent trends, large franchisors, those with more than 500 franchise establishments, are likely to continue to dominate franchising as they have in the past. However, small and medium size franchisors, are likely to grow in their importance during the next decade. Between 1975 and 1986, for example, the number of franchisors with 50 or fewer establishment units nearly doubled and their share of establishments and sales also grew. Medium-size franchisors (those with 151 to 500 establishment units) also experienced significant gains, growing from 113 to 204 franchisors (an 80.5 percent increase). This group’s share of establishments increased from 13.5 to 18.0 percent and its share of sales increased slightly from 17.3 to 18.7 percent.

B. RECOMMENDATIONS FOR FOSTERING FUTURE GROWTH

The recommendations provided in this section are intended to improve the prospects for growth within franchising within the U.S. These recommendations have been framed from the perspective that franchising has generally prospered over the past two decades under a generally stable regulatory environment. While there has been some controversy about abuses in franchise sales and in franchise relationships, the existing data on renewal rates and terminations, and surveys on franchisee satisfaction suggest that whatever problems may exist are probably not widespread and that considerable care should be taken in instituting new regulations which may disrupt a growing sector of the economy. Exhibit 9-8 provides a summary of the recommendations proposed in this section.

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B. Walker, op. cit., p. 3.
Recommendation #1: The Federal Trade Commission Should Continue Efforts to Improve and Streamline Financial Disclosure and Encourage the Provision of Earnings Claims by Franchisors

Recommendation #2: The Federal Trade Commission and State Governments Should Better Coordinate Review and Enforcement of Existing Sales/Solicitation Regulations

Recommendation #3: Federal and State Governments Should Avoid Extensive Government Regulation of Franchising Relationships

Recommendation #4: The SBA and Minority Business Development Agency Should Streamline and Expand Financial Assistance Programs Available to Franchisees; Franchisors Should Examine Alternative Methods for Assisting Prospective Franchisees in Securing Financing

Recommendation #5: The Federal Government -- Perhaps through a Joint Effort by U.S. Department of Commerce and SBA -- Should Reestablish Its Regular Survey of Franchising

Recommendation #6: Private Sector Organizations Should Continue to Fund, Publicize, and Provide Information and Programs on Franchising
1. Recommendation #1: The Federal Trade Commission Should Continue Efforts to Improve and Streamline Financial Disclosure and Encourage the Provision of Earnings Claims by Franchisors

While franchisees and franchisors are generally satisfied with much of the current disclosure process, many feel that additional financial information would be helpful. Franchisees need historical data on actual franchise operations and revenues in order to develop credible and realistic budget and income projections. In addition to detailed and valid data on individual franchise operations, many franchisees also want and need financial information on the franchisors themselves. Because many franchisors are not public companies, franchisees often find it difficult to secure public information on the franchisor's financial history, strength, and capacity to provide services.

In 1990, only about 20 percent of franchisors used earnings claims in their disclosure documents, but the use of disclosure claims appears to be growing because of recent procedural changes by the FTC that made documentation of earnings claims easier. A major reason that many franchisors have not used earnings claims in the past was the fear of litigation if the data provided was later found to be inaccurate. For example, several franchisors that we interviewed indicated that earnings claims were prone to be interpreted by franchisees not as summaries or projections dependent on many factors, but as guarantees of performance of individual franchises. As a result, many franchisors felt (and were advised by legal counsel) that earnings claims opened up a "pandora's box" of litigation possibilities. Another reason cited by many franchisors was the cost of compiling and maintaining current information. Some reported that while they maintained good data on gross sales (because it was the basis for calculating most royalties), they had less systematic data on the actual expenses and on profitability of individual franchisees. Finally, some franchisors felt that providing earnings claims or additional financial
information when it was not mandatory put them at a competitive disadvantage against other franchisors who did not provide the same information.

Despite these concerns, many franchisors expressed a desire to improve the financial information (including earnings claims) provided to franchisees because it would simplify the sales process and encourage franchisees to enter franchising with realistic expectations. Franchisors were also supportive of reducing repetition and making disclosure documents easier to read.

