Franchising
How to Buy or Start a Franchise

Introduction

In my practice two areas of law are "quicksand" for the unwary: securities law and franchising. Securities law is a "trap" because any investment contract (e.g. my investment in your motor scooter) is a security which raises the issues if and what federal and state law may apply. Not only are these issues completely off the radar for many business owners or executives, the penalties are huge, starting at $10,000 for some violations.

Franchising shares a similar problem. Only the relatively sophisticated know that you cannot license a trademark for money and assist in or control its use without being subject to federal law and some state law. Franchises can only be sold or purchased via a franchise disclosure document and franchise agreement. In contrast to a trademark license agreement which might be ten pages or less the typical franchise package has about 150 pages with mandatory disclosures and content. It is not uncommon for persons to be offered a "building cleaning franchise" which consists of nothing more than a contract between the buyer and seller. In this form these offerings are unlawful and often a scam. The seller rotates the commercial accounts from one new franchise to another. The key point here is that franchises are federally regulated by the Federal Trade Commission (FTC), and sometimes state, regulated and, at minimum, consist of a Franchise Disclosure Document and Franchise Agreement.

Big Picture Questions: Is this Franchise Worth Buying or Selling?

Assuming the franchise has been lawfully set up and presented, the next question – often skipped – is whether this is a franchise one should buy. Franchising is so popular with both potential franchisors and franchisees one can find a franchise for just about every kind of business, from concrete to tub repair. Many of these franchises are new. And, there's the rub. It is not unusual for me to be asked to review a franchise with few locations and zero name recognition. So, how does the franchisor know what to offer and the franchisee to look for?

Here, are some key things I look for:

1. **Brand**. Do people know the name or are you paying royalties for a company name that no one has heard of? Often for a new franchise it is your advertising money that is building *their* brand. If the franchise is new, and not known in the area, then it needs to be strong in other areas, e.g. concept and "secret sauce."

2. **Concept**. New, unique? Company early in new untapped market? The early coffee-houses did very well, but the market became saturated and attracted major players. It is much harder for a start-up to compete in that environment.

3. **Secret Sauce/Replicability**: Does the company have a proprietary patent, secret recipe or formula (like Kentucky Fried Chicken or Coke) or can others copy your approach and compete without paying franchise fees. Hurdles to copycat entry are valuable. If you are "another face in the crowd" of coffee houses or fitness centers then you need the brand or something extra.

4. **Operational expertise**. Who in the company knows this industry? Do you have bankers opening hair salons? It is not uncommon to have a franchise company owned by persons who have never actually worked in the industry. They have the money and the contacts, but not the personal expertise. This information will be stated in the Franchise Disclosure Document.

5. **Training and trainer**. Is the person who will give you training with the company or a hired consultant. Does that person have knowledge and experience in the industry? Who will you call with a question or problem? Again, in house knowledge and expertise is a plus.

6. **Operations manual**. Does the operations manual Indicate special knowledge or basically public information? These may now be online, password protected instead of a "handbook" in your possession. Doing things, the same way, the right way, is a key element of a franchise. This book is the "bible" for knowing what you have to do. If it is weak then the franchise may be weak. The problem is that you may never see the Manual until after you have purchased the franchise.

7. **Company financial statements**. I have a client who is looking at a franchise where the franchise company's net worth is less than the deli downstairs. If the franchise company is living on a "shoe-string," then it may not be able to afford the everyday and local support needed to maintain franchise assistance and integrity. This information is provided in the Franchisee Disclosure Document.

8. **Success rate.** With new franchise companies the failure rate may be 50%. This information is provided in the Franchisee Disclosure Document. With that kind of failure rate, something is wrong. Is it under-capitalization, wrong concept, wrong principals, bad operations or what? These should be considered to see if the answer is acceptable.

The above can be "knock out factors," or if on balance you still like the franchise, negotiation leverage. No franchise is perfect, so in the end the proper choice may be a balancing act or with some factors more important than others. For example, someone who has managed or worked in a pizza restaurant may need less training than some one who has never worked there.

Note, they get your money early and it is typically non-refundable, so you could decide the franchise is a dud and still be out your investment. I would try to tie full payment to your acceptance after training.

Franchises can be a terrific way to get up and running and with support, especially for those inexperienced in business. The "big negative" with franchises is "buyer's remorse" two to four years later. By that time, you may know about everything the franchise people know, and the representative they send out for support may be fresh out of college and have zero value to you. Yet you are still paying royalties of, say $50,000 a year.

