Chapter

4 Forms of Business Ownership and Franchising

First Law of Bridge: It's always the partner's fault.

—Anonymous

Humans must breathe, but corporations must make money.

—Alice Embree

LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

1. **EXPLAIN** the advantages and the disadvantages of the three major forms of business ownership: the sole proprietorship, the partnership, and the corporation.
2. **DISCUSS** the advantages and the disadvantages of the S corporation, the limited liability company, the professional corporation, and the joint venture.
3. **DESCRIBE** the three types of franchising: trade name, product distribution, and pure.
4. **EXPLAIN** the benefits and the drawbacks of buying a franchise.
5. **UNDERSTAND** the laws covering franchise purchases.
6. **DISCUSS** the *right* way to buy a franchise.
7. **OUTLINE** the major trends shaping franchising.

Every business operates as some form of legally recognized entity. It may be as simple as sole proprietorship or as complex as a C corporation. The form of business ownership that an entrepreneur selects may have some very significant implications as the business goes forward. What form of ownership is "best" depends on the characteristics of the business and its owner(s). This chapter is designed to allow you to review the advantages and disadvantages of the most common forms of business ownership and then to apply your analytical skills in evaluating these choices in light of the specific circumstances surrounding the new business and its owner(s). Matching the personal circumstances of the owner(s) and the size and nature of the business with the ownership options can result in the avoidance of problems later. Although the decision regarding the selected form of ownership is not irreversible, changing from one ownership form to another can be difficult, time consuming, complicated, and expensive. Consequently, attention to the detailed components of each form of ownership can be very beneficial.

The following are seven critical considerations, which normally comprise the basis of your review and evaluation prior to the final selection of the form of ownership. Clearly, some criteria are more important than others at difficult times in the life of the business.

Tax considerations. The graduated tax rates under each form of ownership, the government's constant tinkering with the tax code, and the year-to-year fluctuations in a company's income mean that entrepreneurs must calculate the firm's tax bill under each ownership option every year.

Liability exposure. Certain forms of ownership offer business owners greater protection from personal liability that might result from financial problems, faulty products, and a host of other difficulties. Entrepreneurs must decide the extent to which they are willing to assume personal responsibility for their companies' obligations.

Start-up capital requirements. Forms of ownership differ in their ability to raise start-up capital. How much capital entrepreneurs need and where they plan to get it make some forms of ownership superior to others.

Control. By choosing certain forms of ownership, entrepreneurs automatically give up some control over the company. Entrepreneurs must decide early on how much control they are willing to sacrifice in exchange for help from other people in building a successful business.

Business goals. How big and how profitable entrepreneurs plan for the business to become will influence the form of ownership chosen. Businesses often switch forms of ownership as they grow, but moving from some formats to others can be extremely complex and expensive.

Management succession plans. When choosing a form of ownership, business owners must look ahead to the day when they will pass their companies on to the next generation or to a buyer. Some forms of ownership make this transition much smoother than others.

Cost of formation. Certain forms of ownership are much more costly and involved to create than others. Entrepreneurs must weigh carefully the benefits and the costs of the particular form they choose.

Entrepreneurs have a wide choice of forms of business ownership. In recent years, various hybrid forms of ownership have emerged. This chapter will attempt to outline the key features of the most common forms of ownership, beginning with the sole proprietorship, the partnership, and the corporation. Franchising will be addressed later in the chapter.

Learning Objective

1-A. Explain the advantages and disadvantages of the sole proprietorship.

THE SOLE PROPRIETORSHIP

Without question the simplest and most popular form of ownership remains the **sole proprietorship**. The sole proprietorship, as its name implies, is a business owned and managed by one individual. The normal perception of sole proprietorships is that they are a small and insignificant part of the national as well as global economy. This could not be further from the truth. The latest government figures place the number of domestic sole proprietorships at approximately 18 million with sales in excess of $1 trillion.[1] Estimates place sole proprietorships at 73 percent of all U.S. businesses. The reasons for their popularity can be found in the advantages of this form of ownership providing, however, its disadvantages are never overlooked.

sole proprietorship— *a business owned and managed by one individual.*

The Advantages of a Proprietorship

SIMPLE TO CREATE. One of the most attractive features of a proprietorship is how fast and simple it is to begin. If an entrepreneur wants to operate a business under his own name (e.g., Strossner's Bakery), he simply obtains the necessary licenses from state, county, and/or local governments and begins operation. For most entrepreneurs, it would not be impossible to start a proprietorship in a single day.

LEAST COSTLY FORM OF OWNERSHIP TO BEGIN. In addition to being easy to begin, the proprietorship is generally the least expensive form of ownership to establish. There is no need to create and file the legal documents that are recommended for partnerships and required for corporations. An entrepreneur simply goes to the city or county government, states the nature of the business he will start, and pays the appropriate fees and license costs. Paying these fees and license costs gives the entrepreneur the right to conduct business in that particular jurisdiction.

Someone planning to conduct business under a trade name should acquire a certificate of doing business under an assumed name from the secretary of state. The fee for filing this certificate usually is nominal. Acquiring this certificate involves conducting a legal search to ensure that the name chosen is not already registered as a trademark or a service mark with the secretary of state. Filing this certificate also notifies the state who the owner of the business is. In a proprietorship, the owner *is* the business.

PROFIT INCENTIVE. One major advantage of the proprietorship is that once the owner pays all of the company's expenses, she can keep the remaining profits (less taxes, of course). The profit incentive is a powerful one, and profits represent an excellent way of "keeping score" in the game of the business.

TOTAL DECISION-MAKING AUTHORITY. Because the sole proprietor is in total control of operations, she can respond quickly to changes, which is an asset in a rapidly shifting market. The freedom to set the company's course of action is a major motivational force. For those who thrive on the enjoyment of seeking new opportunities in business, the freedom of fast, flexible decision making is vital. Many sole proprietors simply thrive on the feeling of control they have over their personal financial future and the recognition they earn as the "owner" of the business.

NO SPECIAL LEGAL RESTRICTIONS. The proprietorship is the least regulated form of business ownership. In a time when government requests for information seem never ending, this feature has much merit.

EASY TO DISCONTINUE. If the entrepreneur decides to discontinue operations, he can terminate the business quickly, even though he will still be personally liable for any outstanding debts and obligations that the business cannot pay.

The Disadvantages of a Proprietorship

UNLIMITED PERSONAL LIABILITY. Probably the greatest disadvantage of a sole proprietorship is the **unlimited personal liability** of the owner, which means that the sole proprietor is personally liable for all of the business's debts. Remember: In a sole proprietorship, the owner *is* the business. He owns all of the business's assets, and if the business fails, creditors can force the sale of these assets to cover its debts. If unpaid business debts remain, creditors can also force the sale of the proprietor's *personal* assets to recover payment. In short, the company's debts are the owner's debts. Laws vary from one state to another, but most states require creditors to leave the failed business owner a minimum amount of equity in a home, a car, and some personal items. The reality: *Failure of a business can ruin a sole proprietor financially.*

unlimited personal liability—*a situation in which the sole proprietor is personally liable for all of the business's debts.*

LIMITED SKILLS AND CAPABILITIES. A sole proprietor may not have the wide range of skills that running a successful business requires. Each of us has areas in which our education, training, and work experiences have taught us a great deal; yet there are other areas where our decision-making ability is weak. Many business failures occur because owners lack the skills, knowledge, and experience in areas that are vital to business success. Owners tend to push aside problems they don't understand or don't feel comfortable with in favor of those they can solve more easily. Unfortunately, the problems they set aside seldom solve themselves. By the time an owner decides to ask for help in addressing these problems, it may be too late to save the company.

FEELINGS OF ISOLATION. Running a business alone allows an entrepreneur maximum flexibility, but it also creates feelings of isolation—that there is no one else to turn to for help in solving problems or getting feedback on a new idea. Most sole proprietors will honestly admit that there are times when they feel the pressure of being alone and being fully and completely responsible for every major business decision. It's a challenge to learn what you need to know about aspects of the business with which you may have had little, or no, previous experience.

LIMITED ACCESS TO CAPITAL. If the business is to grow and expand, a sole proprietor generally needs additional financial resources. However, many proprietors have already put all they have into their businesses and have used their personal resources as collateral on existing loans, making it difficult to borrow additional funds. A sole proprietorship is limited to whatever capital the owner can contribute and whatever money he can borrow. In short, proprietors, unless they have great personal wealth, find it difficult to raise additional money while maintaining sole ownership. Most banks and other lending institutions have well-defined formulas for determining borrowers' eligibility. Unfortunately, many sole proprietorships cannot meet those borrowing requirements, especially in the early days of operation.

LACK OF CONTINUITY FOR THE BUSINESS. Lack of continuity is inherent in a sole proprietorship. If the proprietor dies, retires, or becomes incapacitated, the business automatically terminates. Unless a family member or employee can take over (which means that person is now a sole proprietor), the business could be in jeopardy. Because people look for secure employment and an opportunity for advancement, proprietorships, being small, often have trouble recruiting and retaining good employees. If no one is trained to run the business, creditors can petition the courts to liquidate the assets of the dissolved business to pay outstanding debts.

Some entrepreneurs find that forming partnerships is one way to overcome the disadvantages of the sole proprietorship. For instance, when one person lacks specific managerial skills or has insufficient access to needed capital, he can compensate for these weaknesses by forming a partnership with someone with complementary management skills or money to invest.

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Where Do Small Business Owners Turn for Advice? It's All in the Family

A recent survey conducted by the National Federation of Independent Business and Wells Fargo reveals that when it comes to advice, blood is thicker than water. Of the businesses responding to the survey, 56 percent consulted family members for advice on critical decisions. This was greater than their partners or co-owners (16%) or professionals (accountants, attorneys, consultants) (14%). Family members whom owners turn to are as follows:

Spouse	62% of the time
Son	11% of the time
Father	9.5% of the time
Brother	8.8% of the time

1. Who else could provide a business owner with objective advice?

2. Is the person to whom you turn to for advice a source of potential problems? Explain.

Source: Richard Breeden, "The Big Decision" *Wall Street Journal*, September 24, 2002, p. B6.

THE PARTNERSHIP

Learning Objective

1-B. Explain the advantages and disadvantages of the partnership.

A **partnership** is an association of two or more people who co-own a business for the purpose of making a profit. In a partnership the co-owners (partners) share the business's assets, liabilities, and profits according to the terms of a previously established partnership agreement.

The law does not require a partnership agreement (also known as the articles of partnership), but it is wise to work with an attorney to develop one that spells out the exact status and responsibility of each partner. All too often the parties think they know what they are agreeing to, only to find later that no real meeting of the minds took place. The **partnership agreement** is a document that states in writing all of the terms of operating the partnership and protects each partner involved. Every partnership should be based on a written agreement. "When two entrepreneurial personalities are combined, there is a tremendous amount of strength and energy, but it must be focused in the same direction, or it will tear the relationship apart," explains one business writer. "A good partnership agreement will guide you through the good times, provide you with a method for handling problems, and serve as the infrastructure for a successful operation."[2]

partnership—*an association of two or more people who co-own a business for the purpose of making a profit.*

partnership agreement—*a document that states in writing all of the terms of operating the partnership and protects the interest of each partner.*

When no partnership agreement exists, the Uniform Partnership Act (UPA) governs a partnership, but its provisions may not be as favorable as a specific agreement hammered out among the partners. Creating a partnership agreement is not costly. In most cases the partners can discuss each of the provisions in advance. Once they have reached an agreement, an attorney can draft the formal document. Banks will often want to see a copy of the partnership agreement before lending the business money. Probably the most important feature of the partnership agreement is that it resolves potential sources of conflict that, if not addressed in advance, could later result in partnership battles and the dissolution of an otherwise successful business. Spelling out details—especially sticky ones such as profit splits, contributions, workloads, decision-making authority, dispute resolution, dissolution, and others—in a written agreement at the outset will help avoid damaging tension in a partnership that could lead to a business "divorce." Business divorces, like marital ones, are almost always costly and unpleasant for everyone involved.

It may be impossible to overstate the need to approach the formation of a business partnership in an objective, impersonal, logical, and rational manner. In reality, there is a tendency for partnerships to be created by individuals who don't believe that it is necessary to draw up a partnership agreement. As a result, if and when a disagreement arises between or among the partners, there is no written record of what was agreed to and how a disagreement is to be resolved. Thousands of businesses close each year because the founders saw no need for a partnership agreement with, like in some marriages, "irreconcilable differences" being the stated reason for dissolution of the business.[3]

Generally, a partnership agreement can include any terms the partners want (unless they are illegal). The standard partnership agreement will likely include the following:

1. *Name of the partnership.*
2. *Purpose of the business.* What is the reason the business was brought into being?
3. *Domicile of the business.* Where will the principal business be located?
4. *Duration of the partnership.* How long will the partnership last?
5. *Names of the partners and their legal addresses.*
6. *Contributions of each partner to the business,* at the creation of the partnership and later. This would include each partner's investment in the business. In some situations a partner may contribute assets that are not likely to appear on a balance sheet. Experience, sales contacts, or a good reputation in the community may be reasons for asking a person to join the partnership.
7. Agreement on *how the profits or losses will be distributed.*
8. An agreement on *salaries or drawing rights* against profits for each partner.
9. Procedure for *expansion through the addition of new partners.*
10. If the partners *voluntarily dissolve the partnership, how will the partnership's assets be distributed?*
11. *Sale of partnership interest.* The articles of partnership should include terms defining how a partner can sell his or her interest in the business.

12. *Salaries, draws, and expense accounts for the partners.* How much money will each partner draw from the business? Under what circumstances? How often?
13. *Absence or disability of one of the partners.* If a partner is absent or disabled for an extended period of time, should the partnership continue? Will the absent or disabled partner receive the same share of profits as she did prior to her absence or disability? Should the absent or disabled partner be held responsible for debts incurred while unable to participate?
14. *Dissolution of the partnership.* Under what circumstances will the partnership dissolve? How will the assets of the business be valued for dissolution?
15. *Alterations or modifications of the partnership agreement.* No document is written to last forever. Partnership agreements should contain provisions for alterations or modifications.

The Uniform Partnership Act

The Uniform Partnership Act (UPA) codifies the body of law dealing with partnerships in the United States (except in Louisiana, which has not adopted the UPA and where state law governs in the absence of a partnership agreement). Under the UPA, the three key elements of any partnership are common ownership interest in a business, sharing the business's profits and losses, and the right to participate in managing the operation of the partnership. Under the act each partner has the *right* to:

1. share in the management and operations of the business.
2. share in any profits the business might earn from operations.
3. receive interest on additional advances made to the business.
4. be compensated for expenses incurred in the name of the partnership.
5. have access to the business's books and records.
6. receive a formal accounting of the partnership's business affairs.

The UPA also sets forth the partners' general obligations. Each partner is *obligated* to:

1. share in any losses sustained by the business.
2. work for the partnership without salary.
3. submit differences that may arise in the conduct of the business to majority vote or arbitration.
4. give the other partner complete information about all business affairs.
5. give a formal accounting of the partnership's business affairs.

Beyond what the law prescribes, a partnership is based above all else on mutual trust and respect. Any partnership missing these elements is destined to fail.

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How Will the Assets of the Business Be Valued for Dissolution?

PARTNERSHIPS, DEATH, AND FEUDS

At the age of 81, a New York City real estate mogul, Seymour Milstein, died leaving his billion-dollar real estate empire in turmoil. Some two dozen real estate partnerships held with his brother, Paul, must now, by partnership law, be dissolved. The family must either form a new partnership, split the property, or liquidate the assets. Family feuding may result in the total liquidation of all the real estate partnerships and an end to the business.

1. What provisions of a partnership agreement could have eliminated this problem?

Source: Joanne Gordon, "Kickin' Cousins," *Forbes*, November 26, 2001, pp. 52–53.