The FTC should expand efforts to promote disclosure of financial information and earnings claims by franchisors. Methods of simplifying the burden and reducing costs of providing financial information and earnings claims on the part of franchisors should be examined in detail. Methodology and standardized formats for providing such information should be refined and provided to franchisors, along with technical assistance (if needed).


As noted in Chapter 7, there has been some criticism of the lack of federal and state efforts to effectively review disclosure statements by franchisors and to enforce existing regulations against fraudulent or deceptive franchisors. Currently, the number of federal enforcement actions is limited to the most significant violations and most prosecutions of violations occur at the state level in states requiring registration. Limited federal enforcement activity and varying levels of state enforcement has resulted in complaints that some deceptive and/or illegal practices are not being investigated and prosecuted. At the federal level, some critics argue that the FTC should have additional funding to pursue more enforcement actions.
Franchisors are generally satisfied with the enforcement of current federal franchise disclosure regulations. The predominant sentiment is that the regulations are reasonably clear, and that compliance is relatively easy for most franchisors. From the standpoint of franchisors, the major regulatory costs and difficulties are associated with state regulations and authorities. Franchisors feel that state regulations penalize honest franchisors with excessive delays and technical violations due to semantics, and administrative changes, and do not always weed out "scams" that damage franchising's reputation.

While there have been calls by some critics for increased levels of funding for FTC enforcement, it is not entirely clear whether such resources are needed or would have a beneficial impact upon long-term growth of franchising. First, while there are some legitimate concerns about the shortage of investigative staff to identify and prosecute illegitimate activities, the vast majority of franchise sales and solicitation activities appear to be in compliance with the law. Second, it is also not clear that the aggregate (federal and state) governmental resources devoted to enforcement are inadequate relative to franchising's size in the economy. While franchising is an important and growing sector of the U.S. economy, the total number of franchisors was only about 2,500 in 1988. Even recognizing that there is change among small franchisors who enter franchising one year and depart a few years later, the reality is that most contracts are system-wide documents, with substantially the same legal phrasing which changes very little from year-to-year. From this perspective, it is not apparent that government staffs are inadequate for the review functions. Third, boosting governmental expenditures on enforcement might have the result of increasing the burden and costs of compliance and litigation for legitimate franchisors by introducing additional procedural steps and delays.

In general, rather than looking for an increase in resources, the FTC and state
governments should better utilize existing resources to improve enforcement of existing sales/solicitation regulations. For example, the total resources for enforcement might be more effectively deployed if states reduced variation in requirements of their disclosure laws and better coordinated review of disclosure documents. Further, increased coordination and targeting of enforcement activities by the FTC and state agencies may also result in more cost-effective enforcement of existing sales/solicitation laws.


As discussed in Chapter 8, the basic legal relationship between franchisors and franchisees is largely set out in the franchise agreement. Courts have tended to support the rights, duties, and obligations specifically identified in the agreements. There is currently no federal statute or consistent body of federal case law which defines the legal rights of franchisees in the franchise relationship, except with respect to automotive dealers and gasoline service stations. Instead, the business practices involved in franchising are covered by a body of law which has evolved over a period of time, including contract law, common law, antitrust law, laws covering fraud, and tradename and intellectual property law. The legal framework provides a level of legal protection consistent with the contractual protections afforded in other businesses. At the state level, eighteen states have supplemented this body of law with additional franchise relationship regulation.

Some critics of existing franchise regulations have suggested that additional federal regulation is needed to strengthen the position of franchisees in the relationship and to eliminate abuses. These concerns have partially been spurred by the increasing length of franchise agreements and the inclusion of contractual limits (such as jurisdictional limits,
integration clauses, hold harmless provisions, and arbitration requirements) which clarify the contract, but limit the franchisee's legal recourse. In addition, the principal abuses, according to critics, are in the franchisor's unrestricted rights to terminate the franchisee, impose conditions at renewal, limit transfer of the franchise, and reduce the franchisee's market area or territorial rights.

