Franchising, Joint Ventures, Co-Branding and Licensing

UNTIL THIS POINT, THE FOCUS OF THIS BOOK HAS been on the many ways to raise equity or debt capital to facilitate the growth of your business. As we have seen, equity has its costs in dilution of ownership and control, and debt can weigh heavily on an entrepreneur both because of the burden of repayment and because of the accompanying covenants that will govern and restrict day-to-day operations. Therefore, some entrepreneurs choose an alternative strategy when it comes to developing ways to grow their businesses—one that uses the resources of *others* to meet *their* growth objectives.

You may be thinking, "Wait a minute, using the resources of others to implement my business plan sounds a little like grand larceny!" Of course, it's not. We're talking here about *leveraging your intangible assets* and *developing strategic relationships* through such means as franchising, joint ventures, co-branding and licensing to meet your business-planning and growth objectives. These strategies are not only an efficient way to build your brand awareness, customer base and market share but also are a cost-effective way to achieve growth compared with traditional capital-formation strategies.

For example, a successful chain of five retail stores could go into the capital markets seeking to raise debt or equity to build five more stores. *Or* it could invest an amount equal to the cost of one store into building the systems and infrastructure for franchising 50 stores. Similarly, a young technology company could try to raise the money to build distribution channels and brand awareness from scratch. *Or* it could achieve virtually overnight recognition by seeking joint ventures, strategic alliances and co-branding relationships with already established companies operating in the same marketplace. Finally, an early-stage medical-products company could spend the next 12 to 18 months searching for capital to complete its research and development and find many hurdles in bringing its proprietary product to the market. *Or* it could streamline its costs and overhead by finding an already established medical-products conglomerate to license the proprietary technology and pay license fees and royalties for the rights to use that technology.

Franchising can be viewed as an alternative growth strategy because the original founders of a company avoid dilution of their ownership and are no longer directly responsible for the financial investment needed to fuel future growth and expansion.

As you can see, these strategies may be viable alternatives to traditional capital formation, and in some cases they should be carefully considered as a lead strategy, with capital formation for internal growth as the backup plan. In other cases, such as business-format franchising, it will still be necessary to raise some money so that you have the resources to properly recruit and support your franchisees, but it is likely to be far less than you would need to develop all of these markets yourself, and the capital is likely to cost less, too.

Let's take a look at these strategies in greater detail, starting with franchising.

Business Format Franchising

Franchising can be viewed as an alternative growth strategy because the original founders of a company avoid dilution of their ownership and are no longer directly responsible for the financial investment needed to fuel growth and expansion. Instead, this financial responsibility is shifted to third-party franchisees and area developers who pay the franchisor for the right to use its trademarks and systems in exchange for initial franchise fees and royalties. Over time, this income stream can be a very valuable and lucrative asset around which an estate plan can be built.

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Over the past three decades, franchising has emerged as a popular expansion strategy for a variety of product and service companies. Retail sales from franchised outlets make up about half of all retail sales in the U.S. (estimated at more than $850 billion) and employ some nine million people. You don't have to have the ambition to become a national or multinational corporation to consider franchising, which can be an especially effective option for smaller businesses that cannot afford to finance internal growth. But franchising as a method of marketing and distributing products and services is appropriate only for certain kinds of companies. A host of legal and business prerequisites must be satisfied before any company can seriously consider franchising as a method for rapid expansion.

Many companies prematurely choose franchising as a growth alternative or exit strategy, then haphazardly assemble and launch the franchising program. Other companies are urged to franchise by unqualified consultants or advisers who may be more interested in professional fees than in the long-term success of the franchising program. This has caused financial distress and failure at both the growing company and franchisee level, usually resulting in litigation. Current and future members of the franchising community must be urged to take a responsible view toward the creation and development of their franchising programs.

The Essentials of Franchising

Responsible franchising starts with an understanding of the strategic essence of the business structure. There are three critical components of the franchise system: the brand, the operating system and the ongoing support provided by the franchisor to the franchisee.

First, the brand creates the demand, allowing the franchisee to initially *attract* customers. The brand includes the franchisor's trademarks and service marks, its trade dress and decor, and all the intangible factors that create customer loyalty and build brand equity. Next, the operating system essentially delivers the promise, allowing the franchisee to *maintain* customer relationships and build loyalty. Finally, the ongoing support and training provide the impetus for growth, providing the franchisee with the tools and tips to *expand* its customer base and build its market share.

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The responsibly built franchise system is one that provides value to its franchisees by teaching them how to get and keep as many customers as possible, who consume as many products and services as possible—and as often as possible. In fact, most litigation in franchising revolves around the gap between the *actual* needs of the franchisees to remain competitive in the marketplace and the *reality* of the support the franchisor is able to provide. The genesis of the disappointment often begins during the recruitment phase and continues beyond the start-up as the franchisee struggles to remain competitive, *unless* the franchisor delivers on its promises and is committed to providing excellent initial and ongoing training and support.

Reasons for Franchising

There are many reasons why successful growing companies have selected franchising as a method of growth and distribution. By franchising their product or service, these companies can:

- **obtain operating efficiencies** and economies of scale;
- **achieve more rapid market penetration** at a lower capital cost;

- **reach targeted consumers** more effectively through cooperative advertising and promotion;
- **sell products and services** to a dedicated distributor network;
- **replace the need for internal personnel** with motivated owner-operators; and
- **shift the primary responsibility** for site selection, employee training, personnel management, local advertising and other administrative concerns to the franchisee.

Franchisees typically share the risk of expanding the market share of the growing company by committing their capital and resources to the development of satellite locations modeled after the proprietary business format of the growing company.