The Advantages of the Partnership

EASY TO ESTABLISH Like the proprietorship, the partnership is easy and inexpensive to establish. The owners must obtain the necessary business licenses and submit a minimal number of forms. In most states, partners must file a certificate for conducting business as partners if the business is run under a trade name.

COMPLEMENTARY SKILLS. In a sole proprietorship, the owner must wear lots of different hats, and not all of them will fit well. In successful partnerships, the parties' skills and abilities usually complement one another, strengthening the company's managerial foundation.

DIVISION OF PROFITS. There are no restrictions on how partners distribute the company's profits as long as they are consistent with the partnership agreement and do not violate the rights of any partner. The partnership agreement should articulate the nature of each partner's contribution and proportional share of the profits. If the partners fail to create an agreement, the UPA says that the partners share equally in the partnership's profits, even if their original capital contributions are unequal.

LARGER POOL OF CAPITAL. The partnership form of ownership can significantly broaden the pool of capital available to a business. Each partner's asset base improves the business's ability to borrow needed funds; together the partners' personal assets will support a larger borrowing capacity.

ABILITY TO ATTRACT LIMITED PARTNERS. When partners share in owning, operating, and managing a business, they are **general partners**. General partners have unlimited liability for the partnership's debts and usually take an active role in managing the business. Every partnership must have at least one general partner although there is no limit on the number of general partners a business can have.

Limited partners cannot participate in the day-to-day management of a company, and they have limited liability for the partnership's debts. If the business fails, they lose only what they have invested in it and no more. Limited partners usually are just financial investors in a business. A limited partnership can attract investors by offering them limited liability and the potential to realize a substantial return on their investments if the business is successful. Many individuals find it very profitable to invest in high-potential small businesses, but only if they avoid the disadvantages of unlimited liability while doing so.

general partners—*partners who share in owning, operating, and managing a business and who have unlimited personal liability for the partnership's debts.*

limited partners—*partners who do not take an active role in managing a business and whose liability for the partnership's debts is limited to the amount they have invested.*

LITTLE GOVERNMENTAL REGULATION. Like the proprietorship, the partnership form of operation is not burdened with red tape.

FLEXIBILITY. Although not as flexible as sole ownership, the partnership can generally react quickly to changing market conditions because no giant organization stifles quick and creative responses to new opportunities.

TAXATION. The partnership itself is not subject to federal taxation. It serves as a conduit for the profit or losses it earns or incurs; its net income or losses are passed along to the partners as personal income, and the partners pay income tax on their distributive shares. The partnership, like the proprietorship, avoids the "double taxation" disadvantage associated with the corporate form of ownership.

The Disadvantages of the Partnership

UNLIMITED LIABILITY OF AT LEAST ONE PARTNER. At least one member of every partnership must be a general partner. The general partner has unlimited personal liability, even though he is often the partner with the least personal resources.

CAPITAL ACCUMULATION. Although the partnership form of ownership is superior to the proprietorship in its ability to attract capital, it is generally not as effective as the corporate form of ownership, which can raise capital by selling shares of ownership to outside investors.

DIFFICULTY IN DISPOSING OF PARTNERSHIP INTEREST WITHOUT DISSOLVING THE PARTNERSHIP. Most partnership agreements restrict how a partner can dispose of his share of the business. Often a partner is required to sell his interest to the remaining partner(s). Even if the original agreement contains such a requirement and clearly delineates how the value of each partner's ownership will be determined, there is no guarantee that the other partner(s) will have the financial resources to buy the seller's interest. When the money is not available to purchase a partner's interest, the other partner(s) may be forced either to accept a new partner or to dissolve the partnership, distribute the remaining assets, and begin again. When a partner withdraws from the partnership, the partnership ceases to exist unless there are specific provisions in the partnership agreement for a smooth transition. When a general partner dies, becomes incompetent, or withdraws from the business, the partnership automatically dissolves, although it may not terminate. Even when there are numerous partners, if one chooses to disassociate her name from the business, the remaining partners will probably form a new partnership.

LACK OF CONTINUITY. If one partner dies, complications arise. Partnership interest is often nontransferable through inheritance because the remaining partner(s) may not want to be in a partnership with the person who inherits the deceased partner's interest. Partners can make provisions in the partnership agreement to avoid dissolution due to death if all parties agree to accept as partners those who inherit the deceased's interest.

POTENTIAL FOR PERSONALITY AND AUTHORITY CONFLICTS. Being in a partnership is much like being in a marriage. Making sure partners' work habits, goals, ethics, and general business philosophy are compatible is an important step in avoiding a nasty business divorce. It may often sound foolish, but it is valuable to engage in serious and lengthy discussions between or among potential partners on each of these topics. Never blindly assume that you know how a potential partner might act in a difficult situation. It is important to remember that an unethical action by a partner will always reflect on you.

No matter how compatible partners are, friction among them is inevitable. The key is having a mechanism such as a partnership agreement and open lines of communication for controlling it. The demise of many partnerships can often be traced to interpersonal conflicts and the lack of a procedure to resolve those conflicts.

In many instances, the unlimited personal liability of each partner in a general partnership is a major barrier to attracting needed capital. As a result, limited partnerships have become more popular.

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Rosabeth Moss Kanter on Partnerships

Avoiding ugly and costly business divorces that too often put an end to businesses requires an ongoing and active effort. Howard Professor Rosabeth Moss Kanter suggests from her experience that partners follow the following six rules:

1. Take a close look at what you're getting. Do your research and test your assumptions before you construct the partnership agreement.
2. Invest in the relationship, not just the deal making. Relationships between or among partners must continuously be strengthened. If this role is delegated or ignored, the partnership will fail.
3. Get connected through many people. Have those whom you do business with meet the staff as well as your partners. Through these connections, relationships can be built at many levels in the organization.
4. Respect differences and expect to work out conflicts. When potential sources of conflict exist, address them immediately. Festering wounds seldom heal without medication.
5. Be prepared to change. Be open to new opportunities and share what you see with your partners. Partnerships need to evolve to survive.
6. Help everyone succeed. Work hard to see that every partner plays a role in the business that allows him or her the opportunity to be successful and become viewed by others as a significant player in the business.

1. If you were asked to add a "seventh rule," what would it be?

Source: Rosabeth Moss Kanter, "Six Rules for a Happy Marriage... Uh, Partnership," *Business 2.0*, April 2002, p. 114.

Limited Partnerships

A **limited partnership**, which is a modification of a general partnership, is composed of at least one general partner and at least one limited partner. In a limited partnership the general partner is treated, under the law, exactly as in a general partnership. The limited partner is treated more as an investor in the business venture; limited partners have limited liability. They can lose only the amount invested in the business.

limited partnership—*a partnership composed of at least one general partner and at least one limited partner.*

Most states have ratified the Revised Uniform Limited Partnership Act. The formation of a limited partnership requires its founder to file a certificate of limited partnership in the state in which the limited partnership plans to conduct business. The certificate of limited partnership should include the following information:

1. the name of the limited partnership.
2. the general character of its business.
3. the address of the office of the firm's agent authorized to receive summonses or other legal notices.
4. the name and business address of each partner, specifying which ones are general partners and which are limited partners.
5. the amount of cash contributions actually made, and agreed to be made in the future, by each partner.
6. a description of the value of noncash contributions made or to be made by each partner.
7. the times at which additional contributions are to be made by any of the partners.
8. whether and under what conditions a limited partner has the right to grant limited partner status to an assignee of his or her interest in the partnership.
9. if agreed upon, the time or the circumstances when a partner may withdraw from the firm (unlike the withdrawal of a general partner, the withdrawal of a limited partner does *not* automatically dissolve a limited partnership).
10. if agreed upon, the amount of, or the method of determining, the funds to be received by a withdrawing partner.
11. any right of a partner to receive distributions of cash or other property from the firm, and the times and circumstances for such distributions.
12. the time or circumstances when the limited partnership is to be dissolved.
13. the rights of the remaining general partners to continue the business after withdrawal of a general partner.
14. any other matters the partners want to include.

The general partner has the same rights and duties as under a general partnership: the right to make decisions for the business, to act as an agent for the partnership, to use the property of the partnership for normal business, and to share in the business's profits. The limited partner does not have the right to take an active role in managing the business. In fact, if he or she takes part in managing the business, a limited partner may actually forfeit limited liability, taking on the liability status of a general partner. Limited partners can, however, make management suggestions to the general partners, inspect the business, and make copies of business records. A limited partner is, of course, entitled to a share of the business's profits as agreed on and specified in the certificate of limited partnership. The primary disadvantage of limited partnerships is the complexity and the cost of establishing them.

A Company Example

"Cot" Campbell of ***Dogwood Stable*** *brought the "sport of kings" to a larger audience of thrill-seeking investors when he created the first limited partnership in thoroughbred racing. Dogwood Stable has had 58 stable winners, including the Preakness. Currently Dogwood Stable has 60 horses in competition, all owned by members of limited partnerships. Dogwood Stable retains five percent ownership as the general partner and sells four 23.75 percent shares to limited partners.*[4]

Limited Liability Partnerships

limited liability partnership—*a special type of limited partnership in which all partners, who in many states must be professionals, are limited partners.*

Many states now recognize **limited liability partnerships (LLPs)** in which *all* partners in a business are limited partners, having only limited liability for the debts of the partnership. Most states restrict LLPs to certain types of professionals such as attorneys, physicians, dentists, accountants, and others. Just as with any limited partnership, the partners must file a certificate of limited partnership in the state in which the partnership will conduct business, and the partnership must identify itself as an LLP to those with whom it does business. Also, like every partnership, an LLP does not pay taxes; its income is passed through to the limited partners, who pay taxes on their shares of the company's income.

Master Limited Partnership

master limited partnership—*a partnership whose shares are traded on stock exchanges, just like a corporation's.*

A relatively new form of business structure, **master limited partnerships (MLPs)**, are just like regular limited partnerships, except their shares are traded just like shares of common stock. They provide most of the same advantages to investors as a corporation—including limited liability. Operationally, a master limited partnership behaves like a corporation, and some even trade on major stock exchanges. In 1987, congressional legislation provided that any MLPs not involved in natural resources or real estate would be taxed as corporations and, consequently, eliminated their ability to avoid double taxation.

CORPORATIONS

1-C. Explain the advantages and disadvantages of the corporation.

corporation—*a separate legal entity apart from its owners that receives the right to exist from the state in which it is incorporated.*

domestic corporation—*a corporation doing business in the state in which it is incorporated.*

foreign corporation—*a corporation doing business in a state other than the one in which it is incorporated.*

alien corporation—*a corporation formed in another country but doing business in the United States.*

The corporation is the most complex of the three major forms of business ownership. It is a separate entity apart from its owners and may engage in business, make contracts, sue and be sued, own property, and pay taxes. The Supreme Court has defined the **corporation** as "an artificial being, invisible, intangible, and existing only in contemplation of the law."[5] Because the life of the corporation is independent of its owners, the shareholders can sell their interests in the business without affecting its continuation.

Corporations (also known as C corporations) are creations of the state. When a corporation is founded, it accepts the regulations and restrictions of the state in which it is incorporated and any other state in which it chooses to do business. A corporation doing business in the state in which it is incorporated is a **domestic corporation**. When a corporation conducts business in another state, that state considers it to be a **foreign corporation**. Corporations formed in other countries but doing business in the United States are **alien corporations**.

Generally, the corporation must report annually its financial operations to its home state's secretary of state. These financial reports become public record. If a corporation's stock is sold in more than one state, the corporation must comply with federal regulations governing the sale of corporate securities. There are substantially more reporting requirements for a corporation than for the other forms of ownership.

How to Incorporate

Most states allow entrepreneurs to incorporate without the assistance of an attorney. Some states even provide incorporation kits to help in the incorporation process. Although it is cheaper for entrepreneurs to complete the process themselves, it is not always the best idea. In some states, the application process is complex, and the required forms are confusing. The price for filing incorrectly can be high. If an entrepreneur completes the incorporation process improperly, it is generally invalid.

Once the owners decide to form a corporation, they must choose a state in which to incorporate. If the business will operate within a single state, it is probably most logical to incorporate in that state. States differ—sometimes rather dramatically—in the requirements they place on the corporations they charter and how they treat corporations chartered in other states. They also differ in the tax rate they impose on corporations, the restrictions placed on their activities, the capital required to incorporate, and the fees or organization tax charged to incorporate. Delaware, for instance, offers low incorporation fees and minimal legal requirements.

Every state requires a certificate of incorporation or charter to be filed with the secretary of state. The following information is generally required to be included in the certificate of incorporation:

The corporation's name. **The** corporation must choose a name that is not so similar to that of another firm in the state that it causes confusion or lends itself to deception. It must also include a term such as *corporation, incorporated, company*, or *limited* to notify the public that they are dealing with a corporation.

The corporation's statement of purpose. The incorporators must state in general terms the intended nature of the business. The purpose must, of course, be lawful. An illustration might be "to engage in the sale of office furniture and fixtures." The purpose should be broad enough to allow for some expansion in the activities of the business as it develops.

The corporation's time horizon. In most cases corporations are formed with no specific termination date; they are formed "for perpetuity." However, it is possible to incorporate for a specific duration (e.g., 50 years).

Names and addresses of the incorporators. The incorporators must be identified in the articles of incorporation and are liable under the law to attest that all information in the articles of incorporation is correct. In some states one or more of the incorporators must reside in the state in which the corporation is being created.

Place of business. The street and mailing address of the corporation's principal office must be listed. For a domestic corporation, this address must be in the state in which incorporation takes place.

Capital stock authorization. The articles of incorporation must include the amount and class (or type) of capital stock the corporation wants to be authorized to issue. This is not the number of shares it must issue; a corporation can issue any number of shares up to the amount authorized. This section must also define the different classifications of stock and any special rights, preferences, or limits each class has.

Capital required at the time of incorporation. Some states require a newly formed corporation to deposit in a bank a specific percentage of the stock's par value prior to incorporating.

Provisions for preemptive rights, if any, that are granted to stockholders.

Restrictions on transferring shares. Many closely held corporations—those owned by a few shareholders, often family members—require shareholders interested in selling their stock to offer it first to the corporation. (Shares the corporation itself owns are called **treasury stock**.) To maintain control over their ownership, many closely held corporations exercise this right, known as the **right of first refusal**.

Names and addresses of the officers and directors of the corporation.

Rules under which the corporation will operate. **Bylaws** are the rules and regulations the officers and directors establish for the corporation's internal management and operation.

Once the secretary of state of the incorporating state has approved a request for incorporation and the corporation pays its fees, the approved articles of incorporation become its charter. With the charter in hand, the next order of business is to hold an organizational meeting for the stockholders to formally elect directors who, in turn, will appoint the corporate officers.

treasury stock—*the shares of its own stock that a corporation owns.*

right of first refusal—*a provision requiring shareholders who want to sell their stock to offer it first to the corporation.*

bylaws—*the rules and regulations the officers and directors establish for a corporation's internal management and operation.*

The Advantages of the Corporation

LIMITED LIABILITY OF STOCKHOLDERS. Because it is a separate legal entity, a corporation allows investors to limit their liability to the total amount of their investment in the business. This legal protection of personal assets beyond the business is of critical concern to many potential investors.

This shield of limited liability may not be impenetrable, however. Because start-up companies are so risky, lenders and other creditors require the owners to personally guarantee loans made to the corporation. Robert Morris Associates, a national organization of bank loan officers, estimates that 95 percent of small business owners have to sign personal guarantees to get the financing they need. By making these guarantees, owners are putting their personal assets at risk (just as in a proprietorship) despite choosing the corporate form of ownership.

The corporate form of ownership does not protect its owners from being held personally liable for fraudulent or illegal acts under what is known as the "alter ego doctrine." The act of disregarding the corporate entity and pursuing the stockholders is referred to as "piercing the corporate veil" and can occur under the following circumstances:

1. When corporate assets are used for personal reasons or commingled with personal assets.
2. Failure to act in a responsible manner and creating an unwarranted level of financial risk for the stockholders.