Getting Down to The Nitty Gritty or Brass Tacks

Having decided the franchise you want to buy or offer is worth buying, other factors become important. These include the following:

1. **Territory, exclusive**? Believe it or not, with some franchises there is no exclusive area. And, even if there is, with some the franchisor may put its stores in your area. Either of these alternatives strikes me as a conflict of interest.

2. **Performance std. – sales or purchases**? With some franchises you are required to do a certain volume and generate certain royalties or other dollars. Failure to do this can cause your expulsion as a franchisee.

3. **Franchise Fee.** Amt., when due, Terms? Refundable? Subject to: finding location, completing, passing training, financing? Typically, franchise fees are paid up front, and before training, which may be your first chance to know if the franchise is right for you. Usually, at best, you would only get one-half of your franchise fee back. If you are totally unsuited for the franchise, as shown by the training, the franchise company may reject you as a franchisee.

4. **Royalty Fee.** %, frequency, auto-withdrawal? Royalty fees approach 7% for some franchises now. With this kind of royalty fee, the franchise needs to be unique to have the profit margin to pay this. Given that a typical small business may net 15%, a 7% royalty is a lot. The royalty fee may be half the net profits. And, the 7% comes off the top, not net profits. Moreover, not only is the fee automatically deducted from your operating account, the franchisor may require you to have a certain minimum balance. It also has access to your sales records and financial statements.

5. **Term**. Renewable, how many times, for how long, renewal fee, performance standards, royalties or advertising fee increase, new training, fee, expenses, if not renewable, then compensation? The typical term of a franchise agreement may be five years. If the franchise fee is $75,000, then you are paying $15,000 a year to operate the franchise plus royalties. And, there may be a renewal fee. Again, going back to the "big picture" question of whether the franchise is worth buying (or selling) – a good business

investment – the franchise better be strong on brand, uniqueness, difficulty of replication, operations or *something*. Otherwise you will not be able to pay the royalties.

6. **Training.** Who, how many, length, retraining? It is not unusual for a franchise to be owned by, say, bankers or others who have never operated that kind of business. In this case and others, the franchisor may hire the trainer on a contract basis. But this raises the question "Who ya gonna call" when you have operational questions. That training, that operational expertise is part of what you are paying for. Some franchises are weak in this regard.

7. **Lease.** Who is the tenant? Sub-lease, assignment. With many franchises you will need a shopping center or industrial space location. (This means you should have an attorney review the lease.) Sometimes you, the franchisee, are the tenant in which case the franchisor will ask you and the landlord to sign the franchise company's Lease Rider." The primary contents of the Lease Rider are that the franchisor receives notice of your default and has the right to step into your shoes - itself or with a new franchisee – upon your default. Landlords like this because they have more security with the tenant. But this can be a conflict of interest between the franchisor and the franchisee. In other cases the franchisor will sign the Lease – thereby locking up the space – and sublease the premises to the tenant. Again, the franchisor has dibs on the lease.

8. **Construction.** Who, specifications, equipment. If the franchisor does or hires contracting, what are the construction costs and when are they payable? Typically, the franchisee must find a location and obtain franchisor approval within a certain period of time. After the location is found, usually the franchisee will seek construction bids according to the franchisor's specifications. The franchisee should cross-check these "build out" requirements will local zoning ordinances. (We had a case where the city shut down the franchisee on his opening day. In another case the city rejected the Peru oven which killed the restaurant concept.) As for equipment, the franchisor will either dictate the vendor or the specifications of the equipment. The franchisee can not just buy what or from whomever it wants.

9. **Operations.** Items/services specified? Special licenses required? Owner on site, Mgr. on site? You can buy a franchise where the key employees must be licensed but you don't, e.g. hair salon or lash salon. The key is to know if licenses are required and whether you are comfortable with the answer.

10. **Confidentiality Agreement.** In addition to the Franchise Disclosure Document and the Franchise Agreement there are a number of other agreements. These include but are not limited to the Lease Rider, the Territory Designation, the ACH payment withdrawal form, the key employees' employment agreements and an agreement for you as the franchisee to keep information contained in the Operations Manual as confidential. You may have a similar agreement between you as the franchisee and your key employees or such language may be included in the key employee employment agreement. These agreements are important to the franchisor and you face legal liability for their breach.