In the typical franchising relationship, the franchisee shares the risk of expanding the market share of the growing company by committing its capital and resources to the development of satellite locations modeled after the proprietary business format of the growing company. The risk of business failure of the growing company is further reduced by the improvement in competitive position, reduced vulnerability to cyclical fluctuations, the existence of a captive market for the growing company's proprietary products and services (due to the network of franchisees) and the reduced administrative and overhead costs enjoyed by a growing company.

The Foundation for Responsible Franchising

Responsible franchising is the *only* way that growing companies and franchisees will be able to co-exist harmoniously in the 21st century. Responsible franchising means that there must be a secure foundation from which the franchising program is launched. Any company considering franchising as a method of growth and distribution or any individual considering franchising as a method of getting into business must understand the components of this foundation. The key components are:

A proven prototype location (or chain of stores) that will serve as a basis for the franchising program. The store or stores must have been tested, refined and operated successfully and be consistently profitable. The success of the prototype should not depend too much on the physical presence or specific expertise of the founders of the company.

A strong management team made up of internal officers and directors (as well as qualified consultants) who understand both the particular industry in which the company operates and the legal and business aspects of franchising as a method of expansion.

Sufficient capitalization to launch and sustain the franchising program. Capital should be available for the growing company to provide both initial and ongoing support and assistance to franchisees. A poorly prepared business plan and inadequate capital structure are often the principal causes of failure of early-stage franchisors.

A distinctive and protected trade identity that includes federal and state registered trademarks as well as a uniform trade appearance, signage, slogans, trade dress and overall image.

Proprietary and proven methods of operation and management that can be provided in a comprehensive operations manual, resist duplication by competitors, maintain their value to the franchisees over an extended period of time, and be enforced through clearly drafted and objective quality-control standards.

Comprehensive training program for franchisees that integrates all the latest education and training technologies and can be conducted both at the company's headquarters and on-site at the franchisee's proposed location, both at the outset of the relationship and on an ongoing basis.

Field support staff who are skilled trainers and communicators and who are available to visit, inspect and periodically assist franchisees as well as monitor quality control.

A set of comprehensive legal documents that reflect the company's business strategies and operating policies. Offering documents must be prepared in accordance with applicable federal and state disclosure laws, and franchise agreements should strike a delicate balance between the rights and obligations of the growing company and franchisee.

A demonstrated market demand for the products and services developed by the growing company that will be distributed through the franchisees. The growing company's products and services should meet certain minimum-quality standards, not be subject to rapid shifts in consumer preferences (fads) and be proprietary in nature. Market research and analysis should be sensitive to trends in the economy and specific industry, the plans of direct and indirect competitors, and shifts in consumer preferences.

A carefully developed set of uniform site-selection criteria and architectural standards that can be readily and affordably secured in today's competitive real estate market.

A genuine understanding of the competition (both direct and indirect) that the growing company will face in marketing and selling franchises to prospective franchisees, as well as the competition the franchisee will face when marketing products and services.

Relationships with suppliers, lenders, real estate developers and related key resources as part of the operations manual and system.

A franchisee profile and screening system to identify the minimum financial qualifications, business acumen and understanding of the industry that will be required for success.

An effective system of reporting and record keeping to maintain the performance of the franchisees and ensure that royalties are reported accurately and paid promptly.

Research and development capabilities for the introduction of new products and services on an ongoing basis to consumers through the franchised network.

A communication system that facilitates a continuing and open dialogue with the franchisees, and as a result reduces the chances for conflict and litigation with the franchise network.

National, regional and local advertising, marketing and public relations programs designed to recruit prospective franchisees as well as consumers to the sites operated by franchisees.

Regulatory Issues

The offer and sale of a franchise is regulated at both the federal and state levels. The laws governing the offer and sale of franchises began in 1970, when California adopted its Franchise Investment Law. Shortly thereafter, the Federal Trade Commission (FTC) convened hearings to begin development of federal law governing franchising. In 1979, it adopted its trade regulation rule 436 (the "FTC Rule"), formally titled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Venture." This rule specifies the minimum level of disclosure that must be made to a prospective franchisee in any of the 50 states. In addition, more than a dozen states have adopted their own rules and regulations for the offer and sale of franchises within their borders. Known as the "registration states," these states generally follow a more detailed disclosure format, known as the Uniform Franchise Offering Circular (UFOC).

The states that require full registration before the "offering" or selling of a franchise are California, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, and Washington. Other states that regulate franchise offers are: Hawaii, which requires filing of an offering circular with the state authorities and delivery of an offering circular to prospective franchisees; Michigan and Wisconsin, which require filing of a "Notice of Intent to Offer and Sell Franchises;" Oregon, which requires only that presale disclosure be delivered to prospective investors; and Texas, which requires the filing of a notice of exemption with the appropriate state authorities under the Texas Business Opportunity Act.

Among other things, the FTC Rule requires that every franchisor offering franchises in the U.S. deliver an offering circular (containing certain specified disclosure items) to all prospective franchisees (within certain specified time requirements). The FTC has adopted and enforced its rule pursuant to its power and authority to regulate unfair and deceptive trade practices. The FTC Rule sets forth the minimum level of protection to be afforded to prospective franchisees.

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To the extent that a registration state offers its citizens a greater level of protection, the FTC Rule does not preempt state law. Examples of state laws or regulations that would not be preempted by the rule include state provisions requiring the registration of franchisors and franchise salespersons, state requirements for escrow or bonding arrangements, and state-required disclosure obligations set forth in the rule. Moreover, the rule does not affect state laws or regulations that govern the franchisor/franchisee relationship, such as termination practices, contract provisions, and financing arrangements.