3. Financial misrepresentations, such as operating with more than one set of books.
4. Taking actions in the name of the corporation that were not authorized by the board of directors.

Problems almost always revolve around actions and decisions that fail to maintain the integrity of the corporation.

ABILITY TO ATTRACT CAPITAL. Based on the protection of limited liability, corporations have proved to be the most effective form of ownership for accumulating large amounts of capital. Limited only by the number of shares authorized in its charter (which can be amended), the corporation can raise money to begin business and expand as opportunity dictates by selling shares of its stock to investors. A corporation can sell its stock to a limited number of private investors (a private placement) or to the public (a public offering).

ABILITY TO CONTINUE INDEFINITELY. Unless a corporation fails to pay its taxes or is limited to a specific length of life by its charter, it can continue indefinitely. The corporation's existence does not depend on the fate of any single individual. Unlike a proprietorship or partnership in which the death of a founder ends the business, a corporation lives beyond the lives of those who gave it life. This perpetual life gives rise to the next major advantage—transferable ownership.

TRANSFERABLE OWNERSHIP. If stockholders in a corporation are displeased with the business's progress, they can sell their shares to someone else. Millions of shares of stock representing ownership in companies are traded daily on the world's stock exchanges. Shareholders can also transfer their stock through inheritance to a new generation of owners. During all of these transfers of ownership, the corporation continues to conduct business as usual.

Unlike that of large corporations whose shares are traded on organized stock exchanges, the stock of many small corporations is held by a small number of people ("closely held"), often company founders, family members, or employees. The small number of people holding the stock means that the resale market for shares is limited, which could make the transfer of ownership more difficult.

The Disadvantages of Corporations

COST AND TIME INVOLVED IN THE INCORPORATION PROCESS. Corporations can be costly and time-consuming to establish. The owners are giving birth to an artificial legal entity, and the gestation period can be prolonged for the novice. In some states an attorney must handle the incorporation process, but in most states entrepreneurs can complete all of the required forms alone. However, an owner must exercise great caution when incorporating without the help of an attorney. Also, incorporating a business requires a variety of fees that are not applicable to proprietorships or partnerships. Creating a corporation can cost between $500 and $2,500, typically averaging around $1,000.

DOUBLE TAXATION. Because a corporation is a separate legal entity, it must pay taxes on its net income at the federal level, in most states, and to some local governments as well. Before stockholders receive a penny of its net income as dividends, a corporation must pay these taxes at the *corporate* tax rate. Then stockholders must pay taxes on the dividends they receive from these same profits at the *individual* tax rate. Thus, a corporation's profits are taxed twice. This **double taxation** is a distinct disadvantage of the corporate form of ownership.

double taxation—*disadvantage of the corporate form of ownership in which a corporation's profits are taxed twice: at the corporate rate and at the individual rate (on the portion of profits distributed as dividends).*

POTENTIAL FOR DIMINISHED MANAGERIAL INCENTIVES. As corporations grow, they often require additional managerial expertise beyond that which the founder can provide. Because she created the company and often has most of her personal wealth tied up in it, the entrepreneur has an intense interest in making it a success and is willing to make sacrifices for it. Professional managers the entrepreneur brings in to help run the business as it grows do not always have the same degree of interest in or loyalty to the company. As a result, the business may suffer without the founder's energy, care, and devotion. One way to minimize this potential problem is to link managers' (and even employees') compensation to the company's financial performance through a profit-sharing or bonus plan. Corporations can also stimulate managers' and employees' incentives on the job by creating an employee stock ownership plan (ESOP) in which managers and employees become part or whole owners in the company.

LEGAL REQUIREMENTS AND REGULATORY RED TAPE. Corporations are subject to more legal, reporting, and financial requirements than other forms of ownership. Corporate officers must meet more stringent requirements for recording and reporting management decisions and actions. They must also hold annual meetings and consult the board of directors about major decisions that are beyond day-to-day operations. Managers may be required to submit some major decisions to the stockholders for approval. Corporations that are publicly held must file quarterly and annual reports with the Securities and Exchange Commission (SEC).

POTENTIAL LOSS OF CONTROL BY THE FOUNDER(S). When entrepreneurs sell shares of ownership in their companies, they relinquish some control. Especially when they need large capital infusions for start-up or growth, entrepreneurs may have to give up *significant* amounts of control, so much, in fact, that the founders become minority shareholders. Losing majority ownership—and, therefore, control—in their company leaves the founders in a precarious position. They no longer have the power to determine the company's direction; "outsiders" do. In some cases, founders' shares have been so diluted that majority shareholders actually vote them out of their jobs!

A Company Example

Microsoft Inc. was founded as a partnership between Bill Gates and Paul Allen in 1975. At that time, Bill Gates owned 50 percent of the business. As the company grew, it needed additional capital and Gates and Allen decided to take Microsoft public, selling shares of common stock to investors. The effect has been to reduce Bill Gates's percentage of ownership to 18.5 percent. But not to worry, the Forbes *list of the world's wealthiest people places Mr. Gates's net worth at $40 billion!*

This example illustrates the nature of the dilemma: Often growth requires the sale of ownership (stock) to acquire the needed cash to reach the firm's market potential. Most people believe that Bill Gates made the correct decision, even if his percentage of ownership in Microsoft has been reduced.

OTHER FORMS OF OWNERSHIP

2. Discuss the advantages and disadvantages of the S corporation, the limited liability company, the professional corporation, and the joint venture.

In addition to the sole proprietorship, the partnership, and the corporation, entrepreneurs can choose from other forms of ownership, including the S corporation, the limited liability company, the professional corporation, and the joint venture.

The S Corporation

In 1954 the Internal Revenue Service (IRS) Code created the subchapter S corporation. In recent years the IRS has changed the title to S corporation and has made a few modifications in its qualifications. An **S corporation** is a distinction that is made only for federal income tax purposes and is, in terms of legal characteristics, no different from any other corporation. Although Congress recently simplified some of the rules and requirements for S corporations, a business seeking S status still must meet the following criteria:

S corporation—*a corporation that retains the legal characteristics of a regular (C) corporation but has the advantage of being taxed as a partnership if it meets certain criteria.*

1. It must be a domestic (U.S.) corporation.
2. It cannot have a nonresident alien as a shareholder.
3. It can issue only one class of common stock, which means that all shares must carry the same rights (e.g., the right to dividends or liquidation rights). The exception is voting rights, which may differ. In other words, an S corporation can issue voting and nonvoting common stock.
4. It must limit its shareholders to individuals, estates, and certain trusts, although tax-exempt creations such as employee stock ownership plans (ESOPs) and pension plans can now be shareholders.
5. It cannot have more than 75 shareholders (increased from 35), which is an important benefit for family businesses making the transition from one generation of owners to another.
6. Less than 25 percent of the corporation's gross revenues during three successive tax years must be from passive sources.

You must elect S status with the Internal Revenue Service (IRS) by filing with it within the first two and a half months of the corporation's first taxable year. Failure to meet this deadline results in the firm being treated as a C corporation until timely filing of an S corporation election.

An S corporation election may be filed at any time during the 12 months that precede the taxable year for which the election is to be effective. If you make the election within the first two and a half months of the taxable year, it is effective for the current year, providing that the corporation was eligible to make an S election for the entire year. If a corporation satisfies the definition for an S corporation, the owners must actually elect to be treated as one. The election is made by filing IRS Form 2553 at any time during the year, and *all* shareholders must consent to have the corporation treated as an S corporation.

THE ADVANTAGES OF AN S CORPORATION. The S corporation retains all of the advantages of a regular corporation, such as continuity of existence, transferability of ownership, and limited personal liability for its owners. The most notable provision of the S corporation is that it passes all of its profits or losses through to the individual shareholders, and its income is taxed only once at the individual tax rate. Thus, electing S corporation status avoids a primary disadvantage of the regular (or C) corporation—double taxation. In essence, the tax treatment of an S corporation is exactly like that of a partnership; its owners report their proportional shares of the company's profits on their individual income tax returns and pay taxes on those profits at the individual rate (even if they never take the money out of the business).

Another advantage the S corporation offers is avoiding the tax C corporations pay on assets that have appreciated in value and are sold. Also, owners of S corporations enjoy the ability to make year-end payouts to themselves if earnings are high. In a C corporation, owners have no such luxury because the IRS watches for excessive compensation to owners and managers.

One significant change to the laws governing S corporations that benefits entrepreneurs involves subsidiary companies. Before 1998, if entrepreneurs owned separate but affiliated companies, they had to maintain each one as a distinct S corporation with its own accounting records and tax return. Under current law, business owners can set up all of these affiliated companies as qualified S corporation subsidiaries ("Q Subs") under the umbrella of a single company, each with its own separate legal identity, and still file a single tax return for the parent company. For entrepreneurs with several lines of businesses, this change means greatly simplified tax filing. Owners also can use losses from one subsidiary company to offset profits from another to minimize their tax bills. "The advent of the Q Sub has made [S corporations] more useful and popular than ever," says one tax expert.[6]

DISADVANTAGES OF AN S CORPORATION. Tax implications always factor into an entrepreneur's choice of a form of ownership. Periodically, Congress changes the tax rates for both individuals (hence S corporations) and C corporations, which can reverse instantly any tax advantage one form of ownership has over another. For example, from 1993 to 2002, the maximum individual tax rate was 4.6 percent *higher* than the maximum corporate tax rate, which made S corporations *less* attractive to entrepreneurs. In 2003, however, Congress realigned the tax code, making the maximum corporate tax rate 4 percent higher than the maximum individual rate. This change made the S corporation once again the preferred form of ownership from a tax perspective. In addition to the tax implications of choosing a form of ownership, owners should consider the size of the company's net income, the tax rates of its shareholders, plans to sell the company, and the impact of the C corporation's double taxation penalty on income distributed as dividends.

Another disadvantage of the S corporation is that the costs of many fringe benefits—insurance, meals, lodging, and so on—paid to shareholders with 2 percent or more of stock cannot be deducted as business expenses for tax purposes; these benefits are considered to be taxable income. In addition, S corporations offer shareholders only a limited range of retirement benefits, whereas regular corporations make a wide range of retirement plans available.

WHEN IS AN S CORPORATION A WISE CHOICE? Choosing S corporation status is usually beneficial to start-up companies anticipating net losses and to highly profitable firms with substantial dividends to pay out to shareholders. In these cases the owner can use the loss to offset other income or is in a lower tax bracket than the corporation, thus saving money in the long run. Companies that plan to reinvest most of their earnings to finance growth also find S corporation status favorable. Small business owners who intend to sell their companies in the near future will prefer S over C status because the taxable gains on the sale of an S corporation are generally lower than those of a C corporation.

On the other hand, small companies with the following characteristics are *not* likely to benefit from S corporation status:

- highly profitable personal service companies with large numbers of shareholders, in which most of the profits are passed on to shareholders as compensation or retirement benefits.
- fast-growing companies that must retain most of their earnings to finance growth and capital spending.
- corporations in which the loss of fringe benefits to shareholders exceeds tax savings.
- corporations in which the income before any compensation to shareholders is less than $100,000 per year.
- corporations with sizable net operating losses that cannot be used against S corporation earnings.

LIQUIDATION OF AN S CORPORATION Although, just like a C corporation, the S corporation has perpetual life, the time may come when the stockholders wish to dissolve the company. To liquidate an S corporation its owners must complete the following:

- Pay all taxes, debts, and creditors.
- Obtain the written approval of shareholders to dissolve the company.
- File a statement of intent to dissolve with the secretary of state's office in the state in which the S corporation resides.
- Distribute all assets of the corporation to shareholders.

The Limited Liability Company (LLC)

A relatively new creation, the **limited liability company (LLC)** is, like an S corporation, a cross between a partnership and a corporation. LLCs, however, are not subject to many of the restrictions currently imposed on S corporations and offer more flexibility than S corporations. For example, S corporations cannot have more than 75 shareholders, none of whom can be foreigners or corporations. S corporations are also limited to only one class of stock. LLCs eliminate those restrictions. An LLC must have at least two owners (called "members"), but it offers its owners limited liability without imposing any requirements on their characteristics or any ceiling on their numbers. Unlike a limited partnership, which prohibits limited partners from participating in the day-to-day management of the business, an LLC does not restrict its members' ability to become involved in managing the company.

limited liability company (LLC)—*a relatively new form of ownership that, like an S corporation, is a cross between a partnership and a corporation; it is not subject to many of the restrictions imposed on S corporations.*

In addition to offering its members the advantage of limited liability, LLCs also avoid the double taxation imposed on C corporations. Like an S corporation, an LLC does not pay income taxes; its income flows through to the members, who are responsible for paying income taxes on their shares of the LLC's net income. Because they are not subject to the many restrictions imposed on other forms of ownership, LLCs offer entrepreneurs another significant advantage: flexibility. Like a partnership, an LLC permits its members to divide income (and, thus, tax liability) as they see fit.

These advantages make the LLC an ideal form of ownership for small companies in virtually any industry—retail, wholesale, manufacturing, real estate, or service. Because they offer the tax advantage of a partnership, the legal protection of a corporation, and maximum flexibility, LLCs have become an extremely popular form of ownership among entrepreneurs.

A Company Example

For example, Marian Fletcher launched a profitable party planning and catering service in 1995 as a sole proprietorship. Her company, ***Let's Go Party****, grew quickly, and Fletcher wanted to bring her daughter into the business as an owner. Reviewing the advantages and disadvantages of each form of ownership led Fletcher to create an LLC. "We decided this was the best way to go for us," she says. "In case anything happens, my daughter and I won't be liable for anything more than what we have invested in the company already." Fletcher, who set up her LLC without the help of an attorney for just $50, also found the LLC's tax treatment to be a major advantage for her and her daughter.*[7]

Creating an LLC is much like creating a corporation. Forming an LLC requires an entrepreneur to file two documents with the secretary of state: the articles of organization and the operating agreement. The LLC's **articles of organization**, similar to the corporation's articles of incorporation, actually creates the LLC by establishing its name and address, its method of

articles of organization—*the document that creates an LLC by its name, its method of management, its duration, and other details.*

management (board managed or member managed), its duration, and the names and addresses of each organizer. In most states the company's name must contain the words "limited liability company," "limited company," or the letters "L.L.C." or "L.C." Unlike a corporation, an LLC does not have perpetual life; in most states an LLC's charter may not exceed 30 years. However, the same factors that would cause a partnership to dissolve would also cause the dissolution of an LLC before its charter expires.

operating agreement—*the document that establishes for an LLC the provisions governing the way it will conduct business.*

The **operating agreement**, similar to a corporation's bylaws, outlines the provisions governing the way the LLC will conduct business, such as members' capital contributions to the LLC, the admission or withdrawal of members, distributions from the business, and how the LLC will be managed. To ensure that their LLCs are classified as a partnership for tax purposes, entrepreneurs must draft the operating agreement carefully. The operating agreement must create an LLC that has more characteristics of a partnership than of a corporation to maintain this favorable tax treatment. Specifically, an LLC cannot have any more than two of the following four corporate characteristics:

1. *Limited liability.* Limited liability exists if no member of the LLC is personally liable for the debts or claims against the company. Because entrepreneurs choosing this form of ownership usually do so to get limited liability protection, the operating agreement almost always contains this characteristic.
2. *Continuity of life.* Continuity of life exists if the company continues to exist in spite of changes in stock ownership. To avoid continuity of life, any LLC member must have the power to dissolve the company. Most entrepreneurs choose to omit this characteristic from their LLC's operating agreements.
3. *Free transferability of interest.* Free transferability of interest exists if each LLC member has the power to transfer his or her ownership to another person freely and without the consent of other members. To avoid this characteristic, the operating agreement must state that a recipient of a member's LLC stock cannot become a substitute member without the consent of the remaining members.
4. *Centralized management.* Centralized management exists if a group that does not include all LLC members has the authority to make management decisions and to conduct company business. To avoid this characteristic, the operating agreement must state that the company elects to be "member managed."

