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Franchising: Promises, Problems, Prospects

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During the last two decades, the growth in the franchise system of distribution has been explosive. By 1976, franchised businesses totalled 458,000 outlets and accounted for $195 billion in sales.[1] Nevertheless, franchising in the 1970s differs substantially from franchising in the 1960s. The "cowboy" days of franchising are gone and will never return. This article will attempt to place in perspective the events concerning franchising in the last two decades and will examine the prospects for franchising in the future.

Specifically, the purpose of this article is threefold: to explore (1) the *promise* of franchising; (2) the *problems* of franchising; and (3) the *prospects* of franchising. That is, we shall (1) examine the purported benefits of franchising to society, franchisees, and franchisors; (2) analyze some of the misfortunes that have plagued franchising in recent years, and (3) attempt to forecast the future for franchising in the next decade.

THE PROMISE OF FRANCHISING

What are the advantages of franchising? What are the benefits of the franchise system of distribution to our society? Why would individuals be interested in owning a franchised business instead of a "completely independent" business? In short, what is the promise of franchising? In the 1960s, franchising was touted as holding great promise for (1) society in general, (2) franchisees, and (3) franchisors.

Society in general should benefit from franchising because of (1) decreased economic concentration; (2) lower failure rates for franchised businesses; and (3) increased opportunities for minorities and women. Many social commentators have viewed with alarm the increasing role that giant corporations, often vertically integrated, play in our economy. Advocates of franchising have pointed out that franchising offers a viable alternative to completely integrated vertical chains. For example, Zeidman suggests:

> Franchising may well be the only feasible alternative to the increasing vertical integration of so many segments of our economy. It may well be one of the most promising hopes for the preservation of the independent small businessman in our society.[2]

It is often observed that business failures result in wasted resources and economic disruption. A second advantage of franchising for society stems from the purportedly lower failure rates of franchised businesses vis-à-vis completely independent businesses. Curry, *et al.*, proposed that "history has shown that franchising has reduced 'financial' failures considerably."[3] Similarly, Oxenfeldt and Thompson noted: "Failures are substantially lower than among comparable independent businessmen."[4]

During the past decade, the improvement of the economic condition of minority groups and women has become a major societal objective. A final potential benefit to society is the opening up of opportunities for minorities and women to own their own businesses—to get a "piece of the action." Lapin, among many others, has suggested that franchising could play a prominent role: "There is no form of business, or method of distribution that is more ideally suited to solve the special problems of minority citizens seeking economic betterment, than franchising."[5]

To *franchisees,* franchising held out the promise of all the advantages of belonging to a large chain while, at the same time, being an independent businessperson. To enable franchisees to compete effectively with corporate chain stores and others, franchising offered (1) tradenames and trademarks, (2) preopening assistance, and (3) postopening assistance.

Unquestionably, one of the major potential advantages of a franchise is the tradename of the franchise. All the goodwill (and "badwill") associated with the franchisor's tradename can be transferred to the franchisee's business. Likewise, of great value can be the franchisor's preopening assistance, such as: site selection, building plans, training programs, operating manuals, assistance in finding suppliers, and "grand opening" supervision. Finally, postopening assistance can be valuable to a franchisee. These would include: advertising, bookkeeping, supplies, field supervision, and counseling. Perhaps Diaz best summarizes why individuals seek franchises:

> It is apparent that they were attracted to franchised businesses because the "franchise package" (what they were getting for their investment) was recognized as superior to the "package" that the franchisee as an individual could create through his singular efforts. Perhaps the most difficult business ingredients for an individual business to develop are the very components of the "franchise package" which often includes all or most of the following: established name and reputation, widely advertised brands, popular store design, carefully chosen location, standardized procedures and operations, and initial and continuing assistance (e.g., franchisor training, financing, and research).[6]

To potential *franchisors*, franchising held out the promise of the "American Dream," the dream of "making it big." An entrepreneur with only a small retail establishment or, perhaps, only an idea or concept for a business, could build a large and profitable organization around that idea, concept or establishment. Since franchisees customarily put up most of the capital for their units, a franchisor with very little capital of his own could create a large chain quite rapidly. That is, firms often choose the route of franchised units because they simply do not have access to the capital required to expand via company-operated units. Many franchisors candidly admit that they would have preferred all company-operated units but that capital requirements dictated franchising:

