International Franchise Association
57th Annual Legal Symposium
May 4-6, 2025
Washington, DC

BEAUTY OR BEAST? POSITIONING EMERGING FRANCHISE BRANDS FOR SUCCESS

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INTRODUCTION

Franchising can offer businesses a rapid path to expansion and provide entrepreneurs a chance to buy into an established system. A well-developed franchise brand – a *beauty* – can provide franchisees with a proven model, brand recognition, supply chain efficiencies, and support infrastructure. In contrast, a poorly designed or structured franchise system can be a proverbial *beast* in disguise: it may appear promising but hide fundamental flaws and risks. This can be the case for both emerging and established franchise brands.

Why would a franchisor seek to start to offer franchises – whether in a relatively young and untested system or in a robust and well-established system? And why would prospective franchisees seek to join a new franchise system – whether that be one with a sizable contingent of company-owned operations starting to offer franchises as well, or a system that is new to the market. And what legal considerations are there that justify addressing this topic at an IFA Legal Symposium. As you start to read this paper, "you may ask yourself, Well, how did I get here?"[1]

In reality, parties in the U.S. are free to form and enter contracts. The freedom to contract is so innate to our way of considering legal matters that we might lose sight of its unforgettable modern origin: the U.S. Constitution, which provides that "[n]o State shall … pass any Law impairing the Obligation of Contracts…." [2]

Of course, the freedom to contract is not unbounded, and public policy considerations play a role as well. For example, in the area of franchising, public policy since the 1970's has resulted in state legislation[3] and federal regulation[4] that established a well-developed system of disclosure and (in many states) registration. Although practitioners may debate whether the mandatory disclosure is adequate, the laws set

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1 The Talking Heads, "Once in a Lifetime" (1981).

2 U.S. Const., art I, § 10, cl. 1. See also Murray v. City of Charleston, 96 U.S. 432, 448–49, 24 L. Ed. 760 (1877) ("[t]here is no more important provision in the Federal Constitution than the one which prohibits States from passing laws impairing the obligation of contracts, and it is one of the highest duties of this court to take care the prohibition shall neither be evaded nor frittered away. Complete effect must be given to it in all its spirit. The inviolability of contracts, and the duty of performing them, as made, are foundations of all well-ordered society, and to prevent the removal or disturbance of these foundations was one of the great objects for which the Constitution was framed.")

3 See Cal. Corp. Code §§ 31000-31516; Haw. Rev. Stat. § 482e et seq.; 815 Ill. Comp. Stat. 705/1 et seq.; Ind. Code § 23-2-2.5-1 et seq.; Md. Code Ann., Bus. Reg §§ 14-201 to 14-233; Mich. Comp. Laws §§ 445-1501 to 445-1545; Minn. Stat. § 80c et seq.; N.Y. Gen. Bus. Law §§ 680-695; N.D. Cent. Code §§ 51-19-01 to 51-19-17; R.I. Gen. Laws §§ 19-28.1-1 to 19-28.1-34; S.D. Codified Laws §§ 37-5b-1 to 37-5b-53; Va. Code §§ 13.1-557 to 13.1-574; Wash. Rev. Code §§ 19.100.10 to 19.100.940; and Wis. Stat. §§ 553.01 to 553.78.

4 16 C.F.R. Part 436.

standards in place so that prospective franchisees are provided with basic information about the businesses that they are contemplating joining as a franchisee.

How, then should a new franchisor and a new franchisee approach the opportunity to join together and grow in a new brand? Do special considerations apply in the context of a young franchise system and, if so, how should the franchisor and franchisees approach the opportunity?

There is also a fundamental question that every businessperson considering a franchise must answer for herself or himself: why seek to join a franchise system instead of just starting her or his own similar business, developing their own methods, systems, protocols, procedures, marketing, etc.? Is there a benefit to joining a new system – at the forefront of development – as compared with a more established franchise system? Mandatory disclosure may help to answer some of these questions, but it will often take deeper and insightful analysis to get to a place where uncertainties can be narrowed.

Each of the authors of this paper approach franchising from different perspectives. One is a lawyer whose practice focuses on representing franchisees. Another is a lawyer who works inside one of the country's franchise consulting practices often helping new franchisors. And the other of us is a lawyer whose practice primarily represents franchisors.

Each of us however see many of the same issues: although parties should go into every relationship – certainly including new franchise systems – with their eyes wide open, not every new franchise system is primed for success or doomed to fail, not every new franchise system will succeed or fail for the same reasons, and not every new franchisor and not every franchisee will be equally pleased or disappointed when looking back on their decision with the benefit of a few years' hindsight.

ANALYSIS

With the thought in mind that every franchisor – new or experienced – must comply with the requirements of the FTC Franchise Rule to provide disclosure[5] (as well as the similar state laws), the question that befalls a new franchisor, a new franchisee, and the professionals helping them is how to best utilize that disclosure, how to formulate *additional* questions, how to analyze the information gleaned, and how to best position the parties' for steady and ongoing success.

Young franchisors may start out with outsized uncertainty. Even where there may be a long and successful history of company-owned units, a brand of any size just starting out as a franchise will not yet have developed a history of being a successful *franchisor*. Franchising is a completely new and different business, and mastering it can take time.