Despite their universal appeal to entrepreneurs, LLCs suffer some disadvantages. They can be expensive to create, often costing between $1,500 and $5,000. Although an LLC may be ideally suited for an entrepreneur launching a new company, it may pose problems for business owners considering converting an existing business to an LLC. Switching to an LLC from a general partnership, a limited partnership, or a sole proprietorship by reorganizing to bring in new owners is usually not a problem. However, owners of corporations and S corporations would incur large tax obligations if they converted their companies to LLCs.

To date, the biggest disadvantage of the LLC stems from its newness. However, every state now recognizes the LLC as a legal form of ownership, and the Uniform Limited Liability Act exists at the federal level.

The Professional Corporation

Professional corporations are designed to offer professionals—lawyers, doctors, dentists, accountants, and others—the advantages of the corporate form of ownership. They are ideally suited for professionals, who must always be concerned about malpractice lawsuits, because they offer limited liability. For example, if three doctors formed a professional corporation, none of them would be liable for the others' malpractice. (Of course, each would be liable for his or her own actions.) Owners create a professional corporation in the same way as a regular corporation. Such corporations are often identified by the abbreviations P.C. (professional corporation), P.A. (professional association), or S.C. (service corporation). A professional corporation has the following additional limitations beyond the standard corporation:

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Which Form Is Best?

Watoma Kinsey and her daughter Katrina are about to launch a business that specializes in children's parties. Their target audience is upscale families who want to throw unique, memorable parties to celebrate special occasions for their children between the ages of 5 and 15. The Kinseys have leased a large building and have renovated it to include many features designed to appeal to kids, including special gym equipment, a skating rink, an obstacle course, a mock-up of a pirate ship, a ball crawl, and even a moveable haunted house. They can offer simple birthday parties (cake and ice cream included) or special theme parties as elaborate as the customer wants. Their company will provide magicians, clowns, comedians, jugglers, tumblers, and a variety of other entertainers.

Watoma and Katrina have invested $45,000 each to get the business ready to launch. Based on the quality of their business plan and their preparation, the Kinseys have negotiated a $40,000 bank loan. Because they both have families, the Kinseys want to minimize their exposure to potential legal and financial problems. A large portion of their start-up costs went to purchase a liability insurance policy to cover the Kinseys in case a child is injured at a party. If their business plan is accurate, the Kinseys will earn a small profit in their first year (about $1,500), and a more attractive profit of $16,000 in their second year of operation. Within five years, they expect their company to generate as much as $50,000 in profits. The Kinseys have agreed to split the profits—and the workload—equally.

If the business is as successful as they think it will be, the Kinseys eventually want to franchise their company. That, however, is part of their long-range plan. For now, they want to perfect their business system and prove that it can be profitable before they try to duplicate it in the form of franchises.

As they move closer to the launch date for their business, the Kinseys are reviewing the different forms of ownership.

1. Which form(s) of ownership would you recommend to the Kinseys? Explain.

2. Which form(s) of ownership would you recommend that the Kinseys *avoid*? Explain.

3. What factors should the Kinseys consider as they try to choose the form of ownership that is best for them?

- All shares of stock of the corporation must be owned and held by individuals licensed in the profession of the corporation.
- At least one of the incorporators must be licensed in the profession.
- At least one director and one officer must be licensed in the profession.
- The articles of incorporation, in addition to all other requirements, must designate the personal services to be provided by the corporation.
- The professional corporation must obtain from the appropriate licensing board a certification that declares the shares of stock are owned by individuals who are duly licensed in the profession.

The Joint Venture

A joint venture is very much like a partnership, except that it is formed for a specific, limited purpose. For instance, suppose that you have a 500-acre tract of land 60 miles from Chicago that has been cleared and is normally used in agricultural production. You have a friend who has solid contacts among major musical groups and would like to put on a concert. You expect prices for your agricultural products to be low this summer, so you and your friend form a joint venture for the specific purpose of staging a three-day concert. Your contribution will be the exclusive use of the land for one month, and your friend will provide all the performers as well as technicians, facilities, and equipment. All costs will be paid out of receipts and the net profits will be split, with you receiving 20 percent for the use of your land. When the concert is over, the facilities removed, and the accounting for all costs completed, you and your friend split the profits 20-80, and the joint venture terminates.

In any endeavor in which neither party can effectively achieve the purpose alone, a joint venture becomes a common form of ownership. The "partners" form a new joint venture for each new project they undertake. The income derived from a joint venture is taxed as if it arose from a partnership.

Table 4.1 provides a summary of the key features of the major forms of ownership discussed in this chapter.

TABLE 4.1

Characteristics of the Major Forms of Ownership

Feature	Sole Proprietorship	Partnership	C Corporation	S Corporation	Limited Liability Company
Owner's personal liability	Unlimited	Unlimited for general partners Limited for limited partners	Limited	Limited	Limited
Number of owners	1	2 or more (at least 1 general partner required)	Any number	Maximum of 75 (with restriction on who they are)	2 or more
Tax liability	Single tax: proprietor pays at individual rate	Single tax: partners pay on their proportional shares at individual rate	Double tax: corporation pays tax and shareholders pay tax on dividends distributed	Single tax: owners pay on their proportional shares at individual rate	Single tax: members pay on their proportional shares at individual rate
Maximum tax rate	35%	35%	39%	35%	35%
Transferability of ownership	Fully transferable through sale or transfer of company assets	May require consent of all partners	Fully transferable	Transferable (but transfer may affect S status)	Usually requires consent of all members
Continuity of business	Ends on death or insanity of proprietor or upon termination by proprietor	Dissolves upon death, insanity, or retirement of a general partner (business may continue)	Perpetual life	Perpetual life	Perpetual life
Cost of formation	Low	Moderate	High	High	High
Liquidity of owner's investment in business	Poor to average	Poor to average	High	High	High
Complexity of formation	Extremely low	Moderate	High	High	High
Ability to raise capital	Low	Moderate	Very high	Moderate to high	High
Formation procedure	No special steps required other than buying necessary licenses	No written partnership agreements required (but highly advisable)	Must meet formal requirements specified by state law	Must follow same procedures as C corporation, then elect S status with IRS	Must meet formal requirements specified by state law

FRANCHISING

It is almost impossible to find a town or village that does not have a franchised business of some type. The variety among these businesses is staggering. Most of us would immediately identify the fast-food restaurants that exist in every community, but we may not so easily recognize franchises such as Service Master and Clean Net USA (commercial/residential contract cleaning businesses) or Curves for Women, a women's fitness and weight loss center.

franchising—*a system of distribution in which semi-independent business owners (franchisees) pay fees and royalties to a parent company (franchiser) in return for the right to become identified with its trademark, to sell its products or services, and often to use its business format and system.*

Today, approximately 4,500 franchisers operate more than 600,000 franchise outlets throughout the world, and more are opening at an incredible pace. A new franchise opens somewhere in the world every 6.5 minutes![8] Franchises account for 44 percent of all retail sales, totaling more than *$1 trillion*, and they employ some 8 million people in more than 100 major industries.[9] Much of the popularity of franchising stems from its ability to offer those who lack business experience the chance to own and operate a business with a high probability of success. This booming industry has moved far beyond the traditional boundaries of fast food into fields as diverse as maid services and bakeries to computer sales and pet-sitting.

In **franchising**, semi-independent business owners (franchisees) pay fees and royalties to a parent company (franchiser) in return for the right to become identified with its trademark, to sell

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Tallman's of Savannah

Louise Tallman had always loved to dabble in antiques. To a large degree, this obsession could be traced to the hours she worked with her mother and aunt in their exclusive Savannah, Georgia, antique shop. Her father had passed away when Louise was only 6 years old, and her mother and aunt invested her father's insurance into the rent on a location in the historic district in Savannah and the initial inventory. Louise can still remember the "tight" years growing up when the income from the business was not sufficient for her mother to afford child care or any of the "little girl" experiences such as ballet or piano lessons. The school bus dropped Louise off each afternoon at the store where she did her homework, played house among the antiques, and began to absorb the dynamics of the buying and selling process. Each year her involvement in the business grew and so did her knowledge and love of antiques.

Louise chose to attend the Savannah School of Art and Design where she was able to study the topics of her interest in depth. The result was an expansion of her interest and the ability to "give back" a little to her mother and aunt in the form of new knowledge regarding the origin and use of European antiques.

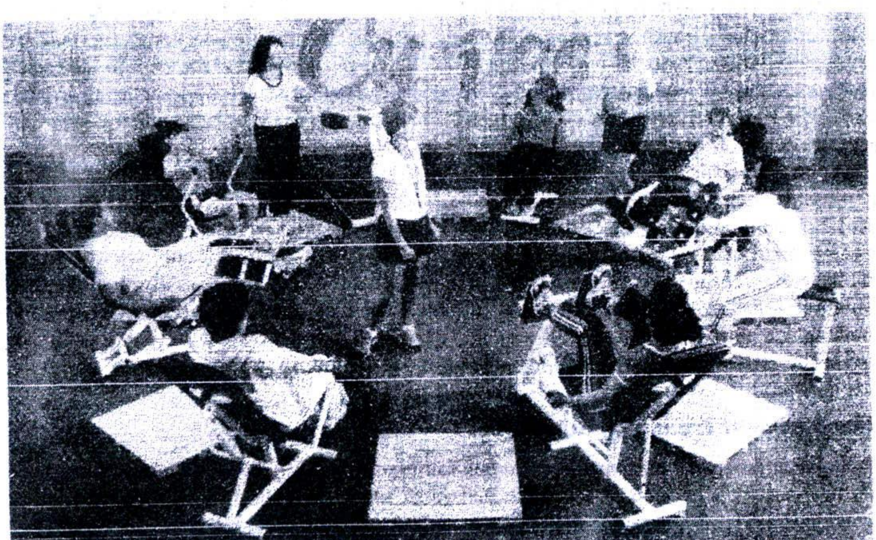
With graduation loans close at hand, the next step for Louise is an antique shop of her own. With the assistance of the Small Business Development Center she has developed a preliminary business plan that has helped her focus on the key questions that she has not yet addressed. One of those key questions is about the best form of ownership for her new business.

1. What are the questions that you would pose to Louise in order to help her select the form of ownership for her antique shop? Explain the relevance of each question and answer in determining the suggested form of ownership.

its products or services, and often to use its business format and system. Franchisees do not establish their own autonomous businesses; instead, they buy a "success package" from the franchiser, who shows them how to use it. Franchisees, unlike independent business owners, don't have the freedom to change the way they run their businesses—for example, shifting advertising strategies or adjusting product lines—but they do have a formula for success that the franchiser has worked out. Most franchisers are selling a successful business model. Many successful franchisers claim that neglecting to follow the formula is one of the chief reasons that franchisees fail.

A Company Example

For example, Anita Schlachter, co-owner of a highly successful Maaco (automotive services) franchise with her husband and her son, is convinced that the system the franchiser taught them is the key to their company's progress and growth to date. The Schlachters follow the franchiser's plan, using it as a road map to success. "If you listen to what your franchiser says and follow its policies and procedures, you'll be successful," she says. "Those who think they know more should not go into franchising." [10]



In 1992, Gary Heavin launched Curves, a women-only fitness center. The company began franchising in 1995 and now has more than 6,000 franchised outlets around the globe, making it one of the fastest growing franchises in the United States.

Courtesy of Curves International

trade-name franchising—*a system of franchising in which a franchisee purchases the right to use the franchiser's trade name without distributing particular products under the franchiser's name.*

Franchising is based on a continuing relationship between a franchiser and a franchisee. The franchiser provides valuable services such as market research, a proven business system, name recognition, and many other forms of assistance; in return, the franchisee pays an initial franchise fee as well as an ongoing percentage of sales to the franchiser as royalties and agrees to operate the outlet according to the franchiser's system. Because franchisers develop the business systems their franchisees use and direct their distribution methods, they maintain substantial control over their franchisees. This standardization lies at the core of franchising's success as a method of distribution.

Learning Objective

[illegible]

TYPES OF FRANCHISING

There are three basic types of franchising: trade-name franchising, product distribution franchising, and pure franchising. **Trade-name franchising** involves a brand name such as True Value Hardware or Western Auto. Here the franchisee purchases the right to use the franchiser's trade name without distributing particular products exclusively under the franchiser's name. **Product distribution franchising** involves a franchiser licensing a franchisee to sell specific products under the franchiser's brand name and trademark through a selective, limited distribution network. This system is commonly used to market automobiles (Chevrolet, Oldsmobile, Chrysler), gasoline products (Exxon, Sunoco, Texaco), soft drinks (Pepsi-Cola, Coca-Cola), bicycles (Schwinn), appliances, cosmetics, and other products. These two methods of franchising allow franchisees to acquire some of the parent company's identity.

product distribution franchising—*a system of franchising in which a franchiser licenses a franchisee to sell its products under the franchiser's brand name and trademark through a selective, limited distribution network.*

pure franchising—*a system of franchising in which a franchiser sells a franchisee a complete business format and system.*

Pure (or comprehensive or business format) **franchising** involves providing the franchisee with a complete business format, including a license for a trade name, the products or services to be sold, the physical plant, the methods of operation, a marketing strategy plan, a quality control process, a two-way communications system, and the necessary business services. The franchisee purchases the right to use all of the elements of a fully integrated business operation. Pure franchising is the most rapidly growing of all types of franchising and is common among fast-food restaurants, hotels, business service firms, car rental agencies, educational institutions, beauty aid retailers, and many others. Although product and trade-name franchises annually ring up more than sales than pure franchisees, pure franchising outlets' sales are growing much faster.

Learning Objective

[illegible] Explain the benefits of buying a franchise.

THE BENEFITS OF BUYING A FRANCHISE

A franchisee gets the opportunity to own a small business relatively quickly and, because of the identification with an established product and brand name, a franchise often reaches the breakeven point faster than an independent business would. Still, most new franchise outlets don't break even for at least six to eighteen months.

Franchisees also benefit from the franchiser's business experience. In fact, experience is the essence of what a franchisee is buying from a franchiser. Many entrepreneurs go into business by themselves and make many costly mistakes. Given the thin margin for error in the typical start-up, a new business owner cannot afford to make many mistakes. In a franchising arrangement, the franchiser already has worked out the kinks in the system by trial and error, and franchisees benefit from that experience. Franchisers have climbed up the learning curve and can share with franchisees the secrets of success they have discovered in the industry. For many "first-time" entrepreneurs, access to business models with a proven track record is the safest way to own a business. One critical question every potential entrepreneur must ask is, "What can a franchise do for me that I cannot do for myself?" The answer to this question will depend on the entrepreneur's situation and is not as important as the systematic evaluation of the franchise opportunity. After careful deliberation, one person may conclude that the franchise offers nothing that she could not do independently, and another may decide that a franchise is the key to success as a business owner. Franchisees often cite the following advantages:

Management Training and Support

Recall from Chapter 1 that one of the leading causes of business failure is incompetent management. Franchisers are well aware of this and, in an attempt to reduce the number of franchise casualties, offer managerial training programs to franchisees prior to opening a new outlet.

Many franchisers, especially the well-established ones, also provide follow-up training and counseling services. This service is vital because most franchisers do not require a franchisee to have experience in the business. These programs teach franchisees the details they need to know for day-to-day operations as well as the nuances of running their businesses successfully.

