

WINNING WITH FRANCHISES
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How many are winning with franchises today? The numbers are impressive. It is estimated that there are over 500,000 franchise outlets in the United States generating almost \$150 billion in annual sales.

With those numbers the question becomes: Is franchising right for you? Which is followed by the second question: Are you a Franchisee or a Franchisor? This article will explore both issues. In Part I, we'll explore signing up as a Franchisee. In Part II we'll discuss starting your own business as a Franchisor. In Part III, we'll look at what is in a Franchise Disclosure Document.

Part I – Becoming a Franchisee

Franchises are so ingrained in our society that many may not even realize that they are purchasing goods or services from a franchise. While you probably recognize your favorite fast food restaurant as a Franchise, you may not know that your favorite hotel, clothing store, work out center or spa are Franchises too. Clearly, franchises are successful business models. And they are here to stay.

Franchises have come a long way from infancy starting with car dealerships and gas stations. There are now a wide variety of franchised businesses. Chances are much greater now that you will find a franchise that fits not only your personality but also your lifestyle and budget.

The beauty of franchises is that you can buy into a proven system, use the Franchisor's know-how and not have to reinvent the wheel when you start your franchised business. A good Franchisor will train you, show you how and show you what sells based on their past experiences.

Yes, you do have to put some money up front to purchase the grant to use the Franchisor's system, trademarks, knowledge and the like. Of course, in addition to the up-front fee(s) there are monthly or yearly costs and percentages of sales costs associated with owning a Franchise. But remember, you would have had to put up capital if you were to start your own business anyway. And hopefully, those ongoing costs are worth the brand recognition, shared volume buying power, proven business operation standards and all of the uniformity factors you can achieve with a franchise.

But remember this: You still own a business. Like all business adventures, you have to stay on task. You cannot just sit back and rely on the Franchisor to generate sales. We're talking about work here. Also, if you are the franchisee breaking new ground, what worked for the Franchisor may not work for your location. The Franchisor wants you to be successful in that location and communication of your situation is key. You will have to work closely with the Franchisor to make your location profitable, especially if you are breaking new ground.

Let's review some key points that prospective franchisees should be aware of when entering into the franchise relationship. First of all, many states as well as the federal government require certain disclosures to be made in a written document, which is known as the Franchise Disclosure Document ("FDD").

If the franchise business you are considering can't provide you with an FDD, you should continue your search. An FDD is just the starting point for franchising. Failure to have one prepared means that the Franchisor is not following basic legal requirements. You don't want to do business with such a company.

If the FDD is prepared you need to read it carefully. A great deal of important information can be learned from it. You may want to have your attorney or other advisor review it as well. Another pair of eyes on a fairly

technical (and sometimes intentionally boring and sleep inducing) document is an excellent idea.

After a close reading of the FDD, you may want to write down a list of your skills, goals and your financial capabilities. Ask yourself, do you have the technical know-how or education to run this type of franchise. Is it something that that can be learned from the Franchisor? Do you have the financial resources or money to invest in this type of venture? And if so, how long can you run the franchise without a steady income to live on while the business is growing? Is this list of goals truly what you want to do and will the franchise fulfill these goals?

Next, do some research on the type of business you are about to buy into. What is typical, standard or customary in the industry and does the franchise system adhere to this standard?

Look at the Franchisor. A lot of background information will be (or at least should be) in the FDD. But you may want to double check and deem whether the information provided is accurate. Are these actually federally registered trademarks you will use in the franchise business? Is the business truly qualified to sell franchises or conduct business in your state?

Next speak with both current and former franchisees. Speak with several of them and not just one current and one former franchisee. Ask current and former franchisees about their thoughts, trials, tribulations, and resulting economic status. You may wish to follow up with the Franchisor on what you found; especially if it was questionable information. However, do not be surprised if a current and former franchisee is prohibited from discussing certain trade secret information because they are bound by a confidentiality clause - no secret of the secret sauce.

Discuss your franchise opportunity with professionals. Seek an attorney's advice on the requirements that are particular to your state. Go to an

accountant or CPA to have them crunch the numbers. How long will it be before you recoup your investment?

