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Representing Prospective Franchisees

Specialized Expertise Required

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Lawyers with any knowledge of franchising recognize that a franchisor cannot even take baby steps toward starting its business without engaging the services of an experienced franchise lawyer. But what about the prospective franchisee? When talking to potential franchisees, a lawyer may hear: "Well, I am told the franchise agreement is not negotiable, so why should I need a lawyer?" or "The franchisor says I don't really need a lawyer until I start my business or negotiate my lease. What can you do for me now?" This article is meant to answer these questions. An experienced franchise lawyer can provide a host of valuable services to a prospective franchisee considering an investment in a franchised business and launching that business. A franchise lawyer can educate the new franchisee on the rights and responsibilities of being a member of a franchise system and offer advice about the franchisee's rights under franchise laws and regulations. The lawyer can give insight into the business of franchising and, upon learning the prospective franchisee's circumstances, can offer constructive comments for negotiation with the franchisor. Aside from the other legal needs that any business, franchised or not, has, a franchise lawyer can help the potential new business owner take a first giant step into the world of franchising.

Business Considerations

Because franchise relationships are not for everyone and there is no guarantee of success, prospective franchisees must evaluate carefully a variety of business considerations wholly apart from legally mandated disclosures received from franchisors. Prospective franchisees must assess the relative benefits, drawbacks, and alternatives to each opportunity. A franchise lawyer should understand the business of franchising, in addition to the law of franchising, in order to serve his or her client effectively.

Consider the following basic business concerns:

- The industry under consideration and prospects for short- and long-term industry growth;
- Whether the particular business can be taught easily to others;
- Whether experience is necessary;
- Whether geographic factors may affect the probabilities for success;
- The time commitment necessary to operate the business successfully;
- The capital investment necessary to establish and maintain the business and the individual prospect's financial capacity to handle it;

- The actual experience (financial and personal) of existing franchisees as well as the franchisor's track record in such a business;
- The legal rights and obligations of the parties in the relationship; and
- Whether the prospect will be compatible with the franchise business, including the capacity to balance entrepreneurial zeal with the necessity of following the franchisor's system of business operation. What is more, working in the franchise business before investing often makes sense.

Once one has decided on a particular industry or type of opportunity, the next step is to evaluate available offers, franchised and nonfranchised, in the field. In addition to legally required disclosure documents for a franchise opportunity, typically a franchisor provides prospects with marketing literature that describes the company and its opportunity. At best, these materials are a starting point for careful evaluation. While informative, often they accentuate the positive and omit the negative. Some suffer from hype and distortion. At worst, they contain fraudulent statements and deceptive omissions. The astute franchise prospect must take time to investigate all available legal and objective sources, including existing and former franchise owners, to assess fully the pros and cons of an opportunity. When doing so, the following key business factors should be addressed:

Financial Performance Representations. A prospect's most important question is: "What kind of money can I make if I buy this franchise?" The prospect should ask existing franchisees about their experience in this area. Frequently, however, their answers may not be informative or reliable. What is more, franchisors need not provide this information as a matter of law. A prospect should proceed very cautiously, if at all, if a franchisor does not include a helpful financial performance representation in its franchise disclosure document (FDD) under circumstances where it ought to have responsive information in its files. It may be that the reason for nondisclosure is that its franchisees are not doing well and a disclosure making this plain will have an adverse effect on its ability to sell franchises. When one is looking to buy a nonfranchised business, detailed information on sales, expenses, and profit/loss is always available. The situation should not be different if a franchise purchase is under consideration. Prospects should avoid distracting salesmanship and act accordingly.

Franchisor's Financial Health. Typically, three years of audited franchisor financial statements are provided in the FDD so that prospects can evaluate its financial condition and historical performance. It may be wise to have an accountant review them. Can the franchisor pay its debts as they come due? Must it sell franchises to meet its obligations (a bad sign), or does it otherwise have sufficient cash flow to operate via franchise royalties, product sales, or similar sources? Does it have sufficient net worth so that it will be there over the long term of a franchise agreement? If sued, can it pay a substantial judgment? Finally, study the notes to the statements because often they contain statements about the franchisor, its affiliates, and its business that have not been filtered through counsel.

Franchisor Personnel. Evaluate the franchisor's staff to determine if it has the expertise, experience, and capacity to provide meaningful support and guidance to franchisees. Is the staff's experience in the actual business of the type to be franchised (such as running a restaurant) or is it in unrelated areas or just franchising itself? Particularly where the franchise involved does not have a well-known trademark, it is the actual know-how in operating the franchised business that

should be most important to prospective franchisees. Financially weak franchisors may allocate their scare resources to other areas, such as franchise sales and accounting. Each opportunity should be carefully scrutinized to see if there are sufficient qualified personnel to train, service, and supervise franchisees adequately. Finally, as with the franchisor organization, any material adverse litigation history or bankruptcy history involving key franchisor personnel should be thoroughly investigated and taken seriously.

Training and Support. Because most prospects don't have experience in the franchise business, they depend greatly on the franchisor's initial training as well as ongoing training and assistance during the relationship. The quality of franchise training programs varies greatly. Similarly, some franchisors regularly visit their franchisees to evaluate and help them in their businesses while others do not. In addition to evaluating a franchisor's capacity to support franchisees by assessing its financial condition and the ability and capacity of available personnel, prospects should investigate extensively with existing franchisees to discern if they are satisfied with the training and support they receive from the franchisor.

Site Selection Guidance. For franchise businesses where location is important, prospects should learn if the franchisor provides (or requires) sophisticated site analysis or merely provides perfunctory approval of sites selected by inexperienced franchisees. Is the site sufficiently accessible? Is there adequate parking? Is it attractive demographically? Because site analysis often calls for sophisticated tools and skills, some franchisors will not allow prospects to do it. A franchisor's undertakings and talents in this area should be seriously considered.