It is also true that, while virtually any business *can* be franchised, the initial question is whether a particular business *should* franchise. Franchising is just one potential growth

[5] 16 C.F.R. § 436.2(a).

method and does not fit every business. Potential emerging franchisors must properly evaluate themselves and the franchise business model itself before taking the steps to actually grow via franchising. Those brands that conduct such an evaluation both thoroughly and honestly are more likely to build successful franchise brands with successful franchisees.

Some first-generation franchisees would do well to assess the viability of emerging franchise concepts and attendant challenges by applying the "IDEA" framework[6] – ***I****ncome*, ***D****istinctiveness*, ***E****conomic resources*, and ***A****ccessibility* – to evaluate whether a business model is fit for franchising. From the franchisor's perspective, the IDEA formula may address the core question of whether a business concept is a good fit for franchising. The same model may also help a prospective franchisee determine whether a business concept is a good fit for their own personal disposition, business and other preferences, as well as their short- and long-term perspective on what they wish to accomplish by owning and operating a franchise.

I. Is the Business Ready to Franchise? The IDEA Framework

As noted above, a potential franchisor should ask themself not only "*can* I franchise this business?" but also "*should* I franchise this business?" There are few legal impediments as to the type, size, or experience needed to establish a business as a franchise, the business considerations abound. What matters is whether the business to be franchised is a good fit for the franchise model.

In order to make an informed decision, brands should conduct some form of a threshold analysis that dives into the key characteristics, capabilities, and considerations that make a business well-suited for franchising. That threshold analysis can take a variety of forms but will typically cover a few common but important areas.

A. Income Potential

Do The Unit Economics Work?

The cornerstone of any successful franchise system is a business model that is (or is likely to be) successful. In a new franchise system without a track record, it will be hard to find a record to support the conclusion that profitability is likely without making some assumptions as to conditions and, in some instances, taking a leap of faith. Among the main questions that need to be addressed are:

1. <u>*From the franchisee's perspective*</u>, do unit economics allow the franchisee to make sufficient revenue to continue to operate the business and take home a reasonably

[6] Megan B. Center, Caroline B. Fitcher, & Darin Kraetsch, *W-19: From the Ground Up: Practical Considerations for Developing a Start-up Franchise System*, American Bar Association 46th Annual Forum on Franchising, 1-7 (Nov. 1-3, 2023) (discussing the "IDEA" framework).

expected rate of return, while still paying a royalty and other ongoing fees to the franchisor or other parties?

2. *From the franchisor's perspective*, is the anticipated royalty stream going to be sufficient to provide the franchisor with the funds needed to properly grow, evolve, and continuously improve the brand?

Prospective franchisors should thoroughly analyze their business model to determine whether franchisees can reasonably achieve profitability after accounting for not only royalty payments but also marketing contributions, tech costs, and other franchise-related expenses. This unit-level economic analysis must take into account any difference in the business model that a potential franchisee might face as compared to the existing company-owned locations from which the data is being drawn from. For example, if all of the existing company-owned locations have drive-throughs but the prospective model franchise will not (or vice versa), the data from existing company-owned stores might not provide a valid basis to internally conclude that a prospective franchisee's unit economics will work.

Again, people are free to imagine and develop businesses and enter agreements to establish those businesses. In fact, many franchised businesses succeed despite the perspective that they are unlikely do so – because the entrepreneurial drive of both franchisors and franchisees make the difference. Many newly franchised businesses also face the potential of success by adopting and applying new technologies to better compete with existing businesses in the same sector. (For example, a new franchise system that can gain a foothold and competitive advantage using 5G telecommunications technology or applied AI may be in the same sector as established franchised and non-franchised models, but the new business may have the dynamism, drive, and smarts to leapfrog their competition.) Of course, there can be no way to predict whether a particular system – even one with the promises to fuel its growth by adopting new technologies – will actually succeed as planned. So it behooves the new franchisor and new franchisees to carefully consider all of the factors involving the opportunity – not to *eliminate* the chance for failure (an impossibility) – but to *narrow* the chance for a negative outcome.

Obviously, a better basis to gain insight and predict future success can come with a track record: more locations, with a longer time in business, and higher variety of markets help to provide a data-driven analysis of past and ostensibly future success. However, even a proven track record cannot always foretell success because other factors unavoidably impact business.[7]

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[7] For example, at the time of this writing, a franchised business model that succeeded in the last several decades may not have yet encountered a competitive landscape brimming with technological challenges, environmental devastation due to ever-increasing hurricane strength, or where public policy considerations may have a significant impact on outcomes (e.g. the blunt force effect of tariffs on supplies and finished goods, volatility in commodity prices due to immigration restrictions, inflation spikes and the associated impact on business financing, and the challenges arising from uncertainty among cross border visitors in general as well as international franchising in particular).

For young franchisors who may have only operated one or two company-owned locations, there will be less certainty in that initial unit economic analysis than with a brand with dozens or more locations operating over a longer period of time. Regardless, if a brand's existing company-owned units lack a strong profit record, franchising concept might not prove to be the appropriate method for expansion. If the unit economics don't work for company-owned stores, it is not likely that unit economics would improve for franchisee-operated locations.