There is no private right of action under the FTC Rule; however, the FTC itself may bring an enforcement action against a franchisor that does not meet its requirements. Penalties for noncompliance have included asset impoundments, cease-and-desist orders, injunctions, consent orders, mandated rescission or restitution for injured franchisees, and civil fines of up to $10,000 per violation.

The FTC Rule regulates two types of offerings: *package and product franchises* and *business opportunity ventures*. Package and product franchises have three characteristics:

- **the franchisee sells goods or services** that meet the franchisor's quality standards (in cases where the franchisee operates under the franchisor's trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor);

BOX 13-1 Topics to Address in the FTC Disclosure Document

1. Identifying information about the franchisor
2. Business experience of the franchisor's directors and key executives
3. The franchisor's business experience
4. Litigation history of the franchisor and its directors and key executives
5. Bankruptcy history of the franchisor and its directors and key executives
6. Description of the franchise
7. Money required to be paid by the franchisee to obtain or open the franchise operation
8. Continuing expenses to the franchisee in operating the franchise business that are payable in whole or in part to the franchisor
9. A list of persons, including the franchisor and any of its affiliates, with whom the franchisee is required or advised to do business
10. Realty services, and so on that the franchisee is required to purchase, lease, or rent and a list of any person with whom such transactions must be made
11. Description of consideration paid (such as royalties and commissions) by third parties to the franchisor or any of its affiliates as a result of franchisee purchases from such third parties
12. Description of any franchisor assistance in financing the purchase of a franchise
13. Restrictions placed on a franchisee's conduct of its business
14. Required personal participation by the franchisee
15. Termination, cancellation and renewal of the franchise
16. Statistical information about the number of franchises and their rate of termination
17. Franchisor's right to select or approve a site for the franchise
18. Training programs for the franchisee
19. Celebrity involvement with the franchise
20. Financial information about the franchisor

- **the franchisor exercises significant assistance** in the franchisee's method of operation, and
- **the franchisee is required to make payment of $500 or more** to the franchisor or a person affiliated with the franchisor either before or within six months after the business opens.

Business opportunity ventures also involve three characteristics:
- **the franchisee sells goods or services** that are supplied by the franchisor or a person affiliated with the franchisor;
- **the franchisor assists the franchisee** in any way with respect to

securing accounts for the franchisee, or securing locations or sites for vending machines or rack displays, or providing the services of a person able to do either; and

- **the franchisee is required to make payment of $500 or more** to the franchisor or a person affiliated with the franchisor either before or within six months after the business opens.

Relationships covered by the FTC Rule include those within the definition of a "franchise" and those represented as being within the definition when the relationship is entered into, regardless of whether, in fact, they are within the definition. The FTC Rule exempts fractional franchises, leased department arrangements and purely verbal agreements. Also, the FTC Rule excludes relationships between employers and employees and among general business partners; membership in retailer-owned cooperatives; certification and testing services; and single-trademark licenses.

The information in the disclosure document must be current as of the completion of the franchisor's most recent fiscal year.

The disclosure document required by the FTC Rule must include information on the 20 subjects listed in Box 13-1 on the opposite page. The information must be current as of the completion of the franchisor's most recent fiscal year. In addition, a revision to the document must be promptly prepared whenever there has been a material change in the information contained in the document. The FTC Rule requires that the disclosure document must be given to a prospective franchisee either at the prospective franchisee's *first personal meeting* with the franchisor, or *ten business days* prior to the execution of a contract, or *ten business days* before the payment of money relating to the franchise relationship, whichever is earliest.

In addition to the disclosure document, the franchisee must receive a copy of all agreements that it will be asked to sign at least *five business days* prior to the execution of the agreements. A business day is any day other than Saturday, Sunda, or the following national holidays: New Year's Day, Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veteran's Day, Thanksgiving and Christmas.

The timing requirements described above apply nationwide and preempt any lesser timing requirements contained in state laws. The ten-day and five-day disclosure periods may run concurrently, and sales contacts with the prospective franchisee may continue during those periods.

In addition to the information required in the FTC disclosure document, you need to provide prospective franchisees with information about your fees, royalties, advertising and other obligations. This information is discussed in the Appendix.

Joint Ventures

Joint ventures are legal structures that offer another alternative to capital formation for small and growing companies. A joint venture is typically structured as a partnership or as a newly formed co-owned corporation or limited-liability company, in which two or more parties are brought together to achieve a series of strategic and financial objectives on a short-term or long-term basis. A less formal method of meeting some of the same objectives without the legal structure can be achieved by creating strategic alliances or co-branding—discussed in detail later in this chapter. Entrepreneurs who wish to explore creating a joint venture should give careful thought to the type of partner they are looking for and what resources teach will contribute to the newly formed entity.

Entrepreneurs who wish to explore creating a joint venture should give careful thought to the type of partner they are looking for and what resources they will be contributing to the newly formed entity.

Each party to the transaction will be making his or her respective contribution of skills, abilities and resources. From the entrepreneur's perspective, a larger joint-venture partner will often have the capital, human resources and strategic market relationships already in place that would take years to develop on a stand-alone basis. In addition to access to resources, the entrepreneur may enjoy other benefits from the relationship, such as a boost in creditability by "piggybacking" on the goodwill and reputation of the larger corporate partner (which will in turn open up capital markets and potential customer relationships) and in some cases, the opportunity to work with, instead of against, an otherwise direct or potential competitor. The key to these relationships is to define expectations and goals clearly in advance, so that each party knows what assets are being contributed to this newly formed entity and how the rewards will be divided.