Franchisors, on the other hand, point to favorable statistics on termination, renewal, and transfers as indicative of generally satisfactory relations within the franchise sector. They note that they have a special responsibility to maintain the quality and market viability of their system over time for other franchisees as well as themselves.

Despite some apparent abuses from time-to-time, a number of factors suggest that federal and state government should avoid extensive new regulation of the franchise relationship. There is little indication that current regulation is unbalanced or unfair in any systematic way. Rapid rates of growth in franchising over the past two decades suggest that current regulations have created an environment that is conducive to franchising and made franchising an attractive alternative for business expansion by franchisors. Under existing regulations governing the relationship between franchisors and franchisees, recent surveys also indicate a high degree of satisfaction among franchisees. For example, about 80 percent of franchisees rated their relationship with their franchisor as either "excellent" or "very good" in a recent survey by the Gallup Organization.\(^{10}\) In addition, high reported rates of renewal seem to indicate that most existing franchisees are satisfied with current conditions.

The introduction of substantial changes in regulations governing the franchising relationship could upset the balance that currently exists between franchisors and franchisees.

\(^{10}\)The Gallup Organization, op. cit.

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franchisees -- leading to uncertain effects on long-term growth of franchising in the U.S. The growth in franchising over the past two decades has, in part, been a reflection of the mutual expectation of franchisors and franchisees that the franchise relationship could be legally defined in a predictable way over a long term. Significant changes in regulations are likely to introduce a period of uncertainty in franchise contract relationships that might disrupt expansion plans among franchisors and/or create incentives for franchisors to use other methods of expansion over the long-term (e.g., company-owned outlets).


As with other small businesses, franchises often require substantial initial investment and working capital to be successful. Most franchise owners use their own personal financial resources and those of their family to purchase and operate their franchise units. Like other small business persons, many franchise owners find that they need additional capital to operate their business. Despite some availability of financial assistance through franchisors and commercial lenders (i.e., there is some evidence that commercial lenders prefer loans to franchises over independent small businesses), the search for capital is often complex and difficult for many franchisees.

A number of government programs, such as business loan guarantees and direct loans through the SBA and Minority Business Development Agency (MBDA) are available to franchisees. However, there are frequent complaints among the franchising community that financing through these programs is "very hard to come by." For example, the median number of franchisees using SBA financing according to a recent survey was 15 percent. Our interviews with franchisors and franchisees revealed both a lack of
understanding about how to access financing through these programs and generally negative views on both the likelihood of receiving resources and the burdens involved to qualify for financing. For example the typical perspective of both franchisors and franchisees that we interviewed was that an SBA application for financial assistance was likely to be a long and arduous process that was unlikely to result in a favorable determination. Most franchisors we interviewed were reluctant to recommend that franchisees investigate SBA financing programs because they felt that the application was unlikely to be successful, or because they had had unsatisfactory contacts with SBA lending sources in the past. Many franchisees were unaware of specific SBA programs and not inclined to seek more information.

The SBA and MBDA should concentrate on making existing financial assistance programs work more effectively and on marketing these program to franchisors through franchise industry groups. In particular, the focus should be on reducing the delays in processing, on identifying clear criteria for qualification, on developing loan programs for some of the less expensive franchises, and on expanding assistance available to women and minorities. Given the difficulties that many small businesses have experienced in recent years in obtaining financing through conventional sources, there is an urgent need for the SBA, MBDA, and the Commerce Department to closely examine the levels of funds available through lending programs for small businesses and the procedures that individuals must go through to access these resources.

Franchisors also need to be aware of the problems that prospective franchisees have with obtaining funds to establish and operate franchise units. They need to work closely with franchisees on the development of strategies for assisting franchisees in obtaining small business loans and identifying other available credit sources. For example,
they may be able to help franchisees by securing some portion of conventional loans or by expanding assistance provided on completing loan applications. It is also possible that franchisors (perhaps with assistance from franchisees) could establish some form of revolving low interest loan fund that would be available to new franchisees or possibly existing franchisees over short periods of time (for specified types of expenditures that are likely to improve productivity or profitability).