11. **Mandatory Purchases, Suppliers, Rebates.** One "dark side" of the franchise relationship is mandatory suppliers. These can be the franchise company itself, as with Quiznos sandwiches, or mandatory third-party vendors. With the latter almost always there are rebates from the vendor back to the franchise company. The franchise company says that the use of one vendor is necessary for quality control, and quantity discount pricing. The former may be true but with prices including the rebate to the franchisor the goods are not usually cheaper and may even be higher. When a franchise company looks for extra profits, this markup and rebate can be one of the first places they look. Recently I reviewed the Franchise Disclosure Document of a semi-national franchise company with about 100 locations. Rebates received in one year were $308,000. That is, $3,000 per store.

12. **Advertising.** Local, national requirements, how calculate, frequency, same time as royalties. With a franchise typically there is, at least, a local and national advertising fee. And, there may be other advertising assessments as well. Advertising is important. And, it is almost impossible to succeed in business without it. Required advertising for the Grand Opening may be $10,000. The problem is that a start-up franchise may not have the sales or income to pay this 5% on top of the 5-7% royalty. Thus, it is important for the franchisee to have cash reserves sufficient to "launch" the location. This should be considered part of the original investment cost, separate from other advertising percentages.

13. **Trademarks**. Separate license? Trademarks are an (if not *the*) essential element of a franchise and its brand. Yet, I have seen (fortunately not often) a franchise where a separate fee was charged for use of the trademark. This strikes me as illogical, unfair and abusive. Having a "brand" is a large part of what a franchise is all about.

14. **Accounting & Reporting Requirements**: Frequency, type, direct access, audited, right to audit/inspect. The franchisee must submit sales reports and perhaps profit and loss statements. These days the franchisor may require a certain accounting system, which it has direct access to. Thus, in addition to direct access to the franchisee bank account (by the ACH form or otherwise) the franchisor can look at your books by direct access to your accounting software.

15. **Non-Competition.** Terms, area, employee confidentiality agreement. Earlier we talked about other agreements besides the Franchise Disclosure Document and the Franchise Agreement. One of them may be a non-competition agreement under and in which the franchisee promises not to do business in the assigned Territory with a competing business either during or after the termination of the franchise relationship for a specified number of years. This agreement may be most important in the case where the franchisee fails but now knows the operations and industry.

16. **Transfer.** Franchise location sale or assignment. The franchisor more or less "has you" when you want to sell your franchise. Naturally, you want as few restrictions as possible; the franchisor wants more. What you want and want to look for are:

a. Reasonable non-consent. (Refusal for good cause only).

b. Reasonable qualifications for the transferee. I have had more than one client liquidate the business because the landlord would not approve the buyer. Same concern here. Note: Have attorney review lease for this and other important reasons.)

c. Reasonable transfer fees.

d. New franchise contract required.

e. Option to increase royalties or advertising fees. If the franchisee buyers are smart, they will realize that this increase comes out of their pocket, so the purchase price paid to you should be less.

f. Right of first refusal (RFR). The franchisor's right to step in an buy the franchise on the terms negotiated with a third-party buyer is a real "deal killer." One look at the franchisor's right of first refusal to steal the deal will cause many if not most potential third-party buyers to go away. They are not going to spend the substantial time, money and work on due diligence, then negotiating purchase terms with the seller franchisee, only to have the franchisor step in and exercise its rights to take the deal. Most of the time, whatever the contract, the party who desires to sell the property should strike this provision. The party who wants the option to buy can still do so or it can pay for the option or RFR.

g. Duty to sell to franchisor. On terms not specified? This can be even worse. If the franchisee must sell to the franchisor then it should be at fair market value and that fair market value term included in the franchise agreement. Otherwise, "no dice," on this term. The franchisor is not a baron and you are not the serf.

17. **Death/Incapacitation.** Definition. Assignment fee, heirs, better terms to operate or sell back to franchisor? Many franchise agreements (as well as "partnership" i.e. co-owner, agreements for that matter – do not contemplate the death or disability of the franchisee (or "partner"). This can cause the franchise (or other) business to have an owner who may not want, and is not qualified to be one. For this reason a buy-sell provision between the franchisor and the franchisee (or between partners) is a good idea. The purchase price or formula for determining the price, as well as terms of payment should be negotiated and included in the agreement. And, the surviving spouse or heir should sign off on same now.