Here are eight reasons you might consider a joint venture or strategic alliance:

- **Develop a new market** (domestic or international)
- **Develop a new product**
- **Develop and share technology**
- **Combine complementary technology**
- **Pool resources** to develop a production and distribution facility
- **Acquire capital**
- **Execute a government contract**
- **Access a distribution network** or sales and marketing capability

For example, suppose that a small business named ProductCorp has the patents to protect the technology necessary for a wide range of new consumer products. The company can commence a search for a capital-rich partner that will invest in the construction of a manufacturing facility to be owned and operated by the newly established entity. As an alternative, ProductCorp could enter into a joint venture with a larger competitor that already has the manufacturing capability to produce the products.

Each strategy has its advantages and disadvantages: The capital-rich joint-venture partner brings the necessary financial resources to achieve company objectives, but it cannot contribute experience in the industry. The larger competitor may offer certain operational and distribution synergies and economies of scale, but it may seek greater control over ProductCorp's management decisions.

All successful joint-venture and strategic-alliance relationships share some essential factors. These critical success factors apply to virtually all industries and types of strategic relationships and include:

- **a complementary unified force or purpose** that binds the two or more companies together;
- **a management team committed** to the success of the venture, free from politics or personal agendas;
- **a genuine synergy** in which the sum of the whole truly exceeds its individual parts;
- **a cooperative culture and spirit** among the strategic partners that leads to trust, resource sharing and a friendly chemistry among the parties;
- **a degree of flexibility** in the objectives of the joint venture to allow for changes in the marketplace and an evolution of technology;
- **an actual alignment of management styles and operational methods,** at least to the extent that it affects the underlying project (as in the case of a strategic alliance) or the management of the new company created (as in the case of a formal joint venture); and
- **the general levels of focus and leadership** from all key parties that are necessary to the success of any new venture or business enterprise.

The Mating Dance: Searching for the Right Joint-Venture Partner

Embarking on a search for a joint-venture partner is a bit like the search for an appropriate spouse. You should carefully and thoroughly review prospective candidates and conduct extensive due diligence on the final few whom you are considering. Develop a list of key objectives and goals to be achieved by the joint venture or licensing relationship, and compare this list with those of your final candidates. Take the time to understand the corporate culture and decision-making process within each company. Consider some of the following issues: How does this fit with your own processes? What about each prospective partner's previous experiences and track record with other joint-venture relationships? Why did these previous relationships succeed or fail?

BOX 13-2 **Comparing Joint Ventures and Strategic Alliances**

	JOINT VENTURES	STRATEGIC ALLIANCES
Term	Usually medium- to long-term	Short-term
Strategic objective	Often serves as the precursor to a merger	Flexible and noncommittal
Legal agreements and structure	Actual legal entity formed	Contract-driven
Extent of commitment	Shared equity	Shared objectives
Capital and resources	Each party makes a capital contribution of cash or intangible assets	No specific capital contributions (may be shared budgeting on even cross-investment)
Tax ramifications	Be on the lookout for double taxation unless pass-through entities utilized	No direct tax ramifications ramifications

In many cases, smaller companies looking for joint-venture partners wind up selecting a much larger Goliath that offers a wide range of financial and nonfinancial resources that will allow the smaller company to achieve its growth plans. The motivating factor under these circumstances for the larger company is to get access and distribution rights to new technologies, products and services. In turn, the larger company offers access to pools of capital, research and development, personnel, distribution channels and general contacts that the small company desperately needs.

But proceed carefully. Be sensitive to the politics, red tape and different management practices that may be in place at a larger company but will be foreign to your company. Try to distinguish between what is being promised and what will actually be delivered. If your primary motivating force is really only capital, consider exploring alternative (and perhaps less costly) sources of money. Ideally, the larger joint-venture partner will offer a lot more than money. If your primary motivating force is access to technical personnel, consider purchasing these resources separately rather than entering into a partnership in which you give up a certain measure of control. Also, consider whether strategic relationships or extended-payment terms with vendors and consultants can be arranged in lieu of the legal structure of a joint venture. Box 13-2 on page 259 highlights the differences between joint ventures and strategic alliances.

If you're considering a joint venture with a large company, proceed carefuly. Be sensitive to the politics, red tape and different management practices that may be in place at the larger company but will be foreign to your company.

Consider also the following key strategic issues before and during joint-venture or strategic-alliance negotiations:

- **Exactly what types of tangible and intangible assets will be contributed to the joint venture by each party?** Who will have ownership rights to the property contributed during the term of the joint venture and thereafter? Who will own property developed as a result of joint development efforts?
- **What covenants of nondisclosure or noncompetition will be expected** of each joint venturer during the term of the agreement and thereafter?
- **What timetables or performance quotas for completion of the projects contemplated by the joint venture will be included in the agreement?** What are the rights and remedies of each party if these performance standards are not met?
- **How will issues of management and control be addressed in the agreement?** What will be the respective voting rights of each party? What are the procedures in the event of a major disagreement or deadlock? What is the fallback plan?

Once you and your prospective partner have discussed all of these preliminary issues, you should prepare, with the assistance of counsel, a formal joint-venture agreement or corporate-shareholders' agreement. The precise terms of the agreement between your company and your joint-venture partner will naturally depend on both of your specific objectives.

Co-Branding

Co-branding is a form of informal partnership whereby two or more established brand names combine to bring added value, economies of scale, and customer recognition to each product. Co-branding can be arranged between two franchise companies, two nonfranchise companies, or a franchise company and a nonfranchise company. It has many forms, including:

FINANCIAL SERVICES CO-BRANDING. In the early 1990s, credit card companies pioneered co-branding, pairing up with airlines or telecommunications companies for mutual branding and shared rewards.