As noted in the first chapter, the U.S. Department of Commerce terminated its annual survey of franchisors and franchisees in the late 1980s. While the International Franchise Association (IFA) has attempted to continue this survey, it has encountered difficulties in obtaining the necessary funding to support such a wide-scale surveying effort. In addition, despite the best efforts of the IFA, there have been some technical concerns about the comparability of data over time and securing a valid response rate among franchisors, as personnel administering the survey have changed from year-to-year, and as the interests and concerns of the IFA membership have varied from year-to-year.

Over the years, franchising has come to play an increasingly important role in the U.S. economy -- and its role is expected to continue to expand into the next century. Understanding underlying trends in franchising is essential for companies and individuals to make informed decisions about whether to invest in franchising and in what specific areas of franchising to invest. Policy makers at the federal and state levels need valid and reliable information to determine whether changes in legislation and/or the regulatory environment are needed, and then, to monitor possible impacts of such changes.
through surveying of companies and individuals involved in franchising and systematic collection of data on franchise sales, establishments, employment, and other trends is it possible to address the following types of franchising issues: Which sectors of franchising are expanding most rapidly and are expected to continue to do so in the future? Are an increasing number of U.S. franchisors setting up foreign outlets? Is it becoming more difficult for the average American to become franchisees? Are certain types of individuals being systematically excluded from franchising? How are franchisors and franchisees being affected by the regulatory framework?

Therefore, the federal government -- perhaps through a joint effort by the U.S Department of Commerce and Small Business Administration -- should reestablish a comprehensive and regular survey of franchising. The results of the survey should be published in a form similar to the previous Franchising in the Economy. In addition, a well-documented public use data tape should be made available to researchers and other private organizations to support additional research efforts.

While it may be preferable for such a survey to be conducted on an annual basis, other less costly alternatives are available. For example, the survey could be administered every second or third year. Alternatively, a relatively short form -- collecting only employment, sales, and number of establishments -- could be administered each year, followed by a comprehensive survey every third or fifth year.

In the past, the Department of Commerce's franchising survey has been administered only to franchisors. In order to gain the perspectives of franchisees and expanded information about their characteristics and perspectives on franchising, the survey effort should be expanded to include a representative sample of franchisees. It may also be desirable to eliminate or modify some earlier data items to provide more
information on selected topics of interest to policy-makers and to facilitate integrating franchise data into other periodic data series. For example, a revised franchising survey may place somewhat more emphasis on such topics as the number of women or minority franchisees, or relate franchising more clearly to such broad economic indicators as retail sales. In order to ensure the cooperation of franchisors and the relevance of the survey data, an advisory committee of franchisors, franchisees, franchise groups, and franchise experts should be formed to review and comment on the survey instrument and findings of the survey.

6. **Recommendation #6: Private Sector Organizations, Such as the International Franchise Association, Should Continue to Fund, Publicize, and Provide Programs on How to Buy and Successfully Operate Franchises**

Private sector organizations active in franchising should continue and, if possible, expand their educational programs and professional workshops on franchising. For example, the International Franchise Association has a special responsibility because of its recognized role as representative of the franchisor community. As a membership organization, many IFA programs have been targeted at franchisors. Encouraging adherence to high ethical standards and greater professionalism are important and appropriate goals for a franchisor organization. However, a major need is for IFA to work in conjunction with SBA and other business groups to develop and provide additional materials (e.g., videos, books, pamphlets, and other print media) and workshops on how to buy and successfully operate a franchise. A particularly difficult problem for many prospective franchisees is how to obtain relatively skilled and economical legal help so that they can really understand and consider the obligations involved in franchise agreements. Other major problems that are faced by many potential franchisees concern obtaining
necessary financing and effectively collecting and evaluating necessary information on the wide range of franchising opportunities that are available.
APPENDIX 1-A:

LIST OF FRANCHISING ATTORNEYS AND EXPERTS INTERVIEWED
APPENDIX 1-A:
LIST OF FRANCHISING ATTORNEYS AND EXPERTS INTERVIEWED