Training programs often involve both classroom and on-site instruction to teach franchisees the basic operations of the business. Before beginning operations, McDonald's franchisees spend 14 days in Illinois at Hamburger University where they learn everything from how to scrape the grill correctly to the essential elements of managing a business with high community visibility and great profit potential. Maaco franchisees spend four weeks at the company's headquarters delving into a five-volume set of operations manuals and learning to run an auto services shop. H & R Block trains its franchisees to unravel the mysteries of tax preparation, whereas Dunkin' Donuts trains a franchisee for as long as five weeks in everything from accounting to dough making. To ensure franchisees' continued success, many franchisers supplement their start-up training programs with ongoing instruction and support. Franchisers offer these training programs because they realize that their ultimate success depends on the franchisee's success.

Despite the positive features of training, inherent dangers exist in the trainer–trainee relationship. Every would-be franchisee should be aware that, in some cases, "assistance" from the franchiser tends to drift into "control" over the franchisee's business. Also, some franchisers charge fees for their training services, so franchisees should know exactly what they are agreeing to, and what it costs.

Brand-Name Appeal

Licensed franchisees purchase the right to use a nationally known and advertised brand name for a product or service. Thus, franchisees have the advantage of identifying their businesses with a widely recognized trademark, which usually provides a great deal of drawing power. Customers recognize the identifying trademark, the standard symbols, the store design, and the products of an established franchise. Indeed, one of the basic tenets of franchising is cloning the franchiser's success. For example, nearly everyone is familiar with the golden arches of McDonald's or the red roof of the Red Roof Inn and the standard products and quality offered at each. A customer is confident that the quality and content of a meal at McDonald's in Fort Lauderdale will be consistent with a meal at a San Francisco McDonald's. There is undoubtedly value in operating a franchise that has a positive brand reputation. Be equally aware, however, that the actions by the franchiser or the actions of other franchisees can harm the value of the brand name and, consequently, have a negative impact on your business. For example, approximately 10 years ago, one of the worst cases of *E. coli* food poisoning ever recorded in the United States hit western Washington. More than 800 people received treatment at local hospitals. Four children died and many others were left with lifelong medical challenges. The source of the food poisoning was undercooked, contaminated beef served at local fast-food restaurants. This tragic event led to a drop in sales throughout the entire chain of restaurants.

Standardized Quality of Goods and Services

Because franchisees purchase a license to sell the franchiser's product or service and the privilege of using the associated brand name, the quality of the goods or service sold determines the franchiser's reputation. Building a sound reputation in business is not achieved quickly, although destroying a good reputation takes no time at all. If some franchisees were allowed to operate at substandard levels, the image of the entire chain would suffer irreparable damage; therefore, franchisers normally demand compliance with uniform standards of quality and service throughout the entire chain. In many cases, the franchiser conducts periodic inspections of local facilities to assist in maintaining acceptable levels of performance.

A Company Example

For instance, John Schnatter, founder of ***Papa John's****, a fast-growing pizza franchise, makes personal visits to some of his franchisees' stores four to five times each week to make sure they are performing up to the company's high quality standards. Franchisees say that Schnatter, known for his attention to detail, often checks pizzas for air bubbles in the crust or tomato sauce for freshness. "Pizza is Schnatter's life, and he takes it very seriously," says one industry analyst.*[11]

Maintaining quality is so important that most franchisers retain the right to terminate the franchise contract and to repurchase the outlet if the franchisee fails to comply with established standards.

National Advertising Programs

An effective advertising program is essential to the success of virtually all franchise operations. Marketing a brand-name product or service over a wide geographic area requires a far-reaching advertising campaign. A regional or national advertising program benefits all franchisees. Normally, such an advertising campaign is organized and controlled by the franchiser. It is financed by each franchisee's contribution of a percentage of monthly sales, usually 1 to 5 percent, or a flat monthly fee. For example, Subway franchisees must pay 3.5 percent of gross revenues to the Subway national advertising program. These funds are pooled and used for a cooperative advertising program, which has more impact than if the franchisees spent the same amount of money separately.

Many franchisers also require franchisees to spend a minimum amount on local advertising. To supplement their national advertising efforts, both Wendy's and Burger King require franchisees to spend at least 3 percent of gross sales on local advertising. Some franchisers assist each franchisee in designing and producing its local ads. Many companies help franchisees create promotional plans and provide press releases and advertisements for grand openings.

Financial Assistance

Because they rely on their franchisees' money to grow their businesses, franchisers typically do not provide any extensive financial help for franchisees. Franchisers rarely make loans to enable franchisees to pay the initial franchise fee. However, once a franchiser locates a suitable prospective franchisee, it may offer the qualified candidate direct financial assistance in specific areas, such as purchasing equipment, inventory, or even the franchise fee. Because the start-up costs of some franchises are already at breathtaking levels, some franchisers find that they must offer direct financial assistance.

A Company Example

*For example, **US Franchise Systems**, franchiser of Microtel Inn and Hawthorn Suites hotels, has set up a subsidiary, US Funding Corporation, that makes available to its franchisees $200 million in construction and mortgage financing. Not only has the in-house financing program cut the time required to open a new hotel franchise, but it also has accelerated the franchise's growth rate.*[12]

Nearly half of the International Franchise Association's members indicate that they offer some type of financial assistance to their franchises; however, only one-fourth offer direct financial assistance. In most instances, financial assistance from franchisers takes a form other than direct loans, leases, or short-term credit. Franchisers usually are willing to assist qualified franchisees in establishing relationships with banks, private investors, and other sources of funds. Such support and connections from the franchiser enhance a franchisee's credit standing because lenders recognize the lower failure rate among established franchises.

Preferred relationships between lenders and franchisers can be critical because finding financing for a franchise can be challenging, just like attracting capital for any business start-up.

A Company Example

*For instance, when Jana Sappenfield began searching for $1.6 million of the $1.9 million needed to purchase a **Primrose School** franchise, the franchiser helped her connect with Newcourt/AT&T, a Small Business Administration–certified lender that has established preferred relationships with about 25 different franchised companies. "They were familiar with Primrose," says Sappenfield, "so no time was wasted researching or approving the franchiser." Because Primrose School had already accepted Sappenfield's application for a franchise, her loan request sailed easily through Newcourt/AT&T's approval process. "We know the leadership and have an understanding of the selection criteria at the franchises we work with regularly," says a top executive at Newcourt/AT&T. "Consequently, when an approved loan application comes in from a [preferred franchise], we are certain the candidate is qualified." Sappenfield's first Primrose School franchise was so successful that she has since purchased a second one.*[13]

Proven Products and Business Formats

What a franchisee essentially purchases is a franchiser's experience, expertise, and products. A franchise owner does not have to build the business from scratch. Instead of being forced to rely solely on personal ability to establish a business and attract a clientele, a franchisee can depend on the methods and techniques of an established business. These standardized procedures and operations greatly enhance the franchisee's chances of success and avoid the most inefficient type of learning—trial and error. In addition, a franchisee does not have to struggle for recognition in the local marketplace as much as an independent owner might.

Centralized Buying Power

A significant advantage a franchisee has over an independent small business owner is participation in the franchiser's centralized and large-volume buying power. If franchisers sell goods and supplies to franchisees (not all do), they may pass on to franchisees any cost savings from quantity discounts they earn by buying in volume. For example, it is unlikely that a small, independent ice cream parlor could match the buying power of Baskin-Robbins with its 4,500-plus retail ice cream stores. In many instances, economies of scale simply preclude the independent owner from competing head-to-head with a franchise operation.

Site Selection and Territorial Protection

A proper location is critical to the success of any small business, and franchises are no exception. In fact, franchise experts consider the three most important factors in franchising to be *location, location,* and *location*. Becoming affiliated with a franchiser may be the best way to get into prime locations. Many franchisers will make an extensive location analysis for each new outlet, including researching traffic patterns, zoning ordinances, accessibility, and population density. McDonald's, for example, is well known for its ability to obtain prime locations in high-traffic areas. Although choosing a location is the franchisee's responsibility, the franchiser usually reserves the right to approve the final site. Choosing a suitable location requires a location analysis, including studies of traffic patterns, zoning ordinances, accessibility, population density, and demographics.

Some franchisers offer franchisees territorial protection, which gives existing franchisees the right to exclusive distribution of brand name goods or services within a particular geographic area. A clause establishing such a protective zone that bars other outlets from the same franchise area gives franchisees significant protection and security. The size of a franchisee's territory varies from industry to industry. For example, one national fast-food restaurant agrees not to license another franchisee within a mile and one-half of existing locations. But one soft-serve ice cream franchiser defines its franchisees' territories on the basis of zip code designations. The purpose of such protection is to prevent an invasion of the existing franchisee's territory and the accompanying dilution of sales. As existing markets have become increasingly saturated with franchise outlets, the placement of new outlets has become a source of friction between franchisers and franchisees. Existing franchisees charge that franchisers are encroaching on their territories by granting new franchises so close to them that their sales are diluted. Although most franchises offer their franchisees some type of territorial protection, be absolutely sure that the territorial protection clause is specific and enforceable.

Greater Chance for Success

Investing in a franchise is not risk free. Between 200 and 300 new franchise companies enter the market each year, and not all of them survive. But available statistics suggest that franchising is less risky than building a business from the ground up. General statistics are useful, but the most valuable numbers are the percentages of successful franchises for any specific business opportunity. Historically, the success rates among franchises are higher than nonfranchise start-ups. This success rate for franchises is attributed to the broad range of services, assistance, and support the franchiser provides. Any statistics regarding the success of a given franchise must be interpreted, however. For example, sometimes when a franchise is in danger of failing, the franchiser often repurchases or relocates the outlet and does not report it as a failure. As a result, some franchisers boast of never experiencing a failure.

The risk involved in purchasing a franchise in the final analysis is largely dependent on the entrepreneur's managerial skills and motivation, and on the franchiser's business experience and system. In light of this risk, many franchise owners prefer the feeling of "not being in this alone" and are convinced that franchising has been a crucial part of their success.

THE DRAWBACKS OF BUYING A FRANCHISE

4-B. Explain the drawbacks of buying a franchise.

Obviously, the benefits of franchising can mean the difference between success and failure for a small business. However, the franchisee must sacrifice some freedom to the franchiser. The prospective franchisee must explore other limitations of franchising before undertaking this form of ownership.

Franchise Fees and Profit Sharing

Virtually all franchisers impose some type of fees and demand a share of the franchisee's sales revenues in return for the use of the franchiser's name, products or services, and business system. The fees and the initial capital requirements vary among different franchisers, even among those in similar industries. For example, Subway reports start-up cost of $52,000–$191,000, Quizno's $208,400–$243,800, Sonic Drive-In Restaurant $288,100–1,200,000, Hardee's $770,800–$1,100,000, McDonald's $489,900–$1,500,000, and Taco Bell $3,000,000. These start-up cost are influenced by the cost of land and construction.

Start-up costs for franchises often include numerous additional fees. Most franchises impose a franchise fee up front for the right to use the company name. Other start-up costs might include site purchase and preparation, construction, signs, fixtures, equipment, management assistance, and training. Some franchise fees include these costs whereas others do not. For example, Closets by Design, a company that designs and installs closet and garage organizers, entertainment centers, and home office systems, charges a franchise fee ranging from $19,500 to $34,900, which includes both a license for an exclusive territory and management training and support. Before signing any contract, a prospective franchisee should determine the total cost of a franchise, something every franchiser is required to disclose in item 10 of its Uniform Franchising Offering Circular (see "Franchising and the Law" later in this chapter).

Franchisers also impose continuing royalty fees as profit-sharing devices. The royalty usually involves a percentage of gross sales with a required minimum or a flat fee levied on the franchise. Royalty fees range from 1 percent to 11 percent although most franchises assess a rate between 3 percent and 7 percent. The Atlanta Bread Company, for example, charges franchisees a royalty of 5 percent of gross sales, which is payable weekly. These ongoing royalties can increase a franchisee's overhead expenses significantly. Because the franchiser's royalties and fees are calculated as a percentage of a franchisee's sales, the franchiser gets paid—even if the franchisee fails to earn a profit. Sometimes unprepared franchisees discover (too late) that a franchiser's royalties and fees are the equivalent of the normal profit margin for a franchise. To avoid such problems, a prospective franchisee should find out which fees are required (some are merely recommended) and then determine which services and benefits the fees cover. One of the best ways to do this is to itemize what you are getting for your money and then determine whether the cost corresponds to the benefits provided. Be sure to get the details on all expenses—amount, time of payment, and financing arrangements; find out which items, if any, are included in the initial franchise fee and which ones are "extra." Even owning a high-profile franchise such as McDonald's does not guarantee success. In fact, 8 percent of McDonald's franchisees sell their rights back to the company under financial stress.[14]

Strict Adherence to Standardized Operations

Although the franchisee owns the business, she does not have the autonomy of an independent owner. To protect its public image, the franchiser requires that the franchisee maintain certain operating standards. If a franchise constantly fails to meet the minimum standards established for the business, the franchiser may terminate its license. Determining compliance with standards is usually accomplished by periodic inspections. At times, strict adherence to franchise standards may become a burden to the franchisee. The owner may believe that the written reports the franchiser demands require an excessive amount of time. In other instances, the owner may be required to enforce specific rules she believes are inappropriate or unfair.

Restrictions on Purchasing

In the interest of maintaining quality standards, franchisees may be required to purchase products, special equipment, or other items from the franchiser or from an "approved" supplier. For example, Kentucky Fried Chicken requires that franchisees use only seasonings blended by a particular company because a poor image could result from franchisees using inferior products to cut costs. Under some conditions, such purchase arrangements may be challenged in court as a violation of antitrust laws, but generally franchisers have a legal right to see that franchisees maintain acceptable quality standards. A franchiser may legally set the prices paid for the products it sells but may not establish the retail prices to be charged on products sold by the franchisee. A franchiser can suggest retail prices for the franchisee's products and services but cannot force the franchisee to abide by them.

Limited Product Line

In most cases, the franchise agreement stipulates that the franchise can sell only those products approved by the franchiser. Unless willing to risk license cancellation, a franchisee must avoid selling any unapproved products through the franchise.

A franchise may be required to carry an unpopular product or be prevented from introducing a desirable one by the franchise agreement. A franchisee's freedom to adapt a product line to local market conditions is restricted. But some franchisers solicit product suggestions from their franchisees.

A Company Example

In fact, a McDonald's franchisee, Herb Peterson, created the highly successful Egg McMuffin while experimenting with a Teflon-coated egg ring that gave fried eggs rounded corners and a poached appearance. Peterson put his round eggs on English muffins, adorned them with Canadian bacon and melted cheese, and showed his creation to McDonald's chief Ray Kroc. Kroc devoured two of them and was sold on the idea when Peterson's wife suggested the catchy name. In 1975, McDonald's became the first fast-food franchise to open its doors for breakfast, and the Egg McMuffin became a staple on the breakfast menu.[15]

Unsatisfactory Training Programs

Every would-be franchisee must be wary of the unscrupulous franchiser who promises extensive services, advice, and assistance but delivers nothing. For example, one owner relied on the franchiser to provide what had been described as an "extensive, rigorous training program" after paying a handsome technical assistance fee. The program was nothing but a set of pamphlets and do-it-yourself study guides. Other examples include those impatient entrepreneurs who paid initial franchise fees without investigating the business and never heard from the franchiser again. Although disclosure rules have reduced the severity of the problem, dishonest characters still thrive on unprepared prospective franchisees.

Market Saturation

As the owners of many fast-food and yogurt and ice cream franchises have discovered, market saturation is a very real danger. Although some franchisers offer franchisees territorial protection, others do not. Territorial encroachment has become a hotly contested issue in franchising as growth-seeking franchisers have exhausted most of the prime locations and are now setting up new franchises in close proximity to existing ones. In some areas of the country, franchisees are upset, claiming that their markets are oversaturated and their sales are suffering.