CONSUMER-PRODUCT INGREDIENT CO-BRANDING. The strength of one brand appears as an ingredient in another as enhancement for sales and cross-consumer loyalty. Examples include Post Raisin Bran's use of Sun-Maid raisins in its cereal; Archway's use of Kellogg's All-Bran in its cookies; Ben & Jerry's Heath Bar Crunch ice cream; and PopTarts with Smuckers fruit fillings.

IMPLIED ENDORSEMENT CO-BRANDING. The co-branded name or logo is used to build consumer recognition even if there is no *actual* ingredient used in the product—for example, the John Deere logo stamped on the back of a Florsheim boot; the Doritos Pizza Craver tortilla chips, whose packaging features Pizza Hut's logo; or Doritos Taco Supreme chips, where the packaging features Taco Bell's logo.

ACTUAL COMPOSITE CO-BRANDING. The co-branded product actually uses a branded pairing of popular manufacturing techniques or processes—Timberland boots with Gore-Tex fabric;

furniture with Scotchguard protectants; Dell or Gateway computers with Intel inside, and so on.

DESIGNER-DRIVEN CO-BRANDED PRODUCTS. Certain manufacturers have co-branded with well-known designers to increase consumer loyalty and brand awareness. For example, the Eddie Bauer edition of the Ford Explorer has been a very strong seller with product differentiation.

RETAIL BUSINESS FORMAT CO-BRANDING. This type of co-branding is growing rapidly within the retailing, hospitality and franchising communities to attract additional customers. This type of co-branding includes: creating complementary product lines to offset different consumer tastes (such as Baskin Robbins and Dunkin Donuts, whose products are now offered at the same co-branded locations) or consuming patterns (combining a traditional breakfast-only consumer traffic with a lunch-only traffic pattern); or selling additional products or services to a "captured customer" (such as selling Starbucks coffee at an auto-service mini-mall while customers wait for their cars to be repaired).

Why Should a Company Think About Co-Branding as a Growth Strategy?

Co-branding is one of four leveraging options; the other three are line extensions, stretching the brand vertically in the existing product class, and creating brand extensions into different product classes. Co-branding should be considered for the following reasons

- **It is a way to leverage the company's intangible assets** (including brand awareness and customer loyalty) by entering another product class.
- **It can provide added value** in the form of customer convenience, thereby creating a point of differentiation from competitive products and services.
- **It is easier and less risky than trying to build** a strong brand because there are many internal and external impediments,

such as corporate bias against innovation, short-term orientation, price pressures and competitive threats.

- **It can gain marketplace visibility** and create new customer interest, which helps a company maintain brand *equity* in light of competitors' new product introductions and declining brand awareness.
- **It can change the perception of a brand.** The company can create a new brand personality (for example, the use of Bart Simpson with Butterfingers), or at least update it.
- **It can help a company gain access** to new product categories that otherwise would have involved a significant investment of time, money and resources.
- **It can provide greater assurance about product quality.** A brand name assists consumers' understanding of a product's characteristics, and the presence of a second brand may signal to potential customers that another firm is willing to stake its reputation on the product.
- **It can reach a new customer base** far more quickly than a new-brand launch, which usually takes several years (three to five years in the credit card industry, for example).
- **It offers a shortcut to an image upgrade,** such as Ford's Special Eddie Bauer Editions.
- **It offers a way to target a key demographic** audience, such as MasterCard's creating a co-branded card with universities to reach college students and alumni.

Things to Consider Before Entering a Co-Branding Arrangement

- **Be aware of the fit of the brands.** For example, a hypothetical Godiva/Slim Fast line of chocolate snack bars would benefit Slim Fast brand by its association with superior chocolates produced by Godiva. However, this would detract from Godiva's upscale brand image. In this scenario, there is not a fit between the brands.
- **Understand consumer perceptions of your product** and its attributes to better determine whether the two brands have a common set of attributes.

- **Examine the degree to which the two brands complement** each other.
- **Rate how each brand is regarded in the marketplace** separately, then rate the co-brand product.
- **Explore the relative contribution each brand will make** to the effectiveness of the co-brand product.
- **What types of partners** would enhance your identity?
- **What types would help reduce** the limitations of your identity?

Advantages and Disadvantages of Co-Branding

Co-branding offers many advantages for your business:

- **shares costs, including marketing and packaging,** but also rent and utilities if the two companies are in same location;
- **permits complementary services to achieve marketing and expense benefits.** For example, many gas stations and restaurants co-brand, and quick-service restaurants have teamed up with each other to serve a different but complementary meal. One brand finds another brand that will not compete directly against it but will bring business in the door at a time of the day when it does not get high traffic. Box 13-3 on the opposite page cites some examples of each.
- **facilitates expansion into international markets;**
- **makes it easier to get brand recognition** for your brand in foreign market if it's tied to a well-known domestic brand: many foreign markets enjoy American products, so the co-branding works to their advantage;
- **creates conveniences for customers, which** can increase business for both companies;
- **taps into national image and awareness of the brand** of the issuing company;
- **increases distribution network;**
- **enhances market clout in terms of the value** and quality communicated to customer; and
- **doubles brand recognition,** doubles the endorsement power and doubles consumer confidence in the co-branded products.

There are also some disadvantages of co-branding:

- **agreements between co-branding partners** can be hard to construct and agree upon;

BOX 13-3 Examples of Complementary Co-Branding

Gas stations/restaurants:
- Texaco Star Marts have teamed with Taco Bell, Pizza Hut, Burger King, McDonald's and Del Taco.
- Chevron and McDonald's opened a joint operation in Marina Del Rey.
- Other gas mini marts have teamed with Dunkin Donuts and Subway.