Mike Baum
Francorp

John Campbell
Franchise Masters

Ken Franklin
Franchise Development Corporation

Robert Martin
Department of Economics, Louisiana State University

Ken McGuire
Performance Group Ltd

Alden Petersen
Appalachian State College of Business

Andres J. Sherman
Attorney, Silver, Friedman, & Taff

Lloyd Tarbutton
Consultant

Bruce Walker
College of Business and Public Administration, University of Missouri

Warren Lewis
Attorney

Neil Simon
Attorney, International Franchise Association

Craug Tregallis
Federal Trade Commission

Carl Zwisler
Attorney, Cooter & Gell
APPENDIX 1-B:

DISCUSSION GUIDES FOR FRANCHISING ATTORNEYS AND EXPERTS
SUMMARY: FRANCHISING EXPERT DISCUSSION GUIDE

REFERRED BY: ________________________ DATE: ________________

BOOK/ARTICLE/QUOTE IN ________________________

INTERVIEWEE: ________________________ POSITION: ________________________

ADDRESS: ____________________________________________

CITY/STATE: ________________________ PHONE ________________________

OTHER: ____________________________________________

KEY POINTS FROM INTERVIEW:

____________________________________________________________________

____________________________________________________________________

____________________________________________________________________

____________________________________________________________________

____________________________________________________________________

Appendix I-B, Page 1
INTRODUCTION: My name is _______ and I’m with James Bell Associates. [If possible, say who suggested you call.] We’re doing a study of successful franchising practices for the U.S. Small Business Administration. The study will analyze the growth of franchising since 1975, examine successful practices and problems in franchising, and discuss major trends for the next 10 years. I would like to ask you a few questions about franchising. It will take about 30 minutes; is this a good time? (If not, when can I call you back?) [ADD IF APPROPRIATE: We’re generally interested in business format franchising, especially in some of the following areas: restaurants, food and nonfood retailing (apart from convenience stores), personnel agencies, construction and maintenance areas.]

[NOTE: DO NOT GO THROUGH ALL QUESTIONS; SELECT ONLY QUESTIONS RELEVANT TO EXPERT’S AREA OF EXPERTISE]

1. BACKGROUND/EXPERIENCE: Tell me about your background in franchising.

   A. What franchising areas/topics have you looked at in detail? Industry specialty?

   B. Have you worked for a franchisor?

   C. Have you ever owned a franchise or other business?

2. EVALUATION PROCESS/ADVISERS

   A. How well prepared are most franchisees to make the franchising decision?

   B. What advice would you give the average franchisee when he/she is evaluating a franchise opportunity?
C. Do the average franchisee have adequate legal representation and accounting assistance?

D. Who else should they talk to? Other franchisees?

E. Should they talk to SBA or other government agency?

3. LEGAL

A. What are the typical legal problems faced by the franchisor?

B. What are the typical legal problems faced by the franchisee?

C. What is the typical cost to franchisees for initial legal services such as reviewing the disclosure documents?
4. **ASSISTANCE TO FRANCHISEES** What are the most important types of assistance that the franchisor can provide to his franchisees?

[PROBE SOME FROM LIST BELOW]

A. Site selection and evaluation?
B. Lease/purchase negotiation?
C. Outlet plans and specifications?
D. Initial estimate of costs realistic/accurate?
E. Financial assistance for initial costs?
F. Assistance in procuring goods and supplies?
G. On-site opening assistance?
H. Initial Training? Additional or continuing training?
I. On-site visits for training or troubleshooting
J. Operating manual of procedures?
K. Additional research to bring out new or improved products or services?
L. Additional marketing information on competition?
M. Advertising support?

5. **FAILURE**

A. In your experience, what are the most frequent causes of failure for franchisees?
6. FEES, ROYALTIES AND FINANCING

A. What advice would you give the franchisor in setting and explaining fees and royalties?

B. What advice could you give the franchisee in evaluating the fees and royalty schedules?

C. Can the franchisee expect any assistance in arranging financing from the franchisor?

D. Do you feel the average franchisee receives a fair and reasonable amount of help for his initial fee? For his continuing royalties or service fees?