> Hardee's would have preferred not to have franchised a single location. We prefer company-owned locations. Here again, profits. But due to the heavy capital investment required, we could only expand company-owned locations to a certain degree—from there we had to stop. Each operation represents an investment in excess of $100,000; therefore, we entered the franchise business.[7]

A second promise of franchising to the franchisor is the "franchising ethic." Simply put, the "franchising ethic" says that franchised units combine the best of both worlds, the sophisticated business procedures of a large company (the franchisor), and the drive and initiative of the independent owner-manager (the franchisee). Since franchisees *own* their units, they can be expected to work harder and be more conscientious than managers of company-operated units. Thus, the franchising ethic implies that franchisors get better managers for their units through franchising than by owning the units themselves.

Such was the promise of franchising: a boon for everyone. Society would get decreased economic concentration, fewer business failures, and more opportunities for minorities and women. Franchisees would own their own businesses and still compete effectively with the corporate chains. And each new franchisor was sure that his franchise system would follow in the successful footsteps of McDonalds and Kentucky Fried Chicken. What could go wrong? Lots.

THE PROBLEMS OF FRANCHISING

Starting in the late 1960s, serious problems began developing concerning franchise systems of distribution. By the early 1970s, the franchise boom was over; the bubble had burst. To highlight this point, in the 1960s there were three franchising magazines: *Franchising Around the World, Modern Franchising,* and the *Franchise Journal.* None of these magazines is publishing today.

The fact that the bubble has burst does not imply that franchising is no longer an important economic force—for it clearly is. Rather, the *euphoria* is gone. Franchising is no longer viewed as a panacea for society's ills. An examination of some of the problems of franchising reveals why the bubble burst.

Problems for Society. The potential benefit of decreased economic concentration became highly suspect when franchise chains such as Howard Johnsons and MacDonalds began buying back their profitable units.[8] Marketing theorists began proposing that franchising is not a "permanent" system of distribution. Rather, they hypothesized that franchise chains would ultimately become wholly-owned corporate chains.[9] The present writer pointed out several powerful reasons for franchisors preferring corporate-owned and managed units: (1) greater profits per unit; (2) greater control over the units; and (3) fewer legal problems.[10] The same research indicated that in restaurant franchising the percentage of total units that were company operated rose from 1.2 percent in 1960 to 11.3 percent in 1971. Furthermore, the large chains were expanding their company-operated units more rapidly than the small chains. Thus, the "decreased economic concentration" argument began to appear tainted.

The notion that society would benefit because of the low failure rate of franchised businesses also became suspect. Although many commentators have stated that few franchised businesses ever fail, the only "hard" evidence comes from a study by Atkinson which found: "Even if the actual franchise failure were actually eight times greater than reported, it would still pay an investor to be franchised rather than start an independent small business."[11] Unfortunately, a careful analysis of the methodology used in the Atkinson study revealed such great errors in data analysis that the International Franchise Association agreed to remove the book from circulation.[12]

Evidence began to mount that many franchises were failing. One study identified 54 entire restaurant franchise systems that turned "belly up" over a two-year period.[13] A Conference Board report carefully reviewed all available information and could find no "solid evidence" that franchisees have either a better or poorer chance for business survival than do similarly qualified independent entrepreneurs. Nevertheless, the report concluded with an *a priori* reason for favoring franchising:

> [However] it is worth noting that literally anyone with sufficient capital can go into business. But franchisees start out as a "screened" sample of the business population.[14]

Minority groups and women have also not reaped the promised benefits of franchising. Granted, many franchisors, such as MacDonalds and Kentucky Fried Chicken, developed special programs to recruit minorities and women. Granted, franchisors have cooperated with the Office of Minority Business Enterprise in joint programs to attract minorities. And granted, the Small Business Administration has worked with franchisors to attempt to finance new minority franchisees. Nevertheless, members of minority groups owned only 1.5 percent of "nontraditional" franchises in 1973 and 1.8 percent in 1974.[15] Recent studies also indicate that women owned only 6.5 percent of franchised businesses in 1976.[16] Franchisors have encountered substantial problems in financing, recruiting, and training women and minority group franchisees. One study concludes:

> In summary, the total real economic contribution of franchising, as a vehicle for black capitalism, tends to be exaggerated by both government and industry proponents. Franchising can and should make a contribution to improving the integration of minority groups into the economic system; but it may be