Quick-service restaurant pairings:
- D'Angelo's sub chain (lunch) has teamed with Pizza Hut (dinner) in more than 100 locations (D'Angelo's is owned by Pizza Hut but maintains a distinct brand).
- Blimpie sub chain (lunch) has teamed with Dunkin' Donuts (breakfast), Baskin Robbins (afternoon/evening treats) and Little Caesars (dinner).
- TCBY has teamed with Subway franchisee, Doctor's Associates to co-locate brands and operations in one location.
- Blimpie Franchise signed a co-brand agreement with Pudgie's Chicken to operate a co-brand store. This agreement was made by a franchisee, indicating that the parent company does not always need to be involved in a co-branding relationship.
- Manhattan Bagel Co. and Ranch 1 Chicken announced plans to develop 20 co-branded locations in Manhattan inside Ranch 1 restaurants.
- Church's Chicken and White Castle Hamburgers announced plans to develop 30 co-branded restaurants and share costs.

- **marketing must be agreed on by both parties,** which can delay time to market and reduce the flexibility of your marketing plans;
- **bad publicity for one company can affect the other company;**
- if one brand fails to live up to its promises made to the other, the co-branding relationship can dissolve; and
- **if co-branding fails, both companies suffer**, and consumers may become confused about new products, diminishing the value of both companies involved in the co-branding relationship..

Preparing a Co-Branding Agreement

Once your company has determined the type of partner you want to pursue, ask yourself the following questions.

- **How will the co-branded opportunity be marketed?**
- **Which company will provide the services** and assistance?
- **Which partner's team will operate the co-branded stores** or sell the co-branded products? Will it vary?

When you and another company have determined that you want to develop a co-brand arrangement, you'll need to formalize the deal by executing a co-branding agreement that addresses the issues listed below.

- **designated territory;**
- **initial term and renewal of the co-branding agreement** (if any);
- **duties of each party;**
- **licensing of the intellectual property;**
- **licensing fees;**
- **financial reporting;**
- **quality control;**
- **non-compete clauses;**
- **termination** (including operation of the co-branded units upon termination); and
- **dispute resolution.**

Before you launch the deal, implement a pilot program to work out any kinks in the arrangement. The pilot program should determine whether the co-branded and combined operations will produce the projected synergies and sales for both companies and the projected reductions in operating costs as a percentage of revenue. The test should also reveal whether equipment, labor and other needs are compatible. Testing should enable your company to develop and refine operating procedures for the preparation and delivery of the products or services of both businesses in and from the same facility, and to develop an operations manual and training programs for the co-branded unit. Finally, the test period should offer both companies the time to develop a productive working relationship.

The following parameters and goals of the test must be established before the test is begun:

- **duration of the test period;**
- **number and types of products** to be tested;
- **goals that the co-branded products are expected to achieve;** and

- **whether the co-branded products will be in,** or at, company-owned or franchisee-operated units.

Licensing

Licensing is a contractual method of developing and exploiting intellectual property by transferring rights of use to third parties *without* the transfer of ownership. Virtually any proprietary product or service may be the subject of a license agreement. Examples range from the licensing of the Mickey Mouse character by Walt Disney Studios in the 1930s to modern-day licensing of computer software and high technology. From a legal perspective, licensing involves complex issues of contract, tax, antitrust, international, tort and intellectual-property law. From a business perspective, licensing involves weighing the economic and strategic advantages of licensing against other methods of bringing a product or service to the marketplace—methods such as direct sales, distributorships and franchises.

Licensing can be viewed as an alternative growth strategy because the founders of the company are no longer directly responsible for the financial investment needed to fuel growth and expansion. Instead, the capital-formation and investment burden is shifted to another, who pays the licensor for the right to use its technology or brand name in exchange for initial license fees and royalties.

The decision to shift to being a licensor of technology instead of bringing products and services directly to the market significantly reduces the amount of capital your company will need.

The decision to shift to being a licensor of technology instead of bringing products and services directly to the market significantly reduces the amount of capital your company will need; it may also lead to your company's becoming a virtual corporation that has only limited day-to-day operations and is really just a holding company that receives and distributes licensing fees.

Many of the benefits of licensing to be enjoyed by a growing company closely parallel the advantages of franchising, namely:

- **spreading the risk and cost of development** and distribution;
- **achieving more rapid market penetration;**
- **earning initial license fees** and ongoing royalty income;
- **enhancing consumer loyalty** and goodwill;
- **preserving the capital** that would otherwise be required for internal growth and expansion;
- **testing new applications** for existing and proven technology; and
- **avoiding or settling litigation** regarding a dispute over ownership of the technology.

The disadvantages of licensing are also similar to the risks inherent in franchising, such as:

- **a diminished ability to enforce quality-**control standards and specifications;
- **a greater risk of another party's infringing on** the licensor's intellectual property;
- **a dependence on the skills, abilities and resources** of the licensee as a source of revenue;
- **difficulty in recruiting, motivating and retaining** qualified and competent licensees;
- **the risk that the licensor's entire reputation and goodwill** may be damaged or destroyed by the act or omission of a single licensee; and
- **the administrative burden of monitoring and supporting** the operations of the network of licensees.

Failure to consider all of the costs and benefits of licensing could easily result in a regretful strategic decision or being stuck with the terms of an unprofitable license agreement. This could occur if the licensee's need for technical assistance and support is underestimated or if the market demand for your products and services is overestimated. To avoid such problems, you should conduct a certain amount of due diligence before engaging in any serious negotiations with a prospective licensee. This preliminary investigation should cover the following areas:

- **market research;**
- **legal steps to fully protect** intellectual property;

- **an internal financial analysis of the technology** with respect to pricing, profit margins and costs of production and distribution;
- **a more specific analysis of the prospective licensee** with respect to its financial strength, research and manufacturing capabilities, and reputation in the industry.