With due diligence on your part and with the help of an advisory team, you will be better prepared to make the right choices when buying a franchise.

Part II – Becoming a Franchisor

You have a great idea for a franchise, now what? Becoming a Franchisor is not to be taken lightly, but the rewards can be significant. When becoming a Franchisor one must plan, plan and do some more planning to start the whole process of developing a franchise. A Franchisor may be a small start-up that has found a system that can work as a franchise or someone whose mature business has franchising in mind from the start. Please keep in mind that while there are strict and demanding rules that govern this type of venture, starting a Franchise is not impossible. Certainly others have done it before you.

First, ask yourself is what you wish to do truly a Franchise? There are three legal elements that would indicate that you do indeed have a franchise. You need all three of these elements in your business plan to constitute as a Franchise. If one is missing, you do not have a franchise. If you have the following elements you have a Franchise:

1. You require someone to follow your marketing scheme, you exert significant control over the other party in the agreement or you have some interest in this person's/entity's business;
2. You have a trademark that will be licensed; and
3. You are charging a fee that is \$500 or more within the first 6 months of the agreement.

These last two legal elements are the same required across the board, be it on a federal or state level. However, the first legal element's definition or

interpretation can and often does differ from state to state. The best way to determine if your business system truly satisfies all three elements is to check your state's rules. I am sure your legal advisor would be willing to see if your proposal qualifies as a Franchise. Why this third element can be confusing is that some state laws may define this element differently. One state may define this third legal element as a Community Interest whereas other states would define it as a Marketing Plan. Community Interest can have a much broader definition than just having a marketing plan. Community Interest may mean that there is an on-going, interdependent relationship between the parties of the agreement. For example, you have a situation where you and another person/entity have a community of interest in the marketing of goods/services either by lease, agreement or otherwise thus you may have Community Interest if that state's definition is worded as such. Keep in mind some states may also have these legal elements divided into four elements and so on.

As a Prospective Franchisor, you must be aware of a number of considerations, not all of which are covered here, when starting a franchise. Many states require certain procedures to be followed and disclosures to be made in the franchise disclosure document. For example, you must register the FDD first before offering or selling the franchise to any prospective franchisee in the State of California. On the other hand, Nevada, the state next door, does not require the FDD to be registered. Laws vary from state to state and will change even after the printing of this E-book.

As a Franchisor, it is always best to contact a franchise lawyer when you intend to enter into this type of business venture. A lawyer specializing in this area on the proper disclosures is highly advised. There are both state and federal laws that require proper disclosure. In fact, legal services to draft the FDD, register the FDD and draft the accompanying agreements should be included in your business plan and start up costs. It is money well spent.

As a Franchisor, not making the proper disclosures can be problematic. If you are missing the information for those items in the FDD, get it. At the state level, civil and criminal penalties can be levied if not all the required information in the FDD is present.

Information about you, the Franchisor, must be placed in the FDD to sell Franchises. The important information in the FDD is discussed below in Part III. As a Franchisor, you should read the above section for franchisees to get a feel for what it is that they need to look for.

Before starting, a Franchisor should have established trademarks and a franchise system. Having a franchise system is key when selling franchises.

Like most types of contracts, termination, transfer, renewal and non-renewal are all important elements of the FDD and the franchise agreement itself. Any details on how, when, where, why, who and how the Franchisor wishes to terminate the relationship, transfer of the franchised business or renew the franchise agreement, need to be present in the FDD for it to be a valid as well as the franchise agreement itself.

These issues can be problematic in that they deal with the potential loss of a Franchisee's rights. As the Franchisor, you must comply not only with disclosure laws but statutory and common-law rights that govern all types of agreements, not just franchise agreements. Planning on the situation that would cause you to terminate a franchisee is important. Some examples are: when the franchisee becomes insolvent, the Franchisee is incarcerated for fraud, the Franchisee fails to pay fees, expenses, charges or other amount when due to the Franchisor, the Franchisees financial statements are understate or missing figures that constitute a percentage difference, the list can go on and on.