E. Are there any payments you feel are often unreasonable? Why?
7. RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE

A. What are main problem areas between franchisors and franchisees? What do the best franchisors and franchisees do to avoid these problems?

B. Are franchise advisory councils effective?

8. GOVERNMENTAL REGULATION

A. Do you feel that there is a need for additional governmental regulation of franchising? (If so, what kind?)

B. Are the existing disclosure requirements of the Federal Trade Commission sufficient?

C. How do you feel about the disclosure requirements of the various states?

D. Do you have any idea of the cost of preparing the disclosure documents?
9. FUTURE

A. What are the most important trends affecting the franchising industry in the next 10 years?

10. RECOMMENDATIONS

A. Could you recommend some companies which have good, solid programs? Could you recommend some other persons to talk to about franchising?
INTRODUCTION: My name is Jim Trulko and I'm working with Andy Kostecka and James Bell Associates on a study of successful franchising practices for the U.S. Small Business Administration. The study will analyze the growth of franchising since 1975, examine successful practices and problems in franchising, and discuss major trends for the next 10 years. I would like to ask you a few questions about franchising. We're generally interested in business format franchising, especially in some of the following areas: restaurants, food and nonfood retailing (apart from convenience stores), personnel agencies, construction and maintenance areas.

[NOTE: DO NOT GO THROUGH ALL QUESTIONS; SELECT ONLY QUESTIONS RELEVANT TO EXPERT'S AREA OF EXPERTISE]

1. BACKGROUND/EXPERIENCE: How did you get interested in franchising as a legal specialty?
   A. Have you worked for a franchisor?
   B. Have you ever owned a franchise or other business?
   C. How much of your practice is involved with counseling franchisees?

2. LEGAL

   A. What are main legal problem areas between franchisors and franchisees? What do the best franchisors and franchisees do to avoid these problems?

   B. What are the typical legal services needed by the franchisee? What is the typical cost to franchisees for initial legal services such as reviewing the disclosure documents?
ATTORNEY

C. FTC Rule 436- what are the most difficult areas of compliance for the average franchisor (such as earning claims, material changes, advertising)? Are there any new developments in enforcement or interpretation by the regulators?

D. State Laws- What are the most difficult areas of compliance for franchisors under the various state laws (in preparing UPOC, for example)?

3. ASSISTANCE TO FRANCHISEES

A. What are the most important types of assistance that the franchisor can provide to his franchisees?

B. Tying Arrangements- Are these still major areas of controversy or is case law and interpretation well-established?

C. In your experience, what are the most frequent causes of failure for franchisees?

4. FEES, ROYALTIES AND FINANCING

A. What advice would you give the franchisor in setting and explaining fees and royalties?
R. What advice could you give the franchisee in evaluating the fees and royalty schedules?

C. Can the franchisee expect any assistance in arranging financing from the franchisor?

5. GOVERNMENTAL REGULATION
   A. Do you feel that there is a need for additional governmental regulation of franchise offerings? (If so, what kind?)

   B. Is there need for additional regulation of the ongoing business relationship between franchisors and franchisees (such as termination rights)?

6. FUTURE
   A. What are the most important trends affecting the franchising industry in the next 10 years?

7. RECOMMENDATIONS
   A. Could you recommend some companies which have good, solid programs? Could you recommend some other persons to talk to about franchising?
APPENDIX 1-C:

DISCUSSION GUIDES FOR FRANCHISORS AND FRANCHISEES
INTRODUCTION: My name is ___ and I'm with James Bell Associates. (If possible, say who suggested you call.) We're doing a study of successful franchising practices for the U.S. Small Business Administration. The study will analyze the growth of franchising since 1975, examine successful practices and problems in franchising, and discuss major trends for the next 10 years. I would like to ask you a few questions about franchising. It will take about 30 minutes; is this a good time? (If not, when can I call you back?)