Is the Return On Investment Sufficient?

Projected returns for franchisees should be realistic and verifiable. While franchisors must avoid making specific earnings claims outside of properly disclosed financial performance representations,[8] they should thoroughly understand unit-level economics and be prepared to discuss factors influencing profitability. Transparency about performance variables builds trust with sophisticated franchise candidates.

Franchisors need to be honest with themselves and with their franchisee candidates about what the actual initial investment requirements of their business are. Keeping the initial investment level as low as possibly might positively impact franchisee recruitment efforts, but setting franchisees up to fail by short changing what they truly need to budget to build this type of business will do way more damage than the value that any boost in recruitment will bring.

For emerging brands, this can be frustrating as they see their more established competitors listing an initial investment level in the Item 7 of their FDD significantly lower than they know to be practicable. Knowing where you stand against your direct franchisee recruitment competition is valuable, but it is crucial for a franchisor to truly evaluate their own business. Competitors may have a completely different business model, or might be leveraging efficiencies from their size and longevity that an emerging franchisor simply does not yet have. Or those competitors could simply be inaccurate, either knowingly or otherwise. Setting the expected investment levels, as well as fees or other elements of the business, based solely on where other competitors set theirs is a recipe for failure.

Initial investment requirements must also balance accessibility with adequate capitalization. Depending on the profile and class of the desired franchisee candidate, emerging franchisors must understand what their ideal candidate can afford as well as their ability to get proper financing. If the ideal candidate pool is such that it limits the number of financially viable candidates, franchising might not be the appropriate model.

There is no silver bullet in determining what level of expected return on franchisee investment is sufficient to make a franchise opportunity "acceptable." A 2007 ABA

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8 "FPRs" are of course governed by Item 19 of the FTC Franchise Rule requirements, found at 16 C.F.R. § 436.5(s).

presentation[9] suggested that properly structured franchise systems should enable franchisees to achieve roughly 15% return on investment by years two or three of operation, after accounting for franchise fees, operational expenses, and management compensation. Whether that benchmark is right or not, the point is that a new franchisor and prospective franchisees should have a reasonable line of sight into what the economic results will be from operating a new franchise. This may be highly dependent on the industry, the profile and class of the franchisee, the overall economy, and a variety of other factors. If the franchisee is intended to be a more traditional hands on owner-operator, then it may be appropriate for the franchisee to take a salary that would impact what level of return on investment was deemed to be appropriate or acceptable. If the franchise model is such that it is intended to be an auxiliary or seasonal business that the franchisee takes on in addition to their existing job, then the level of ROI may be rather different.

Overall the lesson is simple: if the unit economics do not work for franchisees, an emerging brand can quickly turn from boom to bust. If an emerging franchisor cannot realistically produce sufficient data to properly disclose in Item 19 of their FDDs to show that franchisees will achieve adequate levels of success, they may want to pause before franchising their brand. It may be a situation where there simply is not yet enough operational history to confidently produce sufficient evidence of successful unit economics. In those situations, the answer to whether a brand *should* franchise is likely closer to being "not *yet*" than not at all. Either way, franchisors should be honest with themselves when conducting this crucial analysis. Potential franchisees should also do their due diligence to determine on their own whether they agree with a franchisor that the opportunity has the requisite likelihood of success they need in order to invest. And whether or not there is an Item 19 FPR disclosure to assess, the prospective franchisee should dive very deep and very thoroughly (with business advisors, a skilled accountant, an experienced franchisee-oriented lawyer, and existing and former franchisees, if any) before making the decision to sign up with a new franchise system.

B. Distinctiveness: Is the Concept Truly Unique and *Proven*?

Next, a franchisor's offering should have some distinctive quality that sets the franchise brand and its franchisees up for success in the marketplace. This could be a distinguishing product, service, or operating system that that truly sets the brand apart from its competitors. It could be that the franchised brand provides a similar product or service but in a more efficient, effective, or desirable manner. It could be bringing a product that is somewhat common or "tried and true" in one market where it is less established and therefore has more room to grow and establish itself.

It could also simply be that the market is sufficiently elastic in demand terms that it can support another offering due to a continued increase in public demand. For example, in the hamburger segment, the biggest brands (*McDonald's, Burger King,* and

9 Kenneth Darrow, et al., *The Structural Elements of a Franchise System and Their Economic and Legal Implications for Startup and Existing Systems*, ABA 30th Annual Forum On Franchising W2, at 5 (2007).

Wendy's) face ever-growing competition from brands such as *Carl's Jr., Culver's, Five Guys, In-n-Out, Shake Shack, Smashburger, Sonic, Whataburger,* and *White Castle* – showing that the segment can and will support additional brands and market entrants.

Generally, distinctiveness often equates to competitive advantage. Emerging franchisors need to evaluate whether their offering provides something new or distinct, and whether that distinction will last the test of time or will it fade away as more of a novelty. An emerging franchisor needs to give potential franchisee candidates a reason to pick them – the likely more risky and less proven option – over the more established brands. Sometimes this can be as simple as there is no longer territory available for established brands, paving the way for emerging brands to penetrate a market.