Less Freedom

When franchisees sign a contract, they agree to sell the franchiser's product or service by following its prescribed formula. This feature of franchising is the source of the system's success, but it also gives many franchisees the feeling that they are reporting to a "boss." Franchisers want to ensure success, and most monitor their franchisees' performances closely to make sure franchisees follow the system's specifications. Strict uniformity is the rule rather than the exception. Entrepreneurs who want to be their own bosses often are disappointed with a franchise because highly independent, "go-my-own-way" individuals may find a conflict in basic philosophy with a "go-by-the-rules" franchise contract. Table 4.2 describes 10 myths of franchising.

Learning Objective
5. Understand the laws covering franchise purchases.

FRANCHISING AND THE LAW

The franchising boom spearheaded by McDonald's and others in the late 1950s brought with it many prime investment opportunities. However, the explosion of legitimate franchises also ushered in with it numerous fly-by-night franchisers who defrauded their franchisees. In response to these specific incidents and to the potential for deception inherent in a franchise

TABLE 4.2
10 Myths of Franchising

Sources: Adapted from Andrew A. Caffey, "There's More to a franchise Than Meets the Eye," *Entrepreneur*, www.entrepreneurmag.com; Andrew A. Caffey, "Myth vs. Reality, *Entrepreneur*, www.entrepreneurmag.com/page.hts?N=[illegible]&Ad=S; Chieh Chieng, "Do You Want to Know a Secret?" *Entrepreneur*, January 1999, pp. 174–178; Ten Most Common Mistakes Made by Franchise Buyers," *Franchise Doctor*, www.franchisedoc.com/mistakes.html.

Myth #1. Franchising is the safest way to go into business because franchises never fail. Although the failure rate for franchises is lower than that of independent businesses, there are no guarantees of success. Franchises can—and do—fail. Potential franchisees must exercise the same degree of caution in judging the risk of a franchise as they would any other business.

Myth #2. I'll be able to open my franchise for less money than the franchiser estimates. Launching a business, including a franchise, normally takes more money and more time than entrepreneurs estimate. Be prepared. One franchisee of a retail computer store advises, "If a franchiser tells you you'll need $100,000 to get started, you better have $150,000."

Myth #3. The bigger the franchise organization, the more successful I'll be. Bigger is not always better in the franchise industry. Some of the largest franchise operations are struggling to maintain their growth rates because the best locations are already taken. Market saturation is a significant problem for many large franchises, and smaller franchises are accounting for much of the growth in the industry.

Myth #4. I'll use 80 percent of the franchiser's business system, but I'll improve on it by substituting my experience and know-how. When franchisees buy a franchise, they are buying, in essence, the franchiser's experience and know-how. Why pay all of that money to a franchiser if you aren't willing to use its system?

Myth #5. All franchises are the same. Each franchise has its own unique requirements, procedures, and culture. Naturally, some will suit you better than others. Avoid the tendency to select the franchise offering the lowest cost; ask the franchiser and existing franchisees lots of questions to determine whether you'll be comfortable in that system.

Myth #6. I don't have to be a "hands-on" manager. I can be an absentee owner and still be very successful. Most franchisers shy away from absentee owners. They know that franchise success requires lots of hands-on attention, and the owner is the best person to provide that.

Myth #7. Anyone can be a satisfied, successful franchise owner. With more than 4,500 franchises available, the odds of finding a franchise that appeals to your tastes is high. However, not everyone is cut out to be a franchisee. Those "free spirits" who insist on doing things their way will most likely be miserable in a franchise.

Myth #8. Franchising is the cheapest way to get into business for yourself. Although bargains do exist in franchising, the price tag for buying into some systems is breathtaking, sometimes running into several hundreds of thousands of dollars. Franchisers look for candidates who are on solid financial footing.

Myth #9. The franchiser will solve my business problems for me; after all, that's why I pay an ongoing royalty. Although franchisers offer franchisees start-up and ongoing training programs, they will not run their franchisees' businesses for them. Your job is to take the formula that the franchiser has developed and make it work in your location. Expect to solve many of your own problems.

Myth #10. Once I open my franchise, I'll be able to run things the way *I* want to. Franchisees are not free to run their businesses any way they see fit. Every franchisee signs a contract that requires him or her to run the business according to the franchiser's requirements. Franchisees who violate the terms of that agreement run the risk of having their franchise relationship canceled.

relationship, California in 1971 enacted the first Franchise Investment Law. The law (and those of 16 other states that have since passed similar laws) requires franchisers to register a **Uniform Franchise Offering Circular (UFOC)** and deliver a copy to prospective franchisees before any offer or sale of a franchise. The UFOC establishes full disclosure guidelines for any company selling franchises.

Uniform Franchise Offering Circular (UFOC)—*a document that every franchiser is required by law to give prospective franchisees before any offer or sale of a franchise; it outlines 23 important pieces of information.*

In October 1979, the Federal Trade Commission (FTC) enacted the Trade Regulation Rule, requiring all franchisers to disclose detailed information on their operations at the first personal meeting, or at least 10 days before a franchise contract is signed, or before any money is paid. The FTC rule covers *all* franchisers, even those in the 33 states lacking franchise disclosure laws. The purpose of the regulation is to assist the potential franchisee's investigation of the franchise deal and to introduce consistency into the franchiser's disclosure statements. In 1994, the FTC modified the requirements for the UFOC, making more information available to prospective franchisees and making the document shorter and easier to read and understand. The FTC's philosophy is not so much to prosecute abusers as to provide information to prospective franchisees and help them make intelligent decisions. Although the FTC requires each franchiser to provide a potential franchisee with this information, it does not verify its accuracy. Prospective franchisees should use these data only as a starting point for the investigation. The Trade Regulation Rule requires a franchiser to include 23 major topics in its disclosure statement:

1. Information identifying the franchiser and its affiliates and describing their business experience and the franchises being sold.
2. Information identifying and describing the business experience of each of the franchiser's officers, directors, and management personnel responsible for the franchise program.
3. A description of the lawsuits in which the franchiser and its officers, directors, and managers have been involved. Although most franchisers will have been involved in some type of litigation, an excessive number of lawsuits, particularly if they relate to the same problem, is alarming.
4. Information about any bankruptcies in which the franchiser and its officers, directors, and managers have been involved.
5. Information about the initial franchise fee and other payments required to obtain the franchise, including the intended use of the fees. Initial fees typically range from $10,000 to $50,000.
6. A description of any continuing payments franchisees are required to make after start-up, including royalties, service fees, training fees, lease payments, advertising or marketing charges, and others.
7. A detailed description of the payments a franchisee must make to fulfill the initial investment requirement and how and to whom they are made. The categories covered are the initial franchise fee, equipment, opening inventory, initial advertising fee, signs, training, real estate, working capital, legal, accounting, and utilities. These estimates, usually stated in the form of a range of numbers, give prospective franchisees an idea of how much their total start-up costs will be.
8. Information about quality restrictions on goods, services, equipment, supplies, inventory, and other items used in the franchise and where franchisees may purchase them, including restricted purchases from the franchiser.
9. A statement (in tabular form) of the franchisee's obligations under the franchise contract, including items such as selecting a site, paying fees, maintaining quality standards, keeping records, transferring or renewing the franchise relationship, and others.
10. A description of any financial assistance available from the franchiser in the purchase of the franchise.
11. A description of all obligations the franchiser must fulfill in helping a franchisee prepare to open, open, and operate a unit plus information covering location selection methods and the training program provided to franchisees. In addition to the training they provide new franchisees, many franchisers offer help with a grand opening for each outlet and on-site management assistance for a short time to get franchisees started.
12. A description of any territorial protection that will be granted to the franchise and a statement as to whether the franchiser may locate a company-owned store or other outlet in that territory.
13. All relevant information about the franchiser's trademarks, service marks, trade names, logos, and commercial symbols, including where they are registered. Look for a strong trade or service mark that is registered with the U.S. Patent and Trademark Office.

14. Similar information on any patents and copyrights the franchiser owns and the rights to these transferred to franchisees.
15. A description of the extent to which franchisees must participate personally in the operation of the franchise. Many franchisers look for "hands-on" franchisees and discourage "absentee owners."
16. A description of any restrictions on the goods or services franchises are permitted to sell and with whom franchisees may deal. The agreement usually restricts franchisees to selling only those items approved by the franchiser.
17. A description of the conditions under which the franchise may be repurchased or refused renewal by the franchiser, transferred to a third party by the franchisee, and terminated or modified by either party. This section also addresses the method established for resolving disputes.
18. A description of the involvement of celebrities and public figures in the franchise.
19. A complete statement of the basis for any earnings claims made to the franchisee, including the percentage of existing franchises that have actually achieved the results that are claimed. New rules put two requirements on franchisers making earnings claims: (a) Any earnings claim must be included in the UFOC, and (b) the claim must "have a reasonable basis at the time it is made." However, franchisers are *not* required to make any earnings claims at all; in fact, only about 25 percent of franchisers make earnings claims in their circulars, primarily because of liability concerns about committing such numbers to paper.
20. Statistical information about the present number of franchises, the number of franchises projected for the future, the number of franchises terminated, the number the franchiser has not renewed, the number repurchased in the past, and a list of the names and addresses (organized by state) of other franchisees in the system.
21. The franchiser's financial statements.
22. A copy of all franchise and other contracts (leases, purchase agreements, etc.) the franchisee will be required to sign.
23. A standardized, detachable "receipt" to prove that the prospective franchisee received a copy of the UFOC.

The information contained in the UFOC does not fully protect a potential franchise from deception, nor does it guarantee success. It does, however, provide enough information to begin a thorough investigation of the franchiser and the franchise deal.

Learning Objective

6. Discuss the *right* way to buy a franchise.

THE *RIGHT* WAY TO BUY A FRANCHISE

The UFOC is a powerful tool designed to help would-be franchisees select the franchise that is right for them and to avoid being duped by dishonest franchisers. The best defenses a prospective entrepreneur has against unscrupulous franchisers are preparation, common sense, and patience. By investigating thoroughly before investing in a franchise, a potential franchisee minimizes the risk of being hoodwinked into a nonexistent business. Asking the right questions and resisting the urge to rush into an investment decision helps a potential franchisee avoid being taken by unscrupulous operators.

Potential franchisees must beware because franchise fraud still exists in this rapidly growing field. A recent conference of state securities regulators named "illegal franchise offers" as one of the top 10 financial frauds in the United States.[16] The president of one franchise consulting firm estimates that 5 to 10 percent of franchisers are dishonest—"the rogue elephants of franchising." Dishonest franchisers tend to follow certain patterns, and well-prepared franchisees who know what to look for can avoid trouble. The following clues should arouse the suspicion of an entrepreneur about to invest in a franchise:

- Claims that the franchise contract is a standard one and that "you don't need to read it."
- A franchiser who fails to give you a copy of the required disclosure document at your first face-to-face meeting.
- A marginally successful prototype store or no prototype at all.
- A poorly prepared operations manual outlining the franchise system or no manual (or no system) at all.
- Oral promises of future earnings without written documentation.
- A high franchisee turnover rate or a high termination rate.
- An unusual amount of litigation brought against the franchiser.

- Attempts to discourage you from allowing an attorney to evaluate the franchise contract before you sign it.
- No written documentation to support claims and promises.
- A high-pressure sale—sign the contract now or lose the opportunity.
- Claiming to be exempt from federal laws requiring complete disclosure of franchise details.
- "Get-rich-quick schemes," promises of huge profits with only minimum effort.
- Reluctance to provide a list of present franchisees for you to interview.
- Evasive, vague answers to your questions about the franchise and its operation.

Not every franchise "horror story" is the result of dishonest franchisers. More often than not, the problems that arise in franchising have more to do with franchisees who buy legitimate franchises without proper research and analysis. They end up in businesses they don't enjoy and that they are not well suited to operate. How can you avoid this mistake? The following steps will help you make the right choice:

Evaluate Yourself

Before looking at any franchise, entrepreneurs should study their own traits, goals, experience, likes, dislikes, risk orientation, income requirements, time and family commitments, and other characteristics. Will you be comfortable working in a structured environment? What kinds of franchises fit your desired lifestyle? In what region of the country or world do you want to live and work? What is your ideal job description? Knowing what you enjoy doing (and what you don't want to do) will help you narrow your search. The goal is to find the franchise that is right—*for you*! One characteristic successful franchisees have in common is that they genuinely enjoy their work. Table 4.3 provides a test for prospective franchisees that helps them evaluate their franchise potential.

Research Your Market

Before shopping for a franchise, research the market in the area you plan to serve. How fast is the overall area growing? In which areas is that growth occurring fastest? Investing some time at the library developing a profile of the customers in your target area is essential; otherwise, you will be flying blind. Who are your potential customers? What are their characteristics? Their income and education levels? What kinds of products and services do they buy? What gaps exist in the market? These gaps represent potential franchise opportunities for you. Market research also should confirm that a franchise is not merely part of a fad that will quickly fade. Steering clear of fads and into long-term trends is one way to sustain the success of a franchise.

A Company Example

*Before **Papa John's Pizza** allows franchisees to open any store, it requires them to spend six months to a year evaluating the market potential of the local area. "We don't just move into an area and open up 200 stores," says one manager. "We do it one store at a time."*[17]

Consider Your Franchise Options

The International Franchise Association publishes the *Franchise Opportunities Guide*, which lists its members and some basic information about them. Many cities host franchise trade shows throughout the year, where hundreds of franchisers gather to sell their franchises. Attending one of these franchise showcases is a convenient, efficient way to collect information about a variety of available opportunities. Many small business magazines such as *Entrepreneur, Inc., FSB*, and others devote at least one issue to franchising, where they often lists hundreds of franchises. These guides can help you find a suitable franchise within your price range.

Get a Copy of the Franchiser's UFOC

Once you narrow down your franchise choices, you should contact each franchise and get a copy of its UFOC. Then read it! This document is an important tool in your search for the right franchise, and you should make the most of it. When evaluating a franchise opportunity, what should a potential franchisee look for? Although there's never a guarantee of success, the following characteristics make a franchise stand out:

- *A unique concept or marketing approach.* "Me-too" franchises are no more successful than "me-too" independent businesses. Pizza franchiser Papa John's has achieved an impressive growth rate by emphasizing the quality of its ingredients, whereas Domino's is known for its fast delivery.
- *Profitability.* A franchiser should have a track record of profitability and so should its franchisees. If a franchiser is not profitable, its franchisees are not likely to be either. Franchisees who follow the business format should expect to earn a reasonable rate of return.
- *A registered trademark.* Name recognition is difficult to achieve without a well-known and protected trademark.
- A *business system that works.* A franchiser should have in place a system that is efficient and is well documented in its manuals.
- *A solid training program.* One of the most valuable components of a franchise system is the training it offers franchisees. The system should be relatively easy to teach.
- *Affordability.* A franchisee should not have to take on an excessive amount of debt to purchase a franchise. Being forced to borrow too much money to open a franchise outlet can doom a business from the outset. Respectable franchisers verify prospective franchisees' financial qualifications as part of the screening process.
- *A positive relationship with franchisees.* The most successful franchises are those that see their franchisees as partners . . . and treat them accordingly.

The UFOC covers the 23 items discussed in the previous section and includes a copy of the company's franchise agreement and any contracts accompanying it. Although the law requires a UFOC to be written in plain English rather than "legalese," it is best to have an attorney experienced in franchising to review the UFOC and discuss its provisions with you. Watch for clauses that give the franchiser absolute control and discretion. The franchise contract summarizes the details that will govern the franchiser–franchisee relationship over its life. It outlines *exactly* the rights and the obligations of each party and sets the guidelines that govern the franchise relationship. Because franchise contracts typically are long term (50 percent run for 15 years or more), it is extremely important for prospective franchisees to understand the terms *before* they sign the contract.

franchisee turnover rate—*the rate at which franchisees leave a franchise system.*

One of the most revealing items in the UFOC is the **franchisee turnover rate**, the rate at which franchisees leave the system. If the turnover rate is less than 5 percent, the franchise is probably sound. However, a franchise turnover rate approaching 20 percent is a sign of serious, underlying problems in a franchise. Satisfied franchisees are not inclined to leave a successful system.