> unwise (if one is seriously concerned about implementing black capitalism goals) to rely on new black franchisees as a principal vehicle for black capitalism.[17]

Problems for Franchisees. Franchisees have also not received all the promised benefits of franchising. Instead of receiving a valuable, well-known tradename that would bring customers into their establishments, many franchisees found themselves with tradenames that had no drawing power. In particular, many franchisees were lured to franchise systems that were associated with prominent sports figures or entertainment stars. Most of these franchisees were unaware that in almost all cases the prominent persons associated with these systems had little to do with the management of the chain and had simply sold their names to the organizers of the systems. Most of these "celebrity" franchise chains have since folded after absorbing the savings of hundreds, perhaps thousands, of franchisees.

Franchisees also began finding the rosy profit projections of franchisors to be deceptive. Instead of successful businesses, many franchisees found themselves working over 60 hours per week for, essentially, less money than they could make as employees for someone else. One study of 282 restaurant franchisees showed that 92 percent of them were earning *less* than the profit projections that their franchisors were using in current promotional literature.[18]

Also, many of the promises of franchisor "assistances" were not delivered. Franchisors claim the advantage of "mass purchasing power." However, instead of being able to purchase supplies less expensively through the franchisor, many franchisees found themselves paying exorbitant prices for supplies. As examples, the Select Committee on Small Business found that a large restaurant chain was buying maraschino cherries for $1.50 a gallon and selling them to franchisees for $4.50. Further, a pizza chain was buying spices for $3 and reselling to franchisees for $21.50.[19] One disillusioning study found that (1) the practice of requiring franchisees to purchase supplies from their franchisors is widespread; (2) franchisees believe they are being overcharged on their supplies; and (3) franchisees who must buy supplies from their franchisors suffer lower profits.[20]

Finally, franchisees began to be alarmed at the lack of *security* in their franchises, since franchisors could terminate their agreements or fail to renew them. Terminations usually result from one of three general causes: (1) expiration of the term of the contract; (2) franchisee bankruptcy; or (3) some default in the franchisee's performance. Problems arose when franchisees perceived that their contracts were being terminated on arbitrary grounds. This "capricious termination" problem has been termed the "Achilles Heel" of the entire franchising industry.[21]

Critics of franchising point out numerous instances where franchisors have used the "stick" of threatened termination to get franchisees "in line." Consider the following excerpt from a letter sent to all franchisees of an ice cream system:

> Because I feel you [by raising prices] may be putting our whole program in jeopardy, as of this letter, as each lease comes up for renewal, we will review each case individually as to whether we will renew your lease or exercise our prerogative under the franchise agreement to buy back your store at 30 percent of your purchase price. . . ."[22]

Previous research has indicated that 77 percent of a sample of restaurant franchisees perceived a strong need for legislation protecting them from arbitrary termination.[23] Trade associations of franchisees are pleading for such protective legislation:

> We are here because the problem of imminent termination and the even greater threat of abusive use of our franchisor's self-proclaimed "right not to renew" endangers our investments and business lives, and immediate legislative action must be undertaken to protect us. We are threatened with absolute forfeiture to our entire investment because traditional legal concepts do not apply easily to franchising and abuse which is rife in franchising can only be corrected with new federal law.[24]

Problems for Franchisors. Although some franchisors have found the "promised land" through franchising and have grown to giant organizations, the experiences of many franchisors range from substantial problems to outright disasters. As previously mentioned, in the late 1960s and early 1970s scores of fledgling franchise systems and (even) some mature systems entered bankrupcy. Thus, many have found disaster in franchising. Successful franchisors also came to realize that they could make greater profits through company-operated units than via franchised units and that the trade-off for the higher motivation of the franchised owner-manager and the franchisee-supplied capital was *lack of uniformity* throughout the system and *lack of control:*

> Better management control is another reason we have company-owned stores . . . Policies, graphics, advertising,

> merchandising, quality control, remodeling, repairs—how do you convince a franchise dealer that even if a store is only ten years old, he must invest more of his own money for remodeling?[25]

Litigation and legislation have represented other major problems for franchisors. Commentators on contemporary American society suggest that we are turning into a nation of litigants. Franchisees, either single or in "class actions," are bringing suit against their franchisors in ever-increasing numbers. Usually, the suits involve charges that the franchisor either (1) misrepresented the profitability of their franchises, or (2) unfairly attempted to terminate franchisees' contracts, or (3) illegally attempted to force franchisees to purchase supplies from the franchisor. Almost every single major franchisor has been involved in litigation within the last few years. Although the suits were not always successful, the costs of legal fees, damages awarded by courts (sometimes trebled because of antitrust violations), and out-of-court settlements have been staggering.