C. Economic Resources of the Franchisor: Fuel for Sustainable Growth

Another pivotal focus should be whether the franchisor has the economic capacity to support and sustain a network. Franchising should not be seen as a shoestring endeavor; it demands capital and infrastructure on the franchisor's part to provide training, marketing, supply chain management, and ongoing assistance to franchisees. An undercapitalized or financially unstable franchisor may be unable to deliver the support and development it promises.

Doing the proper internal analysis, designing and developing the support structures, and recruiting franchisees can all be costly. The initial group of franchisees may be the key to the system's success: that group's operational and financial success will be the base on which that franchise system grows and may be an anchor that pulls down the future viability of the system.

The chief metric of success for a franchisor at any stage of their development should always be the success of its units. Franchise systems do not succeed if its franchisees don't succeed. Although some franchisors view their own success by measuring how many locations they have open and under contract, that metric should stand second to the actual health of the brand measured by unit-level success, operational excellence, and economic performance.

Generally, franchisors should not grow faster than they can afford to support their system. Growing at the appropriate interval and in geographic areas that require an appropriate level of time and money to support (e.g., because they are relatively close to the brand's resource center) can be the most efficient and effective way to build a brand that will last the test of time. Economic realities can often seem to be the greatest enemy of this "low and slow" philosophy. Emerging franchisors need to do an honest self-evaluation of their own resources.

If the franchise program is going to be sustained solely on the revenue from existing company-owned locations, then there needs to be a sufficient revenue base generated from that existing operation. There is no set minimum number of locations that will automatically be "sufficient," and it will be different for every brand and every industry. Franchisors need to conduct their own business model projections to see what level of growth they can afford to support short term, and what level of growth they need to sustain long term to be able to get to royalty self-sufficiency (e.g., the point at which the revenue from franchisee royalties is sufficient to fund all the support efforts they provide to franchisees, without additional funding from company-owned stored or other sources). Some franchisors do not achieve that royalty-sustaining model for many years and yet others find that it may still make sense to inject capital to sustain future system growth and resilience. For example, in 2018, Dunkin' Brands invested $100 million in a brand refresh – virtually all of which was dedicated to franchised locations (the "Dunkin' Donuts" system is virtually entirely franchised) – leveraging that significant investment towards future growth.[10]

D. Accessibility and Support: The True Measure of a Successful Franchisor

"Accessibility" in the IDEA framework refers to the franchisor's ability and willingness to support its franchisees – to provide training, mentorship, troubleshooting, and guidance on how best to meet the brand standards that the franchisor has established.

Franchisors support their franchisees in a variety of ways, from initial and ongoing training, to manuals that provide the guidelines and brand standards, to ongoing support through a franchisor's field staff. For emerging brands new to franchising, these support structures are sometimes developed in collaboration with their first batch of franchisees. A franchisor likely understands how to train its own employees in its corporate locations or how to market the brand in its own backyard, but doing those things with an independent operator in their own market may seem like stepping into the unknown.

Emerging franchisors can help prepare themselves in a variety of ways. Treating their existing company stores as if they were franchisees, in terms of how they are trained and supported, can be very helpful in developing both the written content for training and manuals as well as the soft skills and experience needed to support actual franchisees once they join the system.

Some things about franchising, including training and support, may be standardized in order to best maintain consistent brand standards, but support across a network of franchisees does not necessarily need to be identical. Many factors, including how long a franchisee has been part of the brand, to the relative sophistication and

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[10] See Ezequiel Minaya, *Dunkin' Donuts Invests $100 Million in Brand Refresh*, Wall St. J. (Aug. 31, 2018) (available at https://www.wsj.com/articles/dunkin-donuts-invests-100-million-in-brand-refresh-1535707800?msockid=23d3393530a16b980a692c1f31386a6d). The investment in growth paid off: two years later, the company was sold to Inspire Brands for $11.3 billion. See Joanna Fantozzi, *Inspire Brands completes purchase of Dunkin' Brands Group for $11.3 billion*, Nation's Rest. News (Dec. 15, 2020) (available at https://www.nrn.com/quick-service/inspire-brands-completes-purchase-of-dunkin-brands-group-for-11-3-billion).

experience of a franchisee, to the personality and internal habits of certain franchisees, may affect how a franchisor can best support them.

The franchisee-franchisor relationship is often discussed in terms of a Parent-Child relationship, and although this is a simplistic (and paternalistic) perspective, it may nonetheless be accurate in some ways. When franchisees first enter a system they often will seek validation and direct support at every interval, no matter how small. Eventually, as they get more comfortable and gain confident, franchisees will begin rejecting this "hand holding" approach and even potentially seek the far reaches of "independence" much as a teenager does. Eventually, maturity and true confidence take hold and franchisees may realize that they can be most successful if they work hand-in-hand with franchisors, collaborating to best support and grow the brand. At each of those levels, a franchisor is likely to provide varying degrees of support in a variety of different methods. The hand-holding of the early stage would likely cause resentment during the "teenage" years, and so on.