Talk to Existing Franchisees

One of the best ways to evaluate the reputation of a franchiser is to interview (in person) several franchise owners who have been in business at least one year about the positive and the negative features of the agreement and whether the franchiser delivered what was promised. Did the franchise estimate their start-up costs accurately? Do they get the support the franchiser promised them? Has the franchise met their expectations concerning profitability and return on investment? Knowing what they know now, would they buy the franchise again?

A Company Example

Bob Phillips, a CPA looking to make a career change, wanted to make sure that he purchased the right franchise, so he invested time poring over the UFOCs he had collected from the dozen franchises that interested him. Rather than rely on the documents alone to judge the franchises, Phillips made calls to franchisees that he randomly selected from the lists included in the UFOCs (item 20). His conversations with franchisees convinced him that ***Ranch 1****, a chain of fast-food grilled chicken stores, was the best choice for him. "Almost every one wanted a second location," he says. "That's indicative of a healthy franchise system." Phillips is convinced that his thorough research led him to the right franchise. Today he owns two Ranch 1 franchises that generate more than $2 million in sales, and he plans to open eight more outlets within three years.*[18]

TABLE 4.3

A Test for Prospective Franchisees

Sources: Adapted from Erika Kotite, "Is Franchising for You?" *Franchise & Business Opportunities 1995*, pp. 14–18; Heather Page, "True Confessions," *Entrepreneur*, January 1996, pp. 184–186; *Franchise Solutions*. www.franchisesolutions.com.

Of those people who set out to buy a franchise, only 15 percent actually buy one. Some of that 15 percent make the wrong decision. They discover too late that they are not cut out to be franchisees. Do you have what it takes to be a successful franchisee? The following quiz will help you determine your "franchise quotient."

1. You own a company. How much operational detail are you comfortable with?
   a. I want direct control over all operations.
   b. I delegate less than half.
   c. I delegate more than half.
2. You have three job offers with comparable salary and benefits. Choose one.
   a. Small company but high management responsibility and exposure.
   b. Midsized company with less personal exposure but more prestigious name.
   c. Large company with least personal exposure but very well-known name.
3. You reach a major stumbling block on a project. You:
   a. Seek help from others immediately.
   b. Think it through and then present possible solutions to your superior.
   c. Keep working until you resolve it on your own.
4. Which investment sounds most appealing?
   a. Five percent fixed return over a period of time.
   b. From −20 percent to +50 percent loss or return over a period of time, depending on changing economic situations.
5. Which business arrangement is most appealing?
   a. You're the sole owner.
   b. You're in a partnership and own a majority of the stock.
   c. You're in an equal partnership.
6. Your company's sales technique increases sales 10 percent per year. You used a technique elsewhere you feel will result in 15 percent to 20 percent annual increases, but it requires extra time and capital. You:
   a. Avoid the risk and stay with the present plan.
   b. Suggest your new method, showing previous results.
   c. Privately use your system, and show the results later.
7. You suggest your system to your boss, and he says, "Don't rock the boat." You:
   a. Drop your different approach.
   b. Approach your boss at a later time.
   c. Go to your boss's boss with your suggestion.
   d. Use your own system anyway.
8. Which would mean the most to you?
   a. Becoming the president of a company.
   b. Becoming the highest-paid employee of a company.
   c. Winning the highest award for achievement in your profession.
9. What three activities do you find most appealing?
   a. Sales and marketing.
   b. Administration.
   c. Payroll.
   d. Training.
   e. Customer service.
   f. Credit and collections.
   g. Management.
10. What work pace do you generally prefer?
    a. Working on one project until it is completed.
    b. Working on several projects at one time.

Scoring: 1. A=5, B=3, C=1. 2. A=3, B=2, C=1. 3. A=1, B=5, C=7. 4. A=2, B=6. 5. A=7, B=5 C=2. 6. A=1, B=6, C=10. 7. A=1, B=5, C=8, D=10. 8. A=8, B=2, C=5. 9. A=10, B=1, C=3, D=3, E=8, F=2, G=5. 10. A=3, B=6.

Total Score:

20–33	You're a corporate player and are happiest in a structured environment. Franchising suits you.
34–71	You're a potentially good franchisee.
72–85	You're an entrepreneur who prefers total independence.

Interviewing past franchisees to get their perspectives on the franchiser–franchisee relationship is also helpful. Why did they leave? Franchisees of some companies have formed associations, which might provide prospective franchisees with valuable information. Other sources of information include the American Association of Franchisees and Dealers, the American Franchise Association, and the International Franchise Association.

Ask the Franchiser Some Tough Questions

Take the time to ask the franchiser questions about the company and its relationship with its franchisees. You will be in this relationship a long time, and you need to know as much about it as you possibly can beforehand. What is its philosophy concerning the relationship? What is the company culture like? How much input do franchisees have into the system? What are the franchise's future expansion plans? How will they affect your franchise? Are you entitled to an exclusive territory? Under what circumstances can either party terminate the franchise agreement? What happens if you decide to sell your franchise in the future? Under what circumstances would you not be entitled to renew the agreement? What kind of profits can you expect? (If the franchiser made no earnings claims in item 19 of the UFOC, why not?) Does the franchiser have a well-formulated strategic plan?

Make Your Choice

The first lesson in franchising is "Do your homework *before* you get out your checkbook." Once you have done your research, you can make an informed choice about which franchise is right for you. Then it is time to put together a solid business plan that will serve as your road map to success in the franchise you have selected. The plan is also a valuable tool to use as you arrange the financing for your franchise. We will discuss the components of a business plan in Chapter 11.

7. Outline the major trends shaping franchising.

TRENDS SHAPING FRANCHISING

Franchising has experienced three major growth waves since its beginning. The first wave occurred in the early 1970s when fast-food restaurants used the concept to grow rapidly. The fast-food industry was one of the first to discover the power of franchising, but other businesses soon took notice and adapted the franchising concept to their industries. The second wave took place in the mid-1980s as our nation's economy shifted heavily toward the service sector. Franchises followed suit, springing up in every service business imaginable—from maid services and copy centers to mailing services and real estate. The third wave began in the early 1990s and continues today. It is characterized by new, low-cost franchises that focus on specific market niches. In the wake of major corporate downsizing and the burgeoning costs of traditional franchises, these new franchises allow would-be entrepreneurs to get into proven businesses faster and at lower costs. These companies feature start-up costs in the $2,000 to $250,000 range and span a variety of industries—from leak detection in homes and auto detailing to day care and tile glazing. Other significant trends affecting franchising are discussed next.

Changing Face of Franchisees

Franchisees today are better educated, are more sophisticated, have more business acumen, and are more financially secure than those of just 20 years ago. Franchising is attracting skilled, experienced businesspeople whose goal is to own multiple outlets that cover entire states or regions.

A Company Example

*For instance, when **Krispy Kreme Doughnuts** began to move its popular product north from its southern stronghold, the Lev family—father Howard, sons Russel and Mel, and nephew John Faber—bought the franchise for the entire state of New York. While on a trip to the South, Mel discovered the tasty orbs and brought some back to his family, who quickly devoured them. Once they returned to their home in New York, the Levs decided to become franchisees. All experienced in business (Howard and Mel once owned a shirt-making company), the Levs and Faber have opened 10 stores and have plans for dozens more.[19] James A. Cosentino's Krispy Kreme in West Palm Beach, Florida, has customers waiting at the front door at 5:30 A.M. The franchise agreement requires the franchisee to pay Krispy Kreme 4.5 percent of total sales as a royalty fee, plus an additional 2.0 percent to help pay for brand development and public relations.*

YOU Be the Consultant . . .

The Opportunity of a Lifetime

"Honey, I think I've found it!" said Joe Willingham to his wife Allie. "This is just what I've been looking for, and just in time, too. My severance package from the company runs out next month. The man said that if we invested in this franchise now, we could be bringing in good money by then. It's that easy!"

Allie knew Joe had been working hard at finding another job since he had been a victim of his company's latest downsizing, but jobs were scarce even for someone with his managerial experience and background in manufacturing. "Nobody wants to hire a 51-year-old man with experience when they can hire 23-year-old college graduates at less than half the salary and teach them what they need to know," Joe told her after months of fruitless job hunting. That's when Joe got the idea of setting up his own business. Rather than start an independent business from scratch, Joe felt more comfortable, given his 26-year corporate career, opening a franchise. "A franchiser can give me the support I need," he told Allie.

"Tell me about this franchise," Allie said.

"It's a phenomenal opportunity for us," Joe said, barely able to contain his excitement. "I saw this booth for American Speedy Print at the Business Expo this morning. There were all kinds of franchises there, but this one really caught my eye," Joe said as he pulled a rather plain-looking photocopy of a brochure from his briefcase.

"Is that their brochure?" asked Allie.

"Well, the company is growing so fast that they have temporarily run out of their normal literature. This is just temporary."

"Oh . . . You would think that a printing franchise could print flashier brochures even on short notice, but I guess . . . ," said Allie.

"The main thing is the profit potential this business has," said Joe. "I met one of their franchisees. I tell you the guy was wearing a $2,000 suit if ever there was one, and he had expensive jewelry dripping from his fingers. He's making a mint with this franchise, and he said we could, too!"

Joe continued, "With the severance package I have from the company, we could pay the $10,000 franchise fee and lease most of the equipment we need to get started. It'll take every penny of my package, but, hey, it's an investment in our future. The representative said the company would help us with our grand opening and would also help us compile a list of potential customers."

"What would you print?" asked Allie.

"Anything!" said Joe. "The franchisee I talked to does flyers, posters, booklets, newsletters, advertising pieces . . . you name it!"

"Wow! It seems like you'd need lots of specialized equipment to do all of that. How much does the total franchise package cost?" said Allie.

"Well, I'm not exactly sure. He never gave me an exact figure, but we can lease all the equipment we need from the franchiser!"

"Is this all of the material they gave you? I thought franchisers were supposed to have some kind of information packet to give to people," said Allie.

"Yeah, I asked him about that," said Joe. "He said that American Speedy Print is just a small franchise. They'd rather put their money into building a business and helping their franchisees succeed than into useless paperwork that nobody reads anyway. It makes sense to me."

"I guess so . . . ," Allie said reluctantly.

"I think we need to take this opportunity, hon," Joe said, with a look that spoke of determination and enthusiasm. "Besides, he said that there was another couple in this county that is already looking at this franchise, and that the company will license only one franchisee in this area. They don't want to saturate the market. He thinks they may take it. I think we have to move on this now, or we'll lose the opportunity of a lifetime."

Allie had not seen Joe exhibit this much enthusiasm and excitement for anything since he had lost his job at the plant. Piles of rejection letters from his job search had sapped Joe's zest for living. Allie was glad to see "the old Joe" return, but she still had her doubts about the franchise opportunity Joe was describing.

"It might just be the opportunity of a lifetime, Joe," she said. "But don't you think we need to find out a little more about this franchise before we invest that much money? I mean . . ."

"Hon, I'd love to do that, but like the man said, we may miss out on the opportunity of a lifetime if we don't sign today. I think we've got to move on this thing now!"

1. What advice would you offer Joe about investing in this franchise?

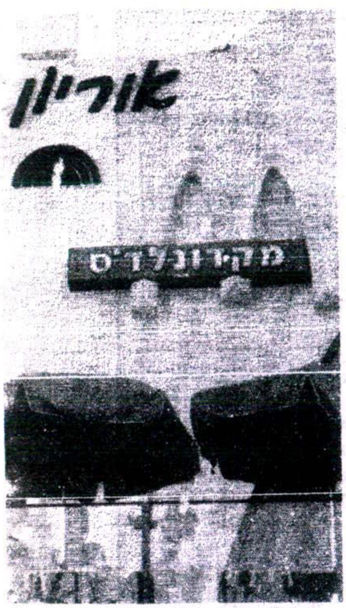
2. Map out a plan for Joe to use in finding the right franchise for him. What can Joe do to protect himself from making a bad franchise investment?

3. Summarize the advantages and disadvantages Joe can expect if he buys a franchise.

International Opportunities

One of the major trends in franchising is the internationalization of American franchise systems. Increasingly, franchising is becoming a major export industry for the United States. Growing numbers of U.S. franchises are moving into international markets to boost sales and profits as the domestic market becomes saturated. According to a report by Arthur Andersen, 44 percent of U.S. franchisers have international locations, up from 34 percent in 1989. International expansion is a relatively new phenomenon in franchising, however; approximately

75 percent of franchisers established their first foreign outlet within the past 10 years.[20] Canada is the primary market for U.S. franchisers, with Mexico, Japan, and Europe following. These markets are most attractive to franchisers because they are similar to the U.S. market—rising personal incomes, strong demand for consumer goods, growing service economies, and spreading urbanization.



McDonald's has achieved much success around the world by adapting its menu to satisfy local tastes. The company has more than 30,000 restaurants in 119 countries.

Courtesy of CORBIS BETTMANN. © Morton Beebe/CORBIS

As they venture into foreign markets, franchisers have learned that adaptation is one key to success. Although a franchise's overall business format may not change in foreign markets, some of the details of operating its local outlets must. For instance, fast-food chains in other countries often must make adjustments to their menus to please locals' palates. In Japan, McDonald's (known as "Makudonarudo") outlets sell teriyaki burgers, rice burgers, and katsu burgers (cheese wrapped in a roast pork cutlet topped with katsu sauce and shredded cabbage) in addition to their traditional American fare. In the Philippines, the McDonald's menu includes a spicy Filipino-style burger, spaghetti, and chicken with rice.

Countries that recently welcomed the free market system are turning to franchising to help them move toward a market economy. Some countries of Eastern Europe, including Hungary, Poland, and Yugoslavia, already have attracted franchises. Even Russia is fertile ground for franchising. McDonald's scored a hit with its 700-seat restaurant in Moscow. Despite being one of the largest McDonald's outlets in the world, "The waiting line winds along busy Pushkin Square for well over 500 yards," reports one Soviet magazine.[21] Franchisers in these countries must have patience, however. Lack of capital, archaic infrastructure, and a shortage of hard currencies mean that profits will be slow in coming. Most franchisers recognize the difficulties of developing franchises in foreign markets and start slowly.

It is valuable to have owners of American franchises be natives of the country in which the franchise is located. For example, Brambang Rachmadi owns 85 McDonald's restaurants in his native Indonesia. Following the September 11, 2001, terrorist attacks in the United States, it was feared that the natives of Indonesia, a Muslim country, might have within its population anti-American radicals who would attack American targets in Indonesia. Mr. Rachmadi immediately took the offensive to defend his McDonald's by erecting a 6-foot-high banner stating that "In the name of Allah, the merciful and the gracious, McDonald's Indonesia is owned by an indigenous Muslim."[22]

Smaller, Nontraditional Locations

intercept marketing—*the principle of putting a franchise's products or services directly in the paths of potential customers, wherever they may be.*

As the high cost of building full-scale locations continues to climb, more franchisers are searching out nontraditional locations in which to build smaller, less expensive outlets. Based on the principle of **intercept marketing**, the idea is to put a franchise's products or services directly in the paths of potential customers, wherever that may be. Locations within locations have become popular. Franchises are putting scaled-down outlets on college campuses, in high school cafeterias, in sports arenas, in hospitals, on airline flights, and in zoos. St. Louis–based Pizzas of Eight already has outlets inside convenience stores, supermarkets, and bowling alleys and plans to open others in video stores.[23] Many franchisees have discovered that smaller outlets in these nontraditional locations generate nearly the same sales volume as full-sized outlets at just a fraction of the cost!