Recent legislation also poses a problem for franchisors. Many state legislatures have passed legislation regulating the activities of franchisors. In response to charges of misrepresentation in the selling of franchises, many states (23 as of this writing) began passing "full disclosure" laws. These laws are designed to protect franchisees from franchisor misrepresentations by requiring each franchisor to provide potential franchisees with sufficient unbiased information to enable them to make sound investment decisions. These disclosures include such items as the background of the franchisor principals, a recent financial statement, franchise fees, royalties, termination provisions, and any requirement to purchase supplies from the franchisor.

In response to "unfair terminations" of franchises, many states have passed so-called "fair practice" laws. These laws generally prohibit franchisors from terminating or failing to renew a franchise without "good cause." Sometimes the laws go further and regulate franchisor practices in such areas as the selling of supplies to franchisees, discriminating among franchisees with regard to royalties, and competing with franchisees in their market areas. As of this writing, ten states have passed such laws for all franchisees in their states. Numerous other states have passed fair practice laws limited solely to automobile dealers, service station operators, or liquor distributors.

In the federal arena, there is substantial legislation pending. There are two national "full disclosure" acts pending in the United States Senate (S.3844 and S.2870). Also, there are "fair practice" acts pending in the Senate (S.2355) and House of Representatives (H.R.8349 and H.R.8982). Finally, the Federal Trade Commission is considering a trade regulation rule on "full disclosure." Of all this pending legislation, the F.T.C. trade regulation rule is the most likely to become law.

THE PROSPECTS FOR FRANCHISING

What does the future hold for franchising; what are its prospects? All available evidence suggests that, although the bubble has burst, franchising's demise is not imminent. Certainly, the total number of franchised units continues to rise. United States Department of Commerce figures show that the total of franchised units grew 8.4 percent between 1972 and 1974, and 14.7 percent from 1974 to 1976—that is, from 368,000 in 1972 to 399,000 in 1974 and 458,000 in 1976.[26]

Other evidence concerning the future growth of franchising comes from a survey of franchisors prepared for this article. A systematic sample of franchisors was taken from the *Franchise Opportunity Handbook*[27] in the five areas of business aids, automobile service, convenience/specialty stores, employment services, and restaurants. Eighty of the 232 franchisors returned completed questionnaires for a response rate of 35 percent.

Franchisors seem optimistic about their expansion plans for the future. Table I shows the survey results for each of the five categories of franchises. Note that in every single industry franchisors expect to increase or substantially increase their franchised units during the next five to ten years. Note also that they do not plan to expand their company-operated units as fast as their franchised units.

Although franchisors are notoriously overly optimistic, this author sees merit in their forecasts. Most franchise systems deal in *services*, not *products*. During the last two decades our economy has steadily become more service-oriented. For example, meals eaten in restaurants take an increasing share of the food dollar. No doubt the trend toward services will continue, and this bodes well for the future growth of franchising.

Franchisors' expectations of increasing franchised units faster than company-operated units contradicts previous findings. Perhaps the trend has, indeed, shifted back to franchised units and away from company-operated ones. However, perhaps franchisors are not being very candid with themselves. Further, the sample of franchisors might be naturally biased toward franchised units. It is worth noting that the sample comes from the *Franchise Opportunity Handbook* and *only franchisors who are actively seeking franchisees* allow themselves to be listed in this publication. Thus, systems seeking growth through company units were probably underrepresented. To this author, the "trend toward company units" still seems a viable long-term hypothesis.

The next decade will also see the rise of more associations of franchisees within and across franchise organizations. Dozens of franchise systems already have franchisee associations to represent the collective interests of their members. Such associations attempt to set up grievance procedures with the franchisor, mediate franchisee-franchisor disputes, provide systematic feedback to the franchisor concerning franchisee problems, and attempt to provide franchisees with a sense of "security" similar to what a union provides its members. The problem of physical distance separating franchisees poses a tremendous barrier to an association's development. Nevertheless, these associations will continue to multiply if for no other reason than franchisee-franchisor litigation will continue to increase in the foreseeable future and associations are natural vehicles through which to initiate class action suits.

