

IFA 41st Annual Legal Symposium

Construction Excerpts from the report entitled Solid to Open: Issues Faced by Franchise Companies in “Onboarding” Franchisees

IV. Pre-Opening Support Beyond Site Selection

As suggested in the Introduction, too many franchisors may not devote adequate resources to critical aspects of pre-opening support. If franchisors analyze reasons why franchisees struggle, in many instances those struggles can be traced to decisions made well before the franchisee opens for business. Was the construction/build-out completed in a timely manner and does it meet the franchisor’s design requirements? Does the franchisor’s store design maximize branding opportunities, operational efficiencies and return on investment? Does the franchisor’s training program adequately prepare the franchisee and its employees for operating the business effectively and efficiently?

Each of these questions and other similar questions related to pre-opening are critical to the franchisor who takes its role as franchisor seriously. For example, the building design or interior layout of a franchisee facility is an extension of the franchisor’s branding and marketing initiatives. The building design and construction also play a significant role on the franchisee’s return on investment and ongoing cash flow. Few would argue that franchisee training also is critical to the success of the business. The franchisee and employees complete initial training one time and one time only. This initial training will shape the franchisee’s and its employees’ attitude and execution on the daily operation of the franchised business, including, most importantly, customer service. Given the critical nature of those various aspects of pre-opening support, we repeat the theme we have established throughout this paper. Rather than the primary focus on avoiding legal exposure, franchisors are better served by balancing the business and legal issues with an approach that takes advantage of the franchisor’s experience and resources and the providing meaningful support that will enable franchisees to open their business successfully.

A. Types of Support

The highly successful franchisor includes several key components in its pre-opening support in addition to site selection assistance. The franchisor’s approach in deciding what types of pre-opening support to provide is based on its business model (retail versus service, mall based or not), its resources (does the franchisor have the resources to build its own construction department or is the function outsourced), and other relevant factors. Further, just as a franchisor constantly looks to improve the products or services offered to customers, it also must strive to enhance and improve the pre-opening support it provides franchisees.

Regardless of the support types, the franchisor's philosophy and culture on accountability and responsibility, as noted in Section II.B, should remain constant. For example, the franchisor's construction specialist must perform with the same principles that he will explain the construction process to the franchisee and how the franchisor will support the franchisee in that process. The construction specialist then follows through on the process and keeps promises. Similarly, as described in Section II.A, a franchisee's expectations regarding pre-opening support beyond site selection generally are the same as the site selection expectations. The franchisee seeks to understand all types of the pre-opening assistance the franchisor will provide, the process that it should follow to gain access to the franchisor's experience, and then it wants its franchisor to keep promises and deliver on that support.

This section IV.A describes briefly the types of support that a franchisor may provide to franchisees beyond site selection.

1. Building Design/Architectural Plans

All franchisors with retail-based businesses have the following options as they consider how to approach building design support: (i) outline general design criteria without specific plan requirements and then allow franchisees to take charge of the build out, provided that the general design criteria are met when the project is completed and the business is ready to open; (ii) outline general design criteria, but then require that the franchisee develops building or architectural plans that are subject to the franchisor's approval before any construction commences; or (iii) require that the franchisee use the franchisor's approved architect or approved building plans modified only to meet certain local requirements. Other options may exist depending on the franchisor and its business, but these three are the most common.

In deciding which approach to pursue, a franchisor should consider the following pressure points:

a. The franchisor must understand its own capabilities and resources for these services. How many units will be built in the next year or two and do they want or need the in-house capability versus outsourcing.

b. How complex is the design and build out of the facility? For example, if the facility has complex plumbing or electrical connections or requires precise finishes, the franchisor will want more detailed plans, rather than general design criteria. On the other hand, in certain in-line businesses with an office setting, general criteria are more acceptable, provided the franchisee follows the general office layout and color schemes.

c. Can the franchisor develop prototypical plans that a franchisee's construction team can follow easily? Do plans include components that may need modification to comply with local standards?

d. Is the franchisor willing to limit the number of architects approved to work on franchisee plans? If the franchisor does limit, it must confirm that the architects are capable, insured, and licensed to work in the states where franchisees are building units. They also must be reasonably priced. Finally, the franchisor must constantly monitor any outsourced service providers to ensure that they are meeting deadlines, delivering on commitments and providing quality services.

2. Construction

Many franchisors provide guidance to their franchisees during the construction phase. If the franchisor has the resources, a common approach is for franchisors to monitor or coordinate franchise projects to make sure that the various components are done on time and in compliance with applicable governmental or franchisor standards. This approach is particularly common if the franchisor has any corporate owned outlets or has played an active role in construction management due to the franchisor's familiarity with the construction issues related to municipal and/or governing agency approval processes, sequencing strategies and deliverables of materials and equipment, and closeout processes in preparation for the opening. A franchisor who is developing or has developed a national franchise system has been exposed to many different process and execution scenarios, and provides a significant benefit to franchisees and the franchise system generally if it shares its construction strategies and experience with franchisees. This approach also will help franchisees avoid delays in the construction build-out process. In addition, the franchisor and franchisee build a level of trust and confidence in each other. Lastly, open and constant communication between the franchisor and franchisee during the construction phase is critical to ensure the unit's timely completion in accordance with the franchise agreement's obligations.