Emerging franchisors can best prepare to support their franchisees at these various stages by being open and candid about what is expected from all parties in the franchisee-franchisor relationship. Such expectations should be set during the early stages of the recruitment process before a franchisee has even signed on. While the franchisee-franchisor relationship is not a partnership, the unique shared experiences that stem from growing a young brand can help develop incredibly effective support processes that go towards continuing to build a strong brand for the long term. Emerging franchisors need to be intentional about cultivating that unique relationship with its franchisee at all stages of the relationship.

In sum, the IDEA factors – Income potential, Distinctiveness, Economic resources, and Accessibility – offer a structured way to vet an emerging franchise opportunity. A business model that promises solid franchisee income, offers a distinctive competitive opportunity, is backed by sufficient capital, and commits to accessible support stands a far better chance of being a beauty that flourishes for all parties. If an emerging franchisor cannot honestly say they've substantially met the requirements set up in each of those pillars, they should reconsider whether they are ready to grow through the franchise model and seek to further build out those areas where they are may be lacking. Emerging franchisors and their initial set of franchisees have the unique opportunity to build a successful brand together and reap the shared benefits of being part of such growth.

II. Timing is Everything: Is Now the Right Time to Franchise?

Even if a business concept passes the initial viability test, timing can make the difference between franchise success and failure. Launching (or joining) a franchise system too early in its life cycle can doom the brand and its franchisees; yet waiting too long can mean missing a market window or ceding ground to competitors.

From the franchisor's perspective, expanding quickly can yield first-mover advantages, such as shaping consumer preferences and locking in prime territories. For instance, a franchisor that promptly expands the market for its products may influence customer habits and gain a competitive edge as an early entrant.[11] This pressure to scale up fast is real – particularly if the concept shows early signs of popularity. The founders of a "hot" new brand might fear that if they don't franchise now, a rival will, or that they'll lose momentum.

However, from the franchisee's perspective, the fact that a franchisor is eager to franchise does not mean it is truly ready to do so. A company in its nascency may need more time to refine operations, build capital, and stabilize its corporate operations before it can responsibly support franchisees. If the franchisor is still financially immature or its own corporate outlets are underperforming, jumping into franchising is premature.

Some academic critiques of franchising focus on whether a franchisor's push to franchise took place when they lacked the resources and infrastructure to sustain growth. Those analyses suggest that a "franchisor life cycle" problem occurs if the franchisor's primary incentive is to attract franchisees (to overcome liquidity constraints), rather than develop an operationally successful model.[12] An infamous example of a failed model – stemming from fraud as well as inadequate planning – can be found in the *BurgerIm* system, which both the FTC and California enforcement authorities pursued, unfortunately after the franchisor's principal had fled from the United States.[13]

The business question of whether a franchisee should or should not "get in on the ground floor" has no legal analogue. The answer to that question comes only from careful, serious, and thoughtful review of the potential opportunity by the prospective franchisee, her or his advisors (e.g., a business consultant, accountant, and experienced franchisee lawyer) and considering factors such as whether the franchisor has demonstrated consistent success and capacity to support additional units. How long has the concept been operating successfully? Has the franchisor piloted the business in multiple locations or markets? Do they have corporate staff dedicated to franchise support right now? If the

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11 Although not a conventional franchisor, Starbucks Corp. is a fascinating example of how a brand can grow and develop a new market segment. An excellent podcast chronicling the company's history, development, and growth can be found at Gilbert & Rosenthal, "*Starbucks (with Howard Schultz),*" Acquired, Season 15, Ep. 5 (June 3, 2024) (https://www.acquired.fm/episodes/starbucks-with-howard-schultz. See also Uri Benoliel, "*Reputation Life Cycle: The Case of Franchising*," 13 Chap. L. Rev. 1, 10 (2009) ("A franchisor that promptly expands the market for its products may influence customer preferences.").

12 See Robert E. Martin & Robert T. Justis, *Franchising, Liquidity Constraints and Entry*, 25 Applied Econ. 1269, 1271-72 (1993) (discussing that franchisees are a superior source of capital rather than passive investors); see also Uri Benoliel, *Reputation Life Cycle: The Case of Franchising*, 13 Chap. L. Rev. 1, 14 (2009) ("Franchisees support the franchisor in overcoming its initial financial constraints, not only by incurring and reducing significant costs, but also by directly providing the franchisor significant capital.").

13 See U.S. v. BurgerIm Group USA, Inc., BurgerIm Group, Inc., and Oren Loni, No. 2:22-CV-00825-DMG, 2024 WL 661189 (C.D. Cal. Jan. 19, 2024) (ordering $48.5 million in consumer redress and $7.8 million in civil penalties); see also Comm'r of Financial Protection and Innovation v. BurgerIm Group USA, Inc. et al., Nos. 170427 and 237772 (Calif. Dep't of Financial Protection and Innovation).

answer to these is “no” or “not yet,” it may be prudent to wait. There are often good reasons not to be the first franchisee. As discussed below, being first in can mean encountering all the unforeseen problems with none of the hindsight. Of course, there are also advantages to being early (like choice of territory and sometimes lower initial fees), so it is a calculated risk. A franchisor may tout the chance to “get in on the ground floor” of the next big brand – which triggers “FOMO” (fear of missing out) for many entrepreneurs. But one must temper that excitement with realism about the brand’s readiness.