Regardless of if you exercise your right to terminate or not renew the franchise agreement in the future, it is important that you state these things to the Franchisee at the inception of the relationship. If you do not state these conditions the Franchisee may be quite shocked that they are being terminated by you and potentially argue: "I had no clue that I could be terminated for that!" If this issue goes to court, the court may sympathize with the clueless Franchisee rather than your reasons for termination.

Something else to be aware of as a Franchisor is that you should prepare a franchise manual, a guidebook that assists the Franchisees in operating your Franchise. To start, the manual assists the Franchisees with the Franchisor's basic business plan, which will be beyond the initial training that Franchisees go through. One can say that the manual provides a systematic approach to the franchise system and insures continuity of that system. The Franchisee might turn to the manual first when a question arises. By having a manual in place, hopefully the Franchisee is more aware of what you expect as well as cutting down on the possibility of disputes later. The manual can take many forms but it should contain such topics as operating procedure, employee/human resource policies, job descriptions, supplies, goods and services provided, maintenance procedures, customer services, advertising and the like. An example of what would be in the manual: the procedure to make the Franchised signature hamburgers would be contained in this book. In sum, any planned marketing strategy, business system/methodology advertisement materials and so on should be in this Manual.

During the process of offering and selling franchises, some issues can arise that the Franchisor must be aware of. One rule of thumb is to present the official FDD to the prospective franchisee at least fourteen (14) days prior to the signing of any documents. You should stress that this is for their benefit and you appreciate their eagerness to enter into the franchise, however this rule must be followed. Another fact to remember is that any type of misrepresentation made by the Franchisor during the sale of a Franchise

could result in adverse consequences, which would affect both the entity and certain individuals. A misrepresentation can arise when the Franchisor claims that the prospective franchisee “will be making money hand over fist” when in reality there is no data to back up this statement or assertion. As a Franchisor, you should always stress the above points with all of your Sales Agents.

Once the Franchise System is established, franchises are sold and operated by Franchisees, you need to properly document and enforce your system, Trademarks and other proprietary issues. By not doing this, as a Franchisor, you run the risk of losing your valuable rights, good name and in some cases your customer base. Obviously, by having some type of compliance program to enforce the System, this not only furthers your objectives but helps lessen the opportunities of franchisee litigation. For example, evidence that you not only followed the agreements to the letter but that you consistently enforced and followed reasonable policies/procedures of the franchise system will assist in defeating a franchisee’s claim of wrongful termination. Being consistent in your enforcement of the system is important when your franchisees are similarly situated. One of the top contentions between the Franchisor and the Franchisee is that the Franchisor was not consistent in their enforcement of the system, especially when the franchisees are similarly situated.

Establishment of a Compliance Committee or Franchisee Group may also be something to consider. By having Franchisee input, you as the Franchisor can better assess what works and what doesn’t in the Franchise System. This will also help insure that the Franchise System is properly enforced. In some cases, it can ease termination of a franchisee if the Compliance Committee or Franchisee Group deems that the franchisee in question is not complying with policies and procedures.

As stated above, this is not an exhaustive list that qualifies your business as a valid Franchise. With an advisory team and due diligence on your part, you will make the right choices when starting a Franchise.

Part III – The Document Important to Both Parties

The FDD is now the required disclosure document. The Uniform Franchise Offering Circular (or “UFOC”) used to be the disclosure document of choice. However, as of July 1, 2008, the Federal Trade Commission (“FTC”) requires every Franchisor use the FDD when selling franchises. The FTC has made some changes to the UFOC. If you see some former UFOC terms, this may be a clue that the Franchisor did not comply with the law and convert to the new FDD format. If you are a Franchisor, get your FDD.

The FDD should be offered at least fourteen (14) days prior to signing any documents or it could be in violation of Federal and State laws. Like the UFOC, the FDD contains 23 items of information about the Franchise as well as any agreements or other important details that assist a Prospective Franchisee in determining if this is the right Franchise for them. If the FDD does not contain the following items, please be wary as a Prospective Franchisee. If you are a Franchisor, get this information in pronto!