During the next decade there will unquestionably be more legislation regulating franchising. When respondents in the study prepared for this article were asked to identify the major problems facing franchising in the next five to ten years, the most often mentioned problem was government regulation/legislation, followed by increasing costs/inflation, market saturation/competition, raising capital, and finding good real estate. As one restaurant franchisor put it: "Government regulation will be the biggest problem. Pending legislation, discussion, and court rulings make the future look confusing (if franchising will be able to continue at all)."

Previous research by this author on state "full disclosure" laws found them to be effective in reducing the incidence of franchisors misleading prospective franchisees concerning the potential profitability of their franchises.[28] However, this benefit is not

TABLE I

Expansion Plans of Franchises for Next Five to Ten Years

	FRANCHISED UNITS						COMPANY-OPERATED UNITS					
	Substantially Increase	Increase	Remain Constant	Decrease	Substantially Decrease	*N*	Substantially Increase	Increase	Remain Constant	Decrease	Substantially Decrease	*N*
Business Aids	35%*	50%	15%	0%	0%	20	13%	31%	50%	6%	0%	16
Automotive	80	14	0	0	5	21	24	43	24	5	5	21
Convenience/ Specialty	100	0	0	0	0	3	33	33	33	0	0	3
Employment Services	67	25	8	0	0	12	18	27	46	9	0	11
Restaurant	30	57	4	4	4	23	9	59	27	5	0	22
Average percent	62%	29%	5%	2%	2%		19%	39%	36%	5%	1%	

N = Number of franchise systems.
*Read: 35 percent of the 20 Business Aids franchise systems expect to substantially increase the number of their franchised units in the next five to ten years.

costless; there is no "free lunch." The same research found the growth rate of franchising in states with full disclosure laws to be lower than the rate in other states. The decrease in growth rates would be socially desirable if it were primarily the result of a decrease in the activity of unethical or "fly-by-night" franchises. However, such was not the case. The data base that documented the lower growth rates was confined *exclusively* to well-established franchise systems.

The same research showed that *smaller franchisors* were being squeezed out of states with disclosure laws because they cannot afford the attorneys' fees and registration costs. Respondents in the present survey voiced similar beliefs. One accounting service franchisor notes:

> Increasing regulation by state governments may force some of the smaller franchisors to stay out of their areas. Although the initial intent of the regulations is good, the real result of the complicated and varying laws may be to [discourage] small franchisors.

An automotive service franchisor addresses a similar issue:

> Because of a costly registration procedure, several smaller states have deprived their citizens of our service. For example, North Dakota has four population centers that would support our franchises but for us the proposition would be marginal because the field service would be very expensive from a time and distance standpoint. *Add registration expenses and we can't make enough money (if any) to justify the project.* [Emphasis added.]

What does the previous discussion imply for the future of small franchise systems? It appears that government regulation and legislation will result in fewer small franchise systems "making it" in the next decade. Department of Commerce figures show that less than 5 percent of all franchise systems account for over half of all franchised units.[29] Ironically, this level of concentration will probably increase as an indirect consequence of governmental activities.

In conclusion, franchising is still a strong and growing system of distribution. Nevertheless, in recent years there have been substantial problems, and there will be more such problems in the future. It appears to this researcher that the fundamental underlying problem has not been the *promise* of franchising, but the *overpromise* of franchising.

Advocates of franchising attempted to make it a panacea; franchising was supposed to solve all society's ills. Franchising fell short and began to incur problems when it could not reach such an *unreasonable* standard of performance. That is, it appears to this author that franchising *does* reduce economic concentration, *does* help minorities and women to own businesses, *does* help independents compete with chain stores, *does* provide valuable trademarks, tradenames and assistance to franchisees, and *does* hold out the promise of the "American Dream" of "making it big." Unfortunately, in *none* of these situations has franchising performed up to the lofty levels its advocates promised. Given that the fundamental problem is one of *overpromising,* is it possible that society may be *overreacting* with excessive legislation and litigation? The temptation may be just too great.

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