In sum, a prospective franchisee should evaluate not only “Is this business franchisable?” but also “Is it franchisable *now*?” Sometimes, the wisest advice to a client is to delay franchising until the business matures – or, if you are the franchisee, to defer investing until the concept is past its infancy. Patience can mean the difference between a roaring success and a cautionary tale.

III. Pitfalls for Early Franchisees in Emerging Brands

Prospective franchisees should consider that when a franchise system is in its infancy, the first cohort of franchisees may face a landscape filled with promise but also with possible hidden traps. These early adopters are pioneers – and like all pioneers, they deal with uncertainties that later followers might avoid. This Part examines several key pitfalls unique to buying into a start-up or emerging franchise: (A) unproven business models and limited operating history; (B) the dangers of rapid expansion strategies; (C) cognitive biases and due diligence failures that lead franchisees to overlook risks; and (D) the potential for franchisor opportunism as the power dynamic shifts over time.

A. Unproven Models and Limited Operational History

Perhaps the most obvious risk is that a start-up franchisor’s business model is untested on a large scale. While the franchisor may have one or a handful of successful outlets, it might not yet demonstrated whether the concept works in different locations and with operators other than the founders and their staff. The absence of a substantial operational history means that the system’s processes and profitability are still assumptions, not certainties. Franchisees investing in such a system must be prepared for the possibility that the concept does not perform as expected outside its original setting.

One concern may arise if there are not yet standardized procedures and manuals. A mature franchise typically has detailed operating manuals, training curricula, supply chains, and marketing playbooks refined over years. A young franchisor may still be developing these elements, which may lead to inconsistencies from one franchised location to another, which in turn can damage brand reputation and customer trust if the service or product quality varies widely. Consistency is the hallmark of franchising; without it, the brand’s value proposition to consumers evaporates. If a franchisor has only run a mom-and-pop operation, they may not have encountered the full range of operational challenges that arise when scaling up. A lack of operational history might mean that some strategies have not yet been fully tested, leaving those franchisees to encounter issues without clear guidance and support. The first franchisees essentially do the testing that the franchisor ought to have done – but they do it with their own money on the line.

Further, a new franchisor may not have fully considered how much difference there may be relating to regional or local market differences and whether a local franchisee can help bridge that gap.[14] For example, a food franchise that succeeds in a college town might not succeed in a suburban family neighborhood, or vice versa, unless the model is adapted to suit the environment. Early franchisees might discover that the concept needs tweaking – menu changes, pricing adjustments, marketing strategy shifts – which they must seek approval to implement on the fly, often without robust guidance. This trial-and-error process can be costly.[15] In contrast, franchisees of an established system benefit from years of refinements and lessons learned. Thus, those considering an emerging franchise must embrace a higher tolerance for the unknown. The franchisor's offering circular (the FDD) may disclose this candidly by showing a short operating history and few (if any) existing franchisees to validate results. The warning signs are there, but eager entrepreneurs sometimes ignore them, convinced that their chosen brand is the next big thing. Again, a prospective franchisee's tenacious due diligence is the key to understanding the opportunity, risks, and possibilities.

B. The Dangers of Rapid Expansion and Under-Investment in Support

A franchise system's reach should not exceed its capabilities. If a franchisor is opening new units without a team in place to support those franchisees, the system may implode. Franchisees should be alert to red flags such as: (1) high numbers of franchise sales in Table 5 of Item 20 in the franchisor's FDD with few openings; and (2) financial statements that show most the franchisor's revenue comes from initial franchise fees, rather than royalty income (strongly suggesting few open units generating sales).[16] Other factors that a franchisee should consider: a franchisor executive team that is extremely small or inexperienced in the brand or the segment.

In sum, rapid expansion of an emerging franchise can be a sign of success or a harbinger of failure. Franchisees should closely examine a franchisor's growth strategy

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14 See Thomas Bürkle & Thorsten Posselt, *Franchising as a Plural System: A Risk-Based Explanation,* 84 J. Retailing 39, 41 (2008) ("Franchisees operate in communities that, in most cases, they know very well, often having lived in them for a long time. Franchisees therefore likely have superior market knowledge compared with franchisors, who lack such local market knowledge when the system expands beyond its original territory.") (citation omitted).

15 See Uri Benoliel, *Reputation Life Cycle: The Case of Franchising*, 13 Chap. L. Rev. 1, 11–12 (2009)

Therefore, the franchisor needs to invest capital in searching for and identifying suitable locations. . . . [T]he franchisor will have to invest resources in learning about local marketing strategies, input suppliers, and customer preferences, at each potential location. These information-gathering costs are likely to augment with increases in the unfamiliarity, diversity, and uncertainty of local markets.