Technology licensing agreements often occur between entrepreneurs who have the technology but lack the resources to penetrate the marketplace and a larger company that has the research and development, production, human resources and marketing capability to make the best use of the technology.

Once you've decided to enter into more formal negotiations, you should discuss the terms and conditions of the license agreement with the licensee. These provisions will vary, depending on whether the license is for merchandising an entertainment property, exploiting a given technology or distributing a particular product to an original-equipment manufacturer or value-added reseller.

There are two main types of licensing: *technology licensing,* where the strategy is to find a licensee for exploitation of industrial and technological developments; and *merchandise and character licensing,* where the strategy is to license a recognized trademark or copyright to a manufacturer of consumer goods in markets not currently served by the licensor.

Technology Licensing

The principal purpose behind technology transfer and licensing agreements is to make a marriage between the technology proprietor (you, as licensor) and an organization that has the resources to develop and market the technology properly (as licensee). This marriage is made between companies and inventors of all sizes, but it often occurs between an entrepreneur who has the technology but lacks the resources to penetrate the marketplace adequately and therefore becomes a licensor, and a larger company that has the research and development, production, human resources and marketing capability to make the best use of the technology. Many successful entrepreneurs have relied on the resources of larger organizations to bring their products to market, including Chester Carlson (inventor of xerography), Edwin Land (Polaroid cameras) and Willis Carrier (air-conditioning). As the base for technological development becomes broader, large companies look not only to entrepreneurs and small businesses for new ideas and technologies, but also to foreign countries, universities, federal and state governments, and to each other to serve as licensors of technology.

In the typical licensing arrangement, the owner of intellectual-property rights (patents, trade secrets, trademarks, and so on) permits another party to use these rights under a set of specified conditions and circumstances set forth in a license agreement. Licensing agreements can be limited to a very narrow component of the proprietor's intellectual-property rights, such as one specific application of a single patent. Or they can be much broader, such as in a "technology-transfer" agreement, where an entire bundle of intellectual-property rights are transferred to the licensee in exchange for initial fees and royalties. The technology-transfer arrangement is actually closer to a sale of the intellectual-property rights, an important difference being that the licensor retains the right to get the intellectual property back if the licensee fails to meet its obligations under the agreement. An example of this type of transaction might be bundling a proprietary environmental cleanup system together with technical support and training services to a master overseas licensee, with reversionary rights in the event of a breach of the agreement or the failure to meet a set of performance standards.

Licensing agreements can be limited to a narrow component of the proprietor's intellectual-property rights, such as one specific application of a single patent. Or they can be much broader in context, such as in a "technology-transfer" agreement, where an entire bundle of intellectual-property rights are transferred.

As a rule, any well-drafted technology license agreement should address the following topics.

SCOPE OF THE GRANT. Carefuly define the exact scope and subject matter of the license. Clearly set forth any restrictions on the geographic scope, rights of use, permissible channels of trade, restrictions on sublicensing, limitations on assignability or exclusion of improvements to the technology (or expansion of the character line) covered by the agreement.

TERM AND RENEWAL. This section specifies the commencement date, duration, renewals and extensions, conditions to renewal, procedures for providing notice of intent to renew, grounds for termination, obligations upon termination, and your reversionary rights in the technology.

You may want to impose certain minimum levels of performance in terms of sales, advertising and promotional expenditures and human resources to be devoted to the exploitation of the technology.

PERFORMANCE STANDARDS AND QUOTAS. To the extent that your primary revenues to the licensor will depend on royalty income that will be calculated from the licensee's gross or net revenues, you may want to impose certain minimum levels of performance in terms of sales, advertising and promotional expenditures, and human resources to be devoted to the exploitation of the technology. The licensee will probably argue for a "best efforts" provision that is free from performance standards and quotas. In such cases, you may want to insist on a minimum royalty level that will be paid regardless of the licensee's actual performance.

PAYMENTS TO THE LICENSOR. Virtually every type of license agreement will include some form of initial payment and ongoing royalty to the licensor. Royalties vary widely, however, and may be based on gross sales, net sales, net profits, fixed sum per product sold or a minimum payment to be made to the licensor over a given period of time; they may also include a sliding scale to provide some incentive to the licensee as a reward for performance.

QUALITY ASSURANCE AND PROTECTION. Here, you should set forth quality-control standards and specifications for the production, marketing and distribution of the products and services covered by the license. In addition, the agreement should include procedures that allow you an opportunity to *enforce* these standards and specifications, such as a right to inspect the licensee's premises; a right to review, approve or reject samples produced by the licensee; and a right to review and approve any packaging, labeling or advertising materials to be used in connection with the exploitation of the products and services that are within the scope of the license.

INSURANCE AND INDEMNIFICATION. You should take all necessary and reasonable steps to ensure that the licensee has an obligation to protect and indemnify you against any claims or liabilities resulting from the licensee's exploitation of the products and services covered by the license.

ACCOUNTING, REPORTS AND AUDITS. You must impose certain reporting and record keeping procedures on the licensee to ensure an accurate accounting for periodic royalty payments. In addition, you should reserve the right to audit the records of the licensee in the event of a dispute or discrepancy, along with provisions as to who will be responsible for the cost of the audit in the event of an understatement.

DUTIES TO PRESERVE AND PROTECT INTELLECTUAL PROPERTY. Carefully define here the obligations that the licensee and its agents and employees have to preserve and protect the confidential nature and acknowledge the ownership of the intellectual property being disclosed in connection with the license agreement. Also describe in this section any required notices or legends that must be included on products or materials distributed in connection with the license agreement (such as the status of the relationship or actual owner of the intellectual property).