[ADD IF APPROPRIATE: We're generally interested in business format franchising, especially in some of the following areas: restaurants, food and nonfood retailing (apart from convenience stores), personnel agencies, construction and maintenance areas.]

[NOTE: DO NOT GO THROUGH ALL QUESTIONS; SELECT ONLY QUESTIONS RELEVANT TO EXPERT'S AREA OF EXPERTISE]

1. BACKGROUND/EXPERIENCE: Tell me about your background in franchising.

   A. What franchising areas/topics have you looked at in detail? Industry specialty?

   B. Have you worked for a franchisor?

   C. Have you ever owned a franchise or other business?

2. COMPANY BACKGROUND: Tell me about your company's background in franchising.

   A. How many years has your company had franchises?

   B. How many franchisee-owned units do you have? Company-owned stores? Has ratio of franchisee-owned to company-owned changed over last 5 years?

   C. Do you generally franchise single units or multiple units?

   D. Do you have franchises nationwide or in specific regions?
INTERVIEWEE 3

E. Who do you regard as your competitors?

F. What distinguishes you from your competition?

G. Why did your company go into franchising?

3. EVALUATION PROCESS

A. How do you find most of your potential franchisees?

B. How do you evaluate prospective franchisees? Do your most successful franchisees have any specific characteristics? What are the most difficult qualities to evaluate?

C. Why are most franchisees attracted to your system?

D. Are there any typical legal problems you face in the franchisee recruitment process?

E. How many other franchisees does the average franchisee talk to before he decides? Does the average franchisee talk to SBA or any other government agency before deciding to become a franchisee?
4. ASSISTANCE TO FRANCHISEES. What are the most important types of assistance that you, as the franchisor, can provide to your franchisees?

[PROBE SOME FROM LIST BELOW]

A. Site selection and evaluation?
B. Lease/purchase negotiation?
C. Outlet plans and specifications?
D. Initial estimate of costs realistic/accurate?
E. Financial assistance for initial costs?
F. Assistance in procuring goods and supplies?
G. On-site opening assistance?
H. Initial Training? Additional or continuing training?
I. On-site visits for training or troubleshooting
J. Operating manual of procedures?
K. Additional research to bring out new or improved products or services?
L. Additional marketing information on competition?
M. Advertising support?

N. How often do you visit or have contact with the average franchisee?

5. FAILURE

A. In your experience, what are the most frequent causes of failure for franchisees?
6. FEES, ROYALTIES AND FINANCING

A. What are your initial and continuing royalty fees for franchisees? Do you have a philosophy for setting fees and royalties?

B. Do you require the franchisee to buy any supplies or services from you?

C. Do you require the franchisee to contribute to an advertising fund?

D. Do you provide franchisees any advice or assistance in seeking funding for the franchise?

7. RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE

A. What are main problem areas between franchisors and franchisees? What should franchisors and franchisees do to avoid these problems?

B. Do you have a franchise advisory council? When does it meet? What does it do?
8. GOVERNMENTAL REGULATION

A. Do you feel that there is a need for additional governmental regulation of franchising? (If so, what kind?)

B. Are the existing disclosure requirements of the Federal Trade Commission sufficient?

C. How do you feel about the disclosure requirements of the various states?

D. What problems or areas of concern do you have about governmental regulation of franchising?
10. FUTURE

A. What are the most important trends affecting your franchising system in the next 10 years?

B. What types of things could significantly reduce the growth of franchising?

11. RECOMMENDATIONS

A. Could you recommend some franchisees we could talk to about franchising? Could I talk to someone on your franchise advisory council? Could I talk to somebody who recently left your system?
SUMMARY: FRANCHISE DISCUSSION GUIDE

REFERRED BY: __________________________ DATE: __________________________

FRANCHISE SYSTEM: __________________________ TYPE: __________________________

INTERVIEWEE#1: __________________________ POSITION: __________________________

INTERVIEWEE#2: __________________________ POSITION: __________________________

ADDRESS: __________________________

CITY/STATE: __________________________ PHONE: __________________________

OTHER: __________________________

KEY POINTS FROM INTERVIEW:

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

________________________________________________________________________

Appendix I-C, Page 8
INTRODUCTION: My name is _____ and I'm with James Bell Associates. (If possible, say who suggested you call.) We're doing a study of successful franchising practices for the U.S. Small Business Administration. The study will analyze the growth of franchising since 1975, examine successful practices and problems in franchising, and discuss major trends for the next 10 years. I would like to ask you a few questions about franchising. It will take about 30 minutes; is this a good time? (If not, when can I call you back?)