Item 1: This is the first item you will see where the title has changed. Formerly called *The Franchisor, Its predecessors and affiliates*. After July 1, 2008, it should be called *The Franchisor and any Parents, Predecessors, and Affiliates*. This section contains foundational information about the Franchisor. It should also contain information about the history and operations of the Franchisor, the franchise being offered and the type of competition that the Prospective Franchisee might face.

Item 2: Important information about the individuals that make up the management of the Franchisor can be found here. This section is in a sense

a résumé or curriculum vitae on each individual involved with the entity that is offering the Franchise. The title of this Section has not changed.

Item 3: This section lists litigation that the Franchise entity may be involved with. If you are a Prospective Franchisee, it is always a good idea to start with this section first. As Prospective Franchisee, you can evaluate the Franchisor by the type of litigation they are involved with. If the Franchisor tends to be sued for breach of contract time and again, do you really want to be a Franchisee? No title change for this item.

Item 4: In this section, the Franchisor, its Directors, Offices and even its Predecessors must disclose any bankruptcy or reorganization under bankruptcy laws that they have been involved with. As a Prospective Franchisee, is it a business venture you want to participate in if the Officers have bankrupt previous ventures of the type of Franchise Offered? Probably not. The title of this section also has not changed.

Item 5: This section use to be called *Initial Franchise Fee*; now it should just state *Initial Fee*. This section sets out the initial fees that the Prospective Franchisee must pay upon signing the agreements. This section will also tell you what fees are refundable, what fees are not and methods of payment. The Franchisor should be aware that they might be required to provide their services prior to receiving payment. For example, the Franchisor may have to provide the training first before they receive payment for it. Therefore, the Franchisor should anticipate having this money on hand prior to starting a Franchise and not rely on the Franchisee's payments.

Item 6: As a Prospective Franchisee, this section really tells what you are in for. Here, the Franchisor provides all the fees that are involved with doing business as a Franchisee. Fees such as annual royalty payments, annual

license fees, rents or the like will be mentioned here. The title of this Section has not changed.

Item 7: This section use to be called *Initial Investment*; now it should read *Estimated Initial Investment*. This section will list all the initial costs to get the franchise business up and running. As a Franchisor starting a Franchise, this may be difficult to do at first. However, once you receive the feedback from the Franchisee, you should be able to reasonably pin down these costs. As a Prospective Franchisee, this section will help you estimate if you have the capital required to enter into the type of business venture.

Item 8: This section will inform the Franchisee what goods or services need to be purchased and from what designated source the purchase must be made from. This section will also specify, among other things, the monetary benefit the designated source will reap when the Franchisee purchases the items or services from them. No title change for this item.

Item 9: This section is important to the Prospective Franchisee because it lists all of the obligations the Prospective Franchisee will have to perform under the franchise agreement. The format of this section is that it states the obligation and then refers the Prospective Franchisee to the section in the contract or offering. An example is it will list, if any, requirements for site selection and other pre-opening requirements of the Franchisee and refer the Prospective Franchisee to where it is listed in the franchise agreement or Offering. The title of this section also has not changed.

Item 10: No change in title, but the name says it all – *Financing*. The terms of any financing the Franchisor may offer is listed here.

Item 11: The FTC also decided to change the item name, *Franchisor's Obligations*. It is now entitled *Franchisor's Assistance, Advertising, Computer Systems, and Training*. Here, you will find lists on the initial and ongoing

support or obligations the Franchisor provides under the franchise agreement. This will assist the Prospective Franchisee in determining if the Franchisor will be there to lend a helping hand or if the Franchisor just sells the Franchise and leaves the rest up to the Franchisee to handle.

Item 12: This section describes any exclusive territory that the Prospective Franchisee may be granted. Concerning the Prospective Franchisee's location, the Franchisor will disclose here if it may establish company owned franchises or offer other franchises using the Franchisor's marks, with or without an exclusive territory agreed upon. The title of this section has not changed.