18. **Termination.** Good cause reqd.; time to cure, special events of default, duties after termination, franchisor option to purchase assets, price; method to determine price. FMV, depreciated value. Given your substantial investment of time and money, not to mention that it sometimes takes years of restraint and saving to have the capital to start a business, the franchisor should only be able to unilaterally terminate the franchise contract for "good cause" and then only with prior notice, demand and opportunity to cure. Examples of "good cause" would be dishonesty in the reporting of sales or unapproved non-franchise competitive locations. The franchisee –or any contract party for that matter – should receive prior notice, demand and opportunity to cure before rights under an

agreement are terminated. As a judge once told me when I attempted to defend the client's termination of a contract without providing the other party the chance to cure the default because the contract did not expressly require it: "Prior notice, demand and opportunity to cure are so fundamental in our law they cannot be waived." Also, as discussed above, the method of determining the future purchase price and terms of payment should be negotiated now when termination is not a live issue.

19. **Guaranty.** Personal guaranties are sometimes presented and treated as an after-thought. But, just as the lease for the location can be the "tail that wags the dog," personal guaranties are important. In fact, a personal guaranty can be one of the most "dangerous" agreements any of us can ever sign. Reasons for this include: Contrary to its name a "guaranty" does not become effective only after the original debtor cannot pay; rather, it is an independent obligation. Often, the guaranty holder will just skip suing the original debtor (who after all is in default of the original obligation) and sue the guarantor. And, the typical separate guaranty agreement *waives* statutory protections, like suing the original debtor first and "marshalling assets," i.e. most proportionate assets first. With statutory protection waived the holder may execute against a house when a car would pay the debt. Given how onerous the typical guaranty is/can be, mitigating its effect is worth the effort. While difficult, the terms of guaranties can be negotiated to limit sums due to an amount more proportionate to an actual claim, e.g. actual fees due and not all sums that would/could have been due under the, say, five (5) year agreement.

20. **Security Agreement.** A security agreement is a contract under which the borrower pledges assets as collateral for the debt. This makes sense if the debt is used to buy the assets serving as collateral, e.g. the car as collateral for the auto loan. But, to grant a security interest to a party is who not loaning you money is questionable, if not dangerous. Granting a security interest to a non-lending party is "dangerous" in the sense that (1) it may violate an underlying loan from a general lender, e.g. bank loan to buy the franchise and (2) it may prevent such a loan, or other financing, in the future, e.g. a line of credit. Whenever possible, ad delete such clauses except in a purchase money loan.

21. I**nsurance.** Types and amounts. Insurance, of course, is routine and beneficial. But the amount should make sense. One may not need $5,000,000 of insurance for a franchise operation.

22. **Applicable law**. Almost always the party providing a product or service will seek to have the "governing law" be the law of its home state. If this is Michigan, and the franchise is located in Arizona, then the franchisee may have no idea what the governing law says about the issue until the issue arises. Fortunately, with franchises the franchisor is required to list differences in the law of other states where it has or intends to have franchises in this franchise agreement.

23. **Venue and Jurisdiction**. In addition to selecting its home state law to govern legal issues and disputes, the franchisor may designate its home state and county as the place where court proceedings must occur. Obviously, this can be disadvantageous to a franchisee in another state.

24. **Arbitration**. Often the franchisee must arbitrate disputes rather than file a legal action in court. Arbitration is private, i.e. non-court, dispute resolution where an attorney, former

judge, or expert in the field is selected to decide the case. The arbitrator's decision or "award," can then be filed as a judgment in the local county records. There are Pros & Cons to arbitration which I discuss in the separate article Arbitration: Pros & Cons. This is something you should discuss with an attorney.

25. **Waive claims when sign or renew.** As a condition of renewing of renewing your franchise for another five years (or whatever) the franchisor will require you to say in writing that you have no present claims against it. On the one had this makes sense. The relationship should only continue if the parties are really getting along. On the other hand, the franchisee may have bona fide claims in which case this requirement makes the franchisee choose between renewing or suing. Interestingly, under Arizona law in the employment context – where public policy protects the employee – an employee is not forced to bring wage or other employment claims during employment. The reason being that otherwise the employee would be in the position of having to choose between the claim and employment. Arguably, for the same reasons of public policy franchisees should not be forced to choose between claims and their livelihood.

Conclusion

As shown, there are important "big picture" and numerous contractual issues to consider in buying a franchise. Buying a franchise, like starting any business, is truly a "life-changing" decision and it should be treated like one. An experienced franchise or business attorney can help you work through these issues. More than that, often the attorney can share with you what he or she has learned over the years. This can be both valuable and interesting.

Thank you.