16 This exact fact pattern was plainly visible as a red flag in the *BurgerIm* FDDs filed with the states and provided to prospective franchisees.

and capacity. A slower, steadier growth plan coupled with proper support is far preferable (from the franchisee's standpoint) to a fast sprint that might be followed by a collapse. Sometimes, saying "no" to an aggressive development schedule – or choosing not to invest in a franchise that is growing irresponsibly – is the best protection of a franchisee's interests.

IV. Strategies and Safeguards for Prospective Franchisees

Given the heightened risks associated with emerging franchise brands, prospective franchisees (and their counsel) should take a proactive approach to protect their interests. While not every risk can be eliminated – franchising, like any business, will always have uncertainties – there are several strategies to mitigate these risks and improve the odds of a successful outcome. This Part discusses (A) rigorous pre-investment due diligence practices, (B) key contractual protections to negotiate or look for in the franchise agreement, and (C) post-investment strategies, such as maintaining strong communication channels with the franchisor as well as other franchisees, to safeguard one's investment.

A. Rigorous Due Diligence and Skeptical Mindset

The first and perhaps most important safeguard is thorough due diligence before signing a franchise agreement. This cannot be overstated whether the prospective franchisee is considering a new and unproven franchisor or an experienced franchise system.

Due diligence means diving deep into all aspects of the opportunity: analyzing the FDD with professional help, researching the market, speaking to current and former franchisees, and assessing the franchisor's background and financials. Franchisees should approach the process with a healthy skepticism – essentially, hope for the best but investigate for the worst. Any claims made by the franchisor's sales team should be verified against the written disclosure. If the franchisor provides an Item 19 Financial Performance Representation, scrutinize it and understand its basis (e.g., is it based on one or more company stores? Does it include expenses or just gross sales? Is it truly representative of all of the open locations?). If no earnings information is provided, that may be a signal to be extra cautious; as one article pointed out, "few would invest in a franchise if clueless about profit potential."[17]

Importantly, engage a franchise attorney early. As earlier noted, most franchisees skip this step, but that is a penny-wise, pound-foolish mistake. An attorney well-versed in franchising can interpret the 100+ page FDD, explain which provisions are unusual or particularly risky, and perhaps negotiate modifications. While emerging franchisors might present their contracts as "non-negotiable," there is often some room for adjustments, especially with key terms like territory, renewal, or an addendum to address specific concerns. At minimum, an attorney can ensure the prospective franchisee understands

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[17] Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship*, 109 Penn St. L. Rev. 105, 146 (2004).

what they're signing – for example, the conditions under which they could be terminated, their obligations, any personal guaranty, and so forth.

Due diligence should also include checking for any franchise relationship laws or regulations in the franchisee's state. Some states (often called "franchise registration" or "relationship" states) not only require FDD registration but also impose protections such as requiring good cause for termination or giving franchisees a right to cure certain defaults. Knowing these laws can inform how much contractual protection one might need to negotiate. For instance, if no state law mandates it, a franchisee may push for a contract clause that says the franchisor cannot terminate except for material breaches and with an opportunity to cure. Similarly, understanding applicable state law on franchise transfer, non-compete enforceability, and other issues is critical.

Another aspect of due diligence is evaluating the franchisor's support promises against reality. An emerging franchisor might promise world-class support, training, marketing, etc., but can they actually deliver? Item 11 of the FDD details the franchisor's obligations – and that detail should be closely reviewed. Does the franchisor commit to any minimum level of support or just say "we may provide assistance in our discretion"? If the latter, that's a sign that the support may or may not be forthcoming – and in some cases, that may be a red flag. As a potential franchisee, you should also ask to meet the support team (if any) or see the training facilities. If the entire franchisor company is just a handful of people, recognize what that means: you might be largely on your own. In such cases, a prospect must be certain to ask current franchisees about the support they have (or have not) received. In an emerging system, current franchisees might be hard to come by (you could even be the first), so also consider the experience of the franchisor's principals. Have they franchised before? If not, their learning curve might come at the same time as you are coming online – and whether that means it's at your expense or with your experience as their learning experience, that may not be what you have in mind. These inquiries all feed into a go/no-go decision. It is far better to walk away from a dubious deal after investing time and some legal fees in due diligence, than to invest your entire net worth and years of effort into a potentially financially devastating venture.

Finally, maintain a skeptical mindset toward sales tactics. High-pressure sales should set off alarms. Some franchisors or their brokers will employ techniques to create a false sense of urgency – "There are only two territories left in your area; you must act now!" or "Franchise fees are going up next month; sign now to lock in the lower rate." Do not be rushed. Legitimate opportunities will be there tomorrow. A <u>Fortune</u> magazine exposé on Subway's aggressive franchise sales in the 1990s revealed how salespeople were trained to "get them to make a decision on the spot. Trap them. Get them to say yes!"[18] This kind of pressure is a sure sign that the franchisor's interests are not aligned

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[18] Richard Behar, *Why Subway Is "The Biggest Problem in Franchising,"* <u>Fortune</u>, Mar. 16, 1998 at 130 (explaining that Subway development agents offered $1.5 billion to buy-out founder who they felt was mismanaging the brand before Subway changed their sales approach to now encourage prospects to carefully consider their decision before making a franchise purchase).

with careful candidate evaluation. A prudent franchisee will slow the process down, seek out the facts, and make an informed decision on their own timetable.