Item 13: This section lists the trademarks that will be licensed to the Prospective Franchisee and what actions the franchisee must take upon any infringement. The trademark is an important asset to the Franchisor. The trademark's worth can be lost due to infringement issues if the Franchisor does not resolve them. As a Prospective Franchisee, is that the case in your situation? No matter what side of the fence you are on, your legal advisor would assist you with this determination. No title change for this item.

Item 14: This section will list other propriety information of the Franchisor, including but not limited to patents and copyrights that will be licensed to the Prospective Franchisee. The same concerns for a Prospective Franchisee in Item 13 apply here as well. The title of this section also has not changed.

Item 15: This section discusses the Prospective Franchisee obligation to participate in the actual operation of the franchised business. The Franchisor should think about whether they allow a Franchisee to operate the franchised business from far away. The Prospective Franchisee should be aware if they have to have direct involvement with the franchised business or if they can have a manager manage the operations instead. The title of this section has not changed.

Item 16: This section discusses the restrictions of what type of goods and services the Prospective Franchisee is to provide in the franchised business. There has been no change to the title of this section.

Item 17: This section explains the details to terminate the relationship, transfer the franchised business or renew the franchise agreement. Although no one wants to anticipate something negative happening in a relationship, it is always a good idea for either party to be aware of and understand how, when, where, why, how and who can terminate, transfer or renew the contract. Again, this item has not changed its name.

Item 18: This section will inform the Prospective Franchisee of whether or not the Franchise has any celebrity endorsements. If it does, it should state how much the celebrity and how much the Franchisor gets. No change to this title.

Item 19: The title to this section has changed. It used to be *Earnings Claims*. Now it is entitled *Financial Performance Representations*. This section will state what earnings claims are being offered. As a Franchisor, do you wish to state any earnings claims? There are two modes of thought on this: one, you state an earning claim and two, you do not. If you do not have earnings claims in this section of your FDD, there are no expectations that the franchise needs to live up to. If at any time during the sales process of the franchise a sales person makes a claim and that earnings claim is not realized, then, despite its absence in the FDD, the franchisee has a legitimate earnings claim complaint. So if you do have some type of earnings claim in place, make it as minimal as possible.

Item 20: This section used to be entitled *List of Outlets*. Now, this item should state *Outlets and Franchisee Information*. Here, the Franchisor lists all franchised outlets – current and prospective – and terminated outlets.

This section will help the Prospective Franchisee understand the geographic scope of the franchised business.

Item 21: This item's title has not changed and will contain the Franchisor's financial statements. These statements can inform a Prospective Franchisee if the Franchisor operating is making money or losing it.

Item 22: This section's title is *Contracts* and it should state all the contracts or agreements included in the FDD that the parties sign in order to enter into a franchise relationship. The FTC did not change this item's title.

Item 23: As above, the item's title didn't change and should state Receipt. The last page of the FDD is a detachable document known as the "Receipt." This is an acknowledgement that the Prospective Franchisee received the FDD. This insures that everyone knows that an offering was made to the Prospective Franchisee. The Franchisee is aware that this was a proper Offering and the Franchisor was aware that this was a proper Offering.

To sum up the FDD, the above 23 Items should be included in the FDD that the Franchisor provides to any Prospective Franchisee. Although important, the 23 Items are just a part of what you need to look at before you leap.

What are the conclusions you can take away today before you leap into the world of Franchising?

As a Franchisee, do your homework! Do you have the skills for this type of franchise? More importantly, is this franchise a business you wish to be a part of? Do the numbers add up? From a legal and business standpoint, does this franchise fit you and your goals?

As the Franchisor, do you have the trademarks and franchise system in place as well as the manuals to navigate that system? Are you in legal compliance

with the state or states you wish to franchise in? Do you have all your documents to start selling franchises?

With any venture, whether a Franchisee or a Franchisor, there are rules, procedures guidelines and information that needs to be sought. If you keep in mind these basic franchise ideas and seek your own legal/business team, then you should be able to navigate the world of franchising and win.