A Company Example

Steve Siegel, owner of 35 ***Dunkin' Donut*** *shops in the Boston area, recently began branching out into small, nontraditional locations where pedestrian traffic counts are high. One of his most profitable spots measures just 64 square feet, but because it is in a business district filled with office workers, it generates a high volume of sales.[24] Such locations will be a key to continued franchise growth in the domestic market.*

Conversion Franchising

conversion franchising—*a franchising trend in which owners of independent businesses become franchisees to gain the advantage of name recognition.*

The recent trend toward **conversion franchising**, in which owners of independent businesses become franchisees to gain the advantage of name recognition, will continue. In a franchise conversion, the franchiser gets immediate entry into new markets and experienced operators; franchisees get increased visibility and often a big sales boost. It is not unusual to experience an increase of 20 percent or better in gross sales. The biggest force in conversion franchising has been Century 21, the real estate sales company.

Multiple-Unit Franchising

multiple-unit franchising—*a method of franchising in which a franchisee opens more than one unit on a broad territory within a specific time period.*

Multiple-unit franchising became extremely popular in the early 1990s. In multiple unit franchising, a franchisee opens more than one unit in a broad territory within a specific time period. Multiple ownership of franchise units has expanded in recent years. It is now becoming more common for one franchisee to own 60, 70, or even 200 units. Franchisers are finding it's far more efficient in the long run to have one well-trained franchisee operate a number of units than to train many franchisees. The popularity of multiple-unit franchising has paralleled the trend toward increasingly experienced, sophisticated franchisees, who set high performance goals that a single outlet cannot meet. The typical multiple-unit franchisee owns between three and six units, but some franchisees own many more.

Master Franchising

master franchise—*a method of franchising that gives a franchisee the right to create a semi-independent organization in a particular territory to recruit, sell, and support other franchisees.*

A **master franchise** (or subfranchise) gives a franchisee the right to create a semi-independent organization in a particular territory to recruit, sell, and support other franchisees. A master franchisee buys the right to develop subfranchises within a broad geographic area or, sometimes, an entire country. Subfranchising "turbocharges" a franchiser's growth. Many franchisers use it to open outlets in international markets more quickly and efficiently because the master franchisees understand local laws and the nuances of selling in local markets. For instance, a master franchisee with TCBY International, a yogurt franchise, has opened 21 stores in China and Hong Kong. Based on his success in these markets, the company has sold him the master franchise in India.[25]

Piggybacking (or Combination Franchising)

Some franchisers also are discovering new ways to reach customers by teaming up with other franchisers selling complementary products or services. A growing number of companies are **piggybacking** outlets—combining two or more distinct franchises under one roof. This "buddy system" approach works best when the two franchise ideas are compatible and appeal to similar customers. For example, franchisers Dunkin' Donuts, Togos' Eatery sandwich shops, and ice cream retailer Baskin-Robbins are working together to build hundreds of combination outlets, a concept that has proved to be highly successful.[26] Properly planned, piggybacked franchises can magnify many times over the sales and profits of individual, self-standing outlets. One Baskin Robbins franchisee saw his sales climb 25 percent when he added a Blimpie Subs and Salads franchise to his existing ice cream shop. Another enterprising franchisee who combined Shell Oil (gas station), Charley's Steakery (sandwich shop), and TCBY (frozen yogurt) franchises under one roof in Columbus, Ohio, says that sales are running 10 percent higher than the three outlets would generate in separate locations.[27]

Serving Aging Baby Boomers

Now that dual-career couples have become the norm, especially among baby boomers, the market for franchises offering convenience and timesaving devices is booming. Customers are willing to pay for products and services that will save them time or trouble, and franchises are ready to provide them. Franchisees of Around Your Neck go into the homes and offices of busy male executives to sell men's apparel and accessories ranging from shirts and ties to custom-made suits. Other areas in which franchising is experiencing rapid growth include home delivery of meals, house-cleaning services, continuing education and training (especially computer and business training), leisure activities (such as hobbies, health spas, and travel-related activities), products and services aimed at home-based businesses, and health care.

CONCLUSION

Franchising has proved its viability in the U.S. economy and has become a key part of the small business sector because it offers many would-be entrepreneurs the opportunity to own and operate a business with a greater chance for success. Despite its impressive growth rate to date, the franchising industry still has a great deal of room to grow. Global companies, as well as U.S. firms, are finding that they can achieve growth through franchising, and we can anticipate that the franchising phenomenon will continue in the future.

CHAPTER SUMMARY

1-A. Explain the advantages and the disadvantages of the sole proprietorship.

A sole proprietorship is a business owned and managed by one individual and is the most popular form of ownership.

Sole proprietorships offer these *advantages*: They are simple to create; they are the least costly form to begin; the owner has total decision-making authority; there are no special legal restrictions; and they are easy to discontinue.

They also suffer from these *disadvantages*: unlimited personal liability of owner; limited managerial skills and capabilities; limited access to capital; and lack of continuity.

1-B. Explain the advantages and the disadvantages of the partnership.

A partnership is an association of two or more people who co-own a business for the purpose of making a profit. Partnerships offer these *advantages*: ease of establishing; complementary skills of partners; division of profits; larger pool of capital available; ability to attract limited partners; little government regulation flexibility; and tax advantages.

Partnerships suffer from these *disadvantages*: unlimited liability of at least one partner; difficulty in disposing of partnership interest; lack of continuity; potential for personality and authority conflicts; and partners bound by the law of agency.

1-C. Explain the advantages and the disadvantages of the corporation.

A corporation, the most complex of the three basic forms of ownership, is a separate legal entity. To form a corporation, an entrepreneur must file the articles of incorporation with the state in which the company will incorporate. Corporations offer these *advantages*: limited liability of stockholders; ability to attract capital; ability to continue indefinitely; and transferable ownership.

Corporations suffer from these *disadvantages*: cost and time involved in incorporating; double taxation; potential for diminished managerial incentives; legal requirements and regulatory red tape; and potential loss of control by the founder(s).

2. Discuss the advantages and the disadvantages of the S corporation, the limited liability company, the professional corporation, and the joint venture.

Entrepreneurs can also choose from several other forms of ownership, including S corporations, and limited liability companies. An S corporation offers its owners limited liability protection but avoids the double taxation of C corporations.

A limited liability company, like an S corporation, is a cross between a partnership and a corporation, yet it operates without the restrictions imposed on an S corporation. To create an LLC, an entrepreneur must file the articles of organization and the operating agreement with the secretary of state.

A professional corporation offers professionals the benefits of the corporate form of ownership.

A joint venture is like a partnership, except that it is formed for a specific purpose.

3. Describe the three types of franchising: trade name, product distribution, and pure.

Trade-name franchising involves a franchisee purchasing the right to become affiliated with a franchiser's trade-name without distributing its products exclusively.

Product distribution franchising involves licensing a franchisee to sell products or services under the franchiser's brand name through a selective, limited distribution network.

Pure franchising involves selling a franchisee a complete business format.

4. Explain the benefits and the drawbacks of buying a franchise.

Franchises offer many *benefits*: management training and support; brand-name appeal; standardized quality of goods and services; national advertising programs; financial assistance; proven products and business formats; centralized buying power; territorial protection; and a greater chance of success.

Franchising also suffers from certain *drawbacks*: franchise fees and profit sharing; strict adherence to standardized operations; restrictions on purchasing; limited product lines; unsatisfactory training programs; market saturation; and less freedom.

5. Understand the laws covering franchise purchases.

The Federal Trade Commission (FTC) enacted the Trade Regulation Rule in 1979, which requires all franchisers to disclose detailed information on their operations at the first personal meeting or at least 10 days before a franchise contract is signed, or before any money is paid. The FTC rule covers *all* franchisers. The Trade Regulation Rule requires franchisers to provide information on 23 topics in their disclosure statements.

Seventeen states have passed their own franchise laws requiring franchisers to provide prospective franchisees a Uniform Franchise Offering Circular (UFOC).

6. Discuss the *right* way to buy a franchise.

The following steps will help you make the right franchise choice: Evaluate yourself; research your market; consider your franchise options; get a copy of the franchiser's UFOC; talk to existing franchisees; ask the franchiser some tough questions; and make your choice.

7. Outline the major trends shaping franchising.

Key trends shaping franchising today include the changing face of franchisees; international franchise opportunities; smaller, nontraditional locations; conversion franchising; multiple-unit franchising; master franchising; and piggybacking (or combination franchising).

DISCUSSION QUESTIONS

1. What factors should an entrepreneur consider before choosing a form of business ownership?
2. Why are sole proprietorships so popular as a form of ownership?
3. How does personal conflict affect partnerships?
4. What issues should the articles of partnership address? Why are the articles important to a successful partnership?
5. Can one partner commit another to a business deal without the other's consent? Why?
6. What issues should the certificate of incorporation cover?
7. How does an S corporation differ from a regular corporation?
8. What role do limited partners play in a partnership? What happens if a limited partner takes an active role in managing the business?
9. What advantages does a limited liability company offer over an S corporation? A partnership?
10. How is an LLC created? What criteria must an LLC meet to avoid double taxation?
11. Briefly outline the advantages and disadvantages of the major forms of ownership.
12. What is franchising?
13. Describe the three types of franchising and give an example of each.
14. Discuss the advantages and the limitations of franchising for the franchisee.
15. Why might an independent entrepreneur be dissatisfied with a franchising arrangement?
16. What kinds of clues should tip off prospective franchisees that they are dealing with a disreputable franchiser?
17. What steps should potential franchisees take before investing in a franchise?
18. What is the function of the FTC's Trade Regulation Rule? Outline the protection the Trade Regulation Rule gives all prospective franchisees.
19. Describe the current trends in franchising.
20. One franchisee says, "Franchising is helpful because it gives you somebody [the franchiser] to get you going, nurture you, and shove you along a little. But the franchiser won't make you successful. That depends on what you bring to the business, how hard you are prepared to work, and how committed you are to finding the right franchise for you." Do you agree? Explain.

THE BUSINESS DISC

Launch *The Business Disc* and proceed to the section where Harry describes the basic forms of ownership. Although you may actually plan to create a corporation (either an S corporation or a C corporation) the Disc gives you two choices: a sole proprietorship or a partnership. For purposes of using the Disc, pick one of these as your form of ownership. What factors did you consider when making your choice? What are the advantages and the disadvantages of the form of ownership you chose?

If you are planning to buy a franchise, you should review the reference material on franchising on *The Business Disc*. From the menu across the top of your screen, select the "Reference" option and then click on "General Information." Click on "Complete Workshop on Franchising." Review the concepts in this reference guide and in Chapter 4. Then click on "Evaluating Franchises" and review the information in this reference guide. Develop a list of questions to ask the franchisers you are considering. Which franchise did you choose? Why?

BUSINESS PLAN PRO

Business PlanPro

Go to the section of the Business PlanPro called "Your Company" and complete the section concerning the form of ownership for your business. Use the comparison matrix of the major forms of ownership in Table 4.1 on page 116 to help you select the form of ownership that is best for you. Which factors are most relevant to your choice? Are you considering a franchise? If so, what are the advantages and disadvantages of buying a franchise? Use the process described on pages 127 to 130 to choose the ideal franchise for you. Which factors are most relevant to your choice?.

BEYOND THE CLASSROOM . . .

1. Interview five local small business owners. What form of ownership did each choose? Why? Prepare a brief report summarizing your findings, and explain advantages and disadvantages those owners face because of their choices.

2. Invite entrepreneurs who operate as partners to your classroom. Do they have a written partnership agreement? Are their skills complementary? How do they divide responsibility for running their company? How do they handle decision making? What do they do when disputes and disagreements arise?

3. Visit a local franchise operation. Is it a trade-name, product distribution, or pure franchise? To what extent did the franchisee investigate before investing? What assistance does the franchiser provide? How does the franchisee feel about the franchise contract he or she signed? What would he or she do differently now?

4. a. Consult a copy of the International Franchise Association publication *Franchise Opportunities Handbook* (the library should have a copy). Write several franchisers in a particular business category and ask for their franchise packages. Write a report comparing their treatment of the topics covered by the Trade Regulation Rule.

   b. Analyze the terms of their franchise contracts. What are the major differences? Are some terms more favorable than others? If you were about to invest in the franchise, which terms would you want to change?

5. Ask a local franchisee to approach his or her regional franchise representative about leading a class discussion on franchising.

6. Contact the International Franchise Association (1350 New York Avenue, N.W., Suite 900, Washington, DC, 20005-4709, (202-628-8000) for a copy of *Investigate Before Investing*. Prepare a report outlining what a prospective franchisee should do before buying a franchise.

A Franchiser Evaluation Checklist

THE FRANCHISER AND THE FRANCHISE

1. Is the potential market for the product or service adequate to support your franchise? Will the prices you charge be in line with the market?
2. Is the market's population growing, remaining static, or shrinking? Is the demand for your product or service growing, remaining static, or shrinking?
3. Is the product or service safe and reputable?
4. Is the product or service a fad, or is it a durable business idea?
5. What will the direct and indirect competition be in your sales territory? Do any other franchisees operate in this general area?
6. Is the franchise international, national, regional, or local in scope? Does it require full- or part-time involvement?
7. How many years has the franchiser been in operation? Does it have a sound reputation for honest dealings with franchisees?
8. How many franchise outlets now exist? How many will there be a year from now? How many outlets are company owned?
9. How many franchises have failed? Why?
10. What service and assistance will the franchiser provide? What training programs are offered? Are they continuous in nature?
11. Will the franchise perform a location analysis to help you find a suitable site?
12. Will the franchiser offer you exclusive distribution rights for the length of the agreement, or may it sell to other franchises in this area?
13. What facilities and equipment are required for the franchise? Who pays for construction? Is there a lease agreement?
14. What is the total cost of the franchise? What are the initial capital requirements? Will the franchiser provide financial assistance? Of what nature? What is the interest rate? Is the franchiser financially sound enough to fulfill all its promises?
15. How much is the franchise fee? Exactly what does it cover? Are there any confining fees? What additional fees are there?
16. Does the franchiser provide an estimate of expenses and income? Are they reasonable for your particular area? Are they sufficiently documented?
17. How risky is the franchise opportunity? Is the return on the investment consistent with the risks?
18. Does the franchiser offer a written contract that covers all the details of the agreement? Have your attorney and your accountant studied its terms and approved it? Do you understand the implications of the contract?
19. What is the length of the franchise agreement? Under what circumstances can it be terminated? If you terminate the contract, what are the costs to you? What are the terms and costs of renewal?
20. Are you allowed to sell the franchise to a third party? If so, will you receive the proceeds?
21. Is there a national advertising program? How is it financed? What media are used? What help is provided for local advertising?
22. Once you open for business, *exactly* what support will the franchiser offer you?
23. How does the franchise handle complaints from and disputes with franchisees? How well has the system worked?

THE FRANCHISEES

1. Are you pleased with your investment in this franchise?
2. Has the franchiser lived up to its promises?
3. What was your greatest disappointment after getting into this business?
4. How effective was the training you received in helping you run the franchise?
5. What are your biggest challenges and problems?
6. What is your franchise's cash flow like?
7. How much money are you making on your investment?
8. What do you like most about being a franchisee? Least?
9. Is there a franchisee advisory council that represents franchisees?
10. Knowing what you know now, would you buy this franchise again?

YOURSELF

1. Are you qualified to operate a franchise successfully? Do you have adequate drive, skills, experience, education, patience, and financial capacity? Are you prepared to work hard?
2. Are you willing to sacrifice some autonomy in operating a business to own a franchise?
3. Can you tolerate the financial risk? Would business failure wipe you out financially?
4. Can you juggle multiple tasks simultaneously and prioritize various projects so that you can accomplish those that are most important?
5. Are you genuinely interested in the product or service you will be selling? Do you enjoy this kind of business? Do you like to sell?
6. Do you enjoy working with and managing people? Are you a "team player"?
7. Will the business generate enough profit to suit you?
8. Has the franchiser investigated your background thoroughly enough to decide if you are qualified to operate the franchise?
9. What can this franchiser do for you that you cannot do for yourself?