B. Post-Investment Protections: Staying Engaged and Collective Action

Franchisees should remain vigilant and engaged throughout the relationship to safeguard their investment. One important strategy is to maintain open lines of communication with the franchisor and to document issues as they arise. Franchisees should provide feedback to the franchisor about what is and isn't working, and attempt to be part of the solution. For instance, if supply chain problems are hurting their business, informing the franchisor in writing and pushing for resolution not only helps potentially fix the issue but also creates a record that the franchisee raised the issue. This could be useful if disputes later occur (to show the franchisor failed to support adequately, for example, if in fact the franchisor had a duty to fix the supply chain).

In many systems, franchisees form an independent franchisee association. This is essentially a trade association for the brand's owners, independent of the franchisor's control. Many famous franchise systems (from *McDonald's* to *7-Eleven*) have independent franchisee associations that advocate for franchisee interests, provide mutual support, share best practices, and even engage in collective bargaining or legal action if necessary. For a fledgling franchise system, an independent association can be tricky (all the franchisees are new and may fear retaliation, whether or not that is a legitimate concern).

Finally, franchisees should keep an eye on the franchisor's compliance with its obligations and on any early signs of trouble in the system. If the franchisor starts missing commitments – e.g., delaying delivery of an operations manual, canceling training sessions, not launching promised advertising – these could indicate deeper problems (financial distress, disorganization, etc.). Early franchisees might feel they have to "just deal with it" since the system is new, but they should not hesitate to hold the franchisor accountable. Often, the franchise agreement will have a mediation or other informal dispute resolution mechanism; while no franchisee wants to antagonize the franchisor, sometimes a stern letter from counsel reminding the franchisor of its contractual duties can prompt corrective action. The key is not to suffer in silence until your business is failing.

In conclusion, a franchisee who enters an emerging system must play a more active role in protecting their investment than one who joins a mature franchise. The framework is not as established, and the balance of power and information initially favors the franchisor. By conducting exhaustive due diligence, negotiating protective contract terms, and remaining constructively engaged (including collectively with fellow franchisees), the franchisee can significantly improve their odds of success and mitigate the unique risks of an emerging brand.

CONCLUSION

Emerging franchise brands occupy a perilous middle ground between independent start-ups and established franchise networks. They offer the enticing possibility of "getting in early" on the next big success – the *beauty* of a ground-floor opportunity – but with that comes the *beast* of uncertainty and risk born by those first through the gate. For every *Starbucks* or *McDonald's* that once had only a handful of units, there are countless concepts that expanded too fast, underperformed, or imploded, taking franchisee capital and dreams with them. "Positioning emerging franchise brands for success" requires a candid appraisal of these realities by all stakeholders: franchisors must be ready and properly equipped before franchising, and franchisees must approach new opportunities with caution, diligence, and eyes wide open.

From the franchisee perspective, the core advice distilled in this paper is: vet the concept rigorously (IDEA: Income, Distinctiveness, Economics, Accessibility), be mindful of timing, and protect yourself both contractually and through prudent behavior. If the business model is solid, the franchisor committed and well-resourced, and the franchisee diligent and well-advised, even a young franchise brand can be a mutually rewarding venture. Indeed, some of today's most successful franchises were built on the hard work, cooperation, and constructive approach taken by early franchisees and franchisors who together navigated growing pains. On the other hand, if key elements are missing – say, the franchisor's support is lacking or the concept's economics do not prove to be successful – then no amount of enthusiasm or optimism will likely compensate, and the relationship may sour into financial loss and legal disputes.

Legal practitioners counseling franchisees should counsel clients to understand not just the legal terms but the broader business context and risks of joining an emerging system. Likewise, franchisor attorneys should counsel restraint to potential franchisor clients: franchising before one is ready can lead to litigation, reputational damage, and regulatory scrutiny. The franchise business model can be a powerful engine for growth, but it must be used judiciously. Timing, transparency, and fairness are paramount.

In the end, an emerging franchise brand can indeed turn out to be a "beauty" – evolving into a thriving national chain that enriches franchisor and franchisees alike – but success is far more likely when both parties enter the relationship with careful planning and realistic expectations. By recognizing the potential "beasts" in the form of risks and addressing them through due diligence, legal safeguards, and ongoing communication, franchisees can greatly enhance their prospects. As the saying goes, forewarned is forearmed. With the insights and strategies outlined above, those venturing into new franchise opportunities will be better prepared to tame the risks and cultivate a successful, sustainable franchise venture.

New franchisors must do their homework to properly and responsibly prepare for market entry. And prospective franchisees of new franchise systems (and any franchise system for that matter!) must conduct thorough if not painstaking due diligence and balance the excitement of the opportunity against a healthy dose of skepticism before making a commitment, signing a franchise agreement, and starting their new adventure.

A famous French proverb is plus ça change, plus c'est la même chose – less sensationally in English: "the more things change, the more they stay the same." It is that way with franchising as well. Your authors wish good luck to all!

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