TECHNICAL ASSISTANCE, TRAINING AND SUPPORT. This section of the agreement delineates any obligation you have as licensor to assist the licensee in developing or exploiting the subject matter being licensed. The assistance may take the form of personal services or documents and records. Either way, this section should also specify any fees due you for such support services that are over and above the initial license and ongoing royalty fee.

WARRANTIES OF THE LICENSOR. A prospective licensee may demand that you provide certain representations and warranties in the license agreement. These may include warranties that you own the technology, with no known infringements or restrictions on the ability to license the technology, or that the technology has the features, capabilities and characteristics previously represented in the negotiations.

Aside from the obvious desire to earn royalty fees and profits, many manufacturers view licensing as a form of merchandising to promote the underlying product or service.

INFRINGEMENTS. The license agreement should contain procedures under which the licensee must notify you of any known or suspected direct or indirect infringements of the subject matter being licensed. The responsibilities for the cost of protecting and defending the technology should also be specified in this section.

Merchandise and Character Licensing Agreements

The use of commonly recognized trademarks, brand names, sports teams, athletes, universities, television and film characters, musicians and designers to foster the sales of specific products and services are at the heart of today's merchandise and character licensing environment. Manufacturers and distributors of a wide range of products and services license words, images and symbols. Certain brand names and characters have withstood the test of time, while others fall prey to fads, consumer shifts and stiff competition.

The trademark and copyright owners of these properties and character images are motivated to license for a variety of reasons. Aside from the obvious desire to earn royalty fees and profits, many manufacturers view licensing as a form of merchandising to promote the underlying product or service. The licensing of a trademark for application on a line of clothing helps to establish and reinforce brand awareness at the consumer level. For example, when R.J. Reynolds Tobacco Co. licenses a leisure apparel manufacturer to produce a line of Camel wear, the goal is not only to enjoy the royalty income from the sale of the clothing line but also to sell more cigarettes, appeal to the lifestyle of targeted consumers and maintain consumer awareness. Similar strategies have been adopted by manufacturers to revive a mature brand or failing product. In certain instances, the product that has been licensed was almost as financially successful as the underlying product it was intended to promote.

Brand-name owners, celebrities and academic institutions must be very careful not to grant too many licenses too quickly. The financial rewards of a flow of royalty income from hundreds of different manufacturers can be quite seductive, but it must be weighed against the possible loss of quality control and dilution of the brand name, logo or character. The loyalty of the licensee network is also threatened when too many licenses are granted in closely competing products.

Brand name owners, celebrities and academic institutions must be very careful not to grant too many licenses too quickly. The loyalty of the licensee network is also threatened when too many licenses are granted in closely competing products.

Retailers will also become cautious when purchasing licensed goods from a licensee if there is a fear that quality control has suffered or that the popularity of the licensed character, celebrity or image will be short-lived. This may result in smaller orders and an overall unwillingness to carry inventory. This is especially true in the toy industry where purchasing decisions are being made (or at least influenced) by the whims of a 5-year-old child who may strongly identify with a character one week and then turn his or her attention to a different character the next week. It is incumbent on the manufacturers and licensees to develop advertising and media campaigns to hold the consumer's attention for an extended period of time. Only then will the retailer be convinced of the potential longevity of the product line. This will require a balancing of the risks and rewards between licensor and licensee in the character-licensing agreement in the areas of compensation to the licensor, advertising expenditures by the licensee, scope of the exclusivity, and quality-control standards and specifications.

In the merchandise-licensing community, the name, logo, symbol or character is typically referred to as the "property" and the specific product or product line (the T-shirts, mugs, posters, and so on) is referred to as the "licensed product." This area of licensing offers opportunities and benefits to both the owner of the property and the manufacturer of the licensed product. For the owner of the property, licensing strengthens and expands brand recognition, goodwill and royalty income. For the manufacturer of the licensed products, there is an opportunity to leverage the goodwill of the property to improve sales of the licensed products. The manufacturer has an opportunity to hit the ground running in the sale of merchandise by gaining access to and use of an already established brand name or character image.

The licensor and the licensee should conduct due diligence on each other. From your perspective as the owner of the property, the manufacturer of the licensed product should demonstrate an ability to meet and maintain quality-control standards, possess financial stability, and offer an aggressive and well-planned marketing and promotional strategy. From the perspective of the manufacturer of the licensed product, you as owner of the property should display integrity and commitment to quality, disclose your future plans for the promotion of the property and be willing to participate and assist in the overall marketing of the licensed products. For example, if a star basketball player were unwilling to appear at promotional events designed to sell his own specially licensed line of shoes,

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this would present a major problem and could lead to a premature termination of the licensing relationship. When preparing and negotiating a merchandise licensing agreement, there are several key areas that must be addressed:

- **scope of the territorial** and product exclusivity;
- **assignability** and sublicensing rights;
- **definition of the property** and licensed products;
- **quality control** and approval;
- **ownership of artwork** and designs;
- **term renewal rights** and termination of the relationship;
- **initial license fee** and ongoing royalty fees;
- **performance criteria** for the licensee;
- **liability insurance;**
- **indemnification;**
- **duty to pursue trademark** and copyright infringement;
- **minimum advertising** and promotional requirements;
- **accounting and record keeping** by the licensee;
- **inspection and audit rights** of the licensor;
- **rights of first refusal** for expanded or revised characters and images;
- **limitations on licensee's distribution** to related or affiliated entities;
- **representations and warranties** of the licensor with respect to its rights to the property;
- **availability of the licensor** for technical and promotional assistance; and
- **miscellaneous legal provisions,** such as law to govern, inurement of goodwill, nature of the relationship, notice and force majeure.