[ADD IF APPROPRIATE: We're generally interested in business format franchising, especially in some of the following areas: restaurants, food and nonfood retailing (apart from convenience stores), personnel agencies, construction and maintenance areas.]

[NOTE: DO NOT GO THROUGH ALL QUESTIONS; SELECT QUESTIONS RELEVANT TO SITUATION]

1. BACKGROUND/EXPERIENCE: Tell me about your background before you got into this franchise.

   A. Did you have previous experience in this industry?

   B. Have you ever owned a franchise or other business?

   C. What is your educational/professional background?

2. COMPANY BACKGROUND:

   A. How many years have you been a franchisee with this company?

   B. How many franchise units do you own?

   C. What is your franchise territory?

   D. Who do you regard as your competitors?

   E. What distinguishes you from your competition?
3. EVALUATION PROCESS Tell me about how you went about evaluating various franchises before you bought this one.

A. How many franchises did you evaluate? Different industries or the same industry? How long did it take?

B. Why did you decide to go into a franchised business? (versus an independent business)

C. At what point did you have legal representation? What did your attorney do? What was the approximate cost of legal review? Was the legal agreement generally understandable to you when you signed?

D. Did your accountant review the information? Was he helpful?

E. How many other franchisees did you talk to before you decided?

F. Did you talk to SBA or any other government agency before deciding to become a franchisee?

G. Was there anything that was a key factor in your decision to buy this franchise?

H. Was there any additional information that you wish you had?
4. ASSISTANCE TO FRANCHISEES What are the most important types of assistance that you, as the franchisee, have received from the franchisor?

[PROBE SOME FROM LIST BELOW]

A. Site selection and evaluation?
B. Lease/purchase negotiation?
C. Outlet plans and specifications?
D. Initial estimate of costs realistic/accurate?
E. Financial assistance for initial costs?
F. Assistance in procuring goods and supplies?
G. On-site opening assistance?
H. Initial Training? Additional or continuing training?
I. On-site visits for training or troubleshooting
J. Operating manual of procedures?
K. Additional research to bring out new or improved products or services?
L. Additional marketing information on competition?
M. Advertising support?

N. What could your franchisor have done better? Is there any assistance you wish that you had?

O. How often do you have visits or contact with the franchisor?

5. FAILURE

A. In your experience, what are the most frequent causes of failure for franchisees?
6. FEES, ROYALTIES AND FINANCING

A. Were your initial and continuing royalty fees about what you expected?

B. Are you required to buy any supplies or services from the franchisor? Are prices reasonable?

C. Are you required to contribute to an advertising fund? Is the advertising program worth it?

D. Did you receive any advice or assistance in seeking funding for the franchise?

E. Overall, are there any payments you feel are unreasonable?

7. RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE

A. How would you describe your relationship to the franchisor? What are main problem areas between franchisors and franchisees?

B. Do you have a franchise advisory council? When does it meet? What does it do?
8. GOVERNMENTAL REGULATION

A. Do you feel that there is a need for additional governmental regulation of franchising? (If so, what kind?)

B. Were you satisfied with the existing disclosure requirements of the Federal Trade Commission?

C. How do you feel about the disclosure requirements of the various states?

D. What problems or areas of concern do you have about governmental regulation of franchising?
10. **FUTURE**

A. What are the most important trends affecting your franchising system in the next 10 years?

B. What do you think about your future with this franchise? Are you happy you bought this franchise?

11. **RECOMMENDATIONS**

A. Could you recommend some other franchisees we could talk to about franchising?