The construction coordination process typically includes review of all plans, coordinating and negotiating bids, direct contact with contactors, and periodic review at various points during the process to ensure timely completion and address any issues immediately, rather than at the time the franchisee believes he is ready to open, but then opening is delayed due to the franchisor identifying construction problems. A number of franchisors also will include some form of lease negotiation or assistance as part of its construction coordination. The purpose for the lease support is to enable the franchisee to get the location it needs without getting bogged down in lease discussion and negotiations, which can be overwhelming to a franchisee who has little or no real estate or lease experience. Lease support or assistance can be as simple as providing forms and information to franchisees or it can include direct discussions and involvement with brokers and landlords.

Other approaches a franchisor might consider with the construction component are:

(i) a “hands-off” approach where the franchisor exerts little or no control or guidance, which may limit franchisor liability, but can cause significant delays if the franchisee fails to meet any required guidelines or standards;

(ii) a franchisor-approved contactor or contractors, in effect outsourcing the management function to these third parties, which can work if the contractor has specific experience with the franchisor’s units and a proven track record, but must be balanced with the elimination of an aggressive and competitive bid process; and

(iii) a turn-key approach where the franchisor builds the location and then sells or leases it to the franchisee.

Regardless of the franchisor’s approach, the following are some due diligence issues a franchisor should consider and share with its franchisees prior to construction (the importance of these issues varies widely depending on the franchisor and its prototypical facility):

(i) identify municipal and governing agency design review processes and timelines;

(ii) identify permitting timelines;

(iii) identify trade dress review and approval;

(iv) identify utility tap fees, as further described below,

(v) understand non-union versus union construction costs (union costs may range from 15%-30% over non-union depending on region);

(vi) note that development of a historic buildings may be costly to renovate or present trade dress limitations due to historic design restrictions;

(vii) if franchisee plays the lead role, teach the franchisee how to properly qualify a construction bid based on historical figures from franchisor development; understand differences in process and costs between endcap and freestanding build-outs; and

(viii) understand landlord deliverables prior to property possession by franchisee.

Each of these issues has several subparts that a franchisor should fully understand as it decides on its approach to the level of construction support it provides to franchisees. The following sections explore a few of those issues in more detail.

Understand the Construction Climate of a Region

Is the area where the location is being built union or non-union? Union involvement can increase certain costs significantly. Construction costs also can be higher due to unavailable trades and labor resources in hot markets such as Arizona, California, Texas, Nevada, Florida, Illinois, and New York. In addition, the construction industry has experienced intense pricing pressures and availability of materials over the past 10 years.

Are bidders qualified and well resourced to undertake the project? Because of market pressures and demand in the industry today, new general contractors enter the market many times under resourced and under financed to execute properly. In order to avoid unqualified contractors, the franchisor may want to provide a list of approved general contractors for a franchisee's use. Even if the franchisor does not have an approved list, it should identify minimum industry requirements for general contractors.

Identify Permitting Timelines & Fees

Franchisors should generally advise franchisees how much time it may take for local agencies to review, comment, and approve the construction documents for the necessary building permits. The franchisor or franchisee also must consider whether the state is required to review. For example, does the permitting process include special committee reviews such as design review board, historic review board, signage & trade dress review boards, or state reclamation boards? This process may take months above and beyond standard municipal review timelines. Alternatively, the franchisor or franchisee should determine if the municipality has permit expeditors to undertake the above referenced processes. Significant time and money can be saved using an expeditor.

One other key area that is often overlooked is costs associated with permitting and utility tap fees. Tap fees are almost always underestimated in a franchisor/franchisee construction proforma. These costs can be excessive and alter the economics of a project. For example, utility water tap fees in certain states like California or Colorado can exceed \$75,000 for a typical 2-inch water line and more for a 6-inch fire line. If these costs are not included in construction due diligence prior to the launch of the project, the project may be doomed from the beginning because of cost overruns.

Based on the myriad construction-related issues, each franchisor should understand the critical nature of construction support for franchisees. System development and unit openings suffer when franchisees are left alone to shoulder the burdens of procurement

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when inexperienced in industry pricing, practices and methods. As we have noted, the key is that the franchisor must clearly communicate the level of support that it will provide and then deliver on that commitment.

The franchisor may provide a high level of support or little support. Regardless of the level, the key is to provide the promised support. Further, if the franchisor develops a construction vendor/consultant network, it should do so to provide franchisees with predictability and consistency of the build-out process in order to ensure timely delivery. A well designed and established vendor/consultant network should provide advantageous pricing and capacity to deliver products and services in a shorter period of time compared to regional vendors.

The entire IFA report was written by Brian C. Schnell, CFE, Partner, of Faegre & Benson LLP, for the IFA 41st Annual Legal Symposium in Washington, DC, May 11-13. Universal Consulting, Inc. contributed to the above referenced paragraphs related to construction practices and options.