Trademark and Advertising. The strength of the principal mark under which the franchise will operate is crucially important. It should be distinctive, legally protectable against use by unauthorized third parties, and the subject of customer goodwill in the marketplace. The great majority of franchises do not offer trademarks with substantial goodwill, particularly in the locality where most franchisees will set up shop. Also, the prospect must determine the kinds and extent of advertising (national, regional, local) that is provided by the franchise system and undertaken by franchisees. Advertising (for the brand's products/services, not for the solicitation of franchise sales) has been described as the "life blood" of a franchise system. While franchisees typically are assessed fees for advertising programs administered by the franchisor, such payments do not always translate into promotions that drive sales in their markets.

Source Restrictions. Whether for the establishment or ongoing operation of the franchise business, many franchisors make their franchisees purchase or lease goods, services, equipment, or real estate from them, their affiliates, or designated suppliers in which they have a financial interest. This may be done for quality control purposes or to offer franchisees necessary items on the most attractive terms available. Conversely, however, some franchisors treat their franchisees as profit centers and make a tidy markup on these transactions. Some franchisors receive rebates or comparable benefits from suppliers to franchisees that increase the cost of these items to franchisees. Prospects should investigate carefully any source restrictions to understand the financial ramifications to them and to learn if they will have any freedom to deal with alternative suppliers.

Territorial and Competitive Consider-ations. Although not appropriate for every business,

typically franchisees want protection from market saturation. While interbrand competition is understandable, intrabrand competition from encroaching units in their own system can be a serious problem. They seek the franchisor's promise by contract to grant them an exclusive territory in which the franchisor will not establish competing system units. Some franchisors agree to this while others do not. And even when they do, typically they reserve rights to compete against their franchisees in other ways. They may establish competing businesses under different trademarks or sell competing goods or services through other distribution channels, such as through retail outlets or via the Internet. Prospects must assess the franchise offering carefully, as well as specific markets under consideration, to fully understand their rights and risks in this area.

Legal Considerations

The Franchise Disclosure Document. When a prospect is considering the purchase of a franchised business, the most easily obtainable information is contained in the FDD, which must be given to a prospective franchisee 14 days (or in some states 10 business days) before the franchisee pays for the franchise or signs an agreement. The information contained in the FDD is precisely prescribed by the Federal Trade Commission and must contain all of the information required by the FTC Franchise Rule. Though the prospective franchisee should not rest his or her investigation of a franchised business solely on review of the FDD, the information in the FDD addresses most of the topics discussed above and is the most important document for the prospect to review during due diligence.

Among others, the following items must be included in the FDD: cost figures for the establishment and operation of the business (which include the initial franchise fee, royalties, and advertising fees), the type of assistance that the franchisor may offer to the franchisee (such as training and site selection), contractual provisions (including rights and obligations involving termination, renewal, and transfer of the franchise), important financial information (including financial statements of the franchisor), litigation and bankruptcy history of the franchisor and its management personnel, and historical statistics on the franchise system (including number of units open, terminations, nonrenewals, and transfers). Also, the FDD must describe the territory's exclusivity, or lack thereof.

As for forward-looking financial information, it is important for the lawyer and potential franchisee to understand that any financial performance representations or projections about the franchised business presented by the franchisor to the franchisee outside of the FDD may well be illegal. If properly instructed, franchise salespersons will be very careful to avoid giving such information other than that contained in the FDD. Figures written on cocktail napkins have been the subject of successful lawsuits against franchisors. Such financial information must be contained in the FDD in the financial performance representation section or not be disclosed at all. When considering franchises that do not give a financial performance representation in the FDD, the potential franchisee must be thorough in interviewing current and past franchisees because they are permitted to discuss the financial aspects of their businesses. The FDD must contain lists of franchisees, both current and past. Contacting these franchisees, both those recommended by the franchisor and others randomly selected from these lists, is an important part of the due diligence that a prospective franchisee should undertake prior to making an investment decision.

The Franchise Agreement. Just as one's house rests on a foundation, a franchised business rests on the franchise agreement. A form of the franchise agreement is contained in the FDD. Franchise agreements are prepared in the best interests of the franchisor, and there are good reasons for this. They contain many franchisor rights and corresponding franchisee obligations in order to achieve a uniform identity among outlets in a franchise system. This benefits both the franchisor and the franchisees and strengthens many aspects of the franchise relationship, such as use by franchisees of the franchisor's trademarks and standards for goods and services offered by franchisees under them.

Especially in states where franchisees have no statutory or other substantial noncontractual legal rights, the foundation of the franchisee's business will be shaky if built upon many of the provisions contained in the typical franchise agreement. Accordingly, franchisee counsel must fully explain to the prospect that she or he will be in a vulnerable position if she or he signs the agreement initially presented by the franchisor. Negotiating certain rights in order to firm up the foundation for the franchised business is good practice. Generally, if a franchisee does not negotiate even a modicum of rights at the start, he or she will not gain them during the relationship. It is far better for a franchisee to enter the relationship relying on rights clearly established rather than on hopes that the franchisor will do the right thing in a critical situation.

In the franchise sales process, a prospect may hear from the franchisor that it does not really enforce certain provisions of the franchise agreement in practice and conducts business in a different way, sometimes blaming the provisions on its legal counsel's insistence. It may refer the prospective franchisee to other operators in the system for proof of current practice. The lawyer should question why the agreement does not reflect the practices of the franchisor and request amendment or written clarification. Even if a franchisor does continue to maintain its current practice, franchise systems are sold frequently, and the purchaser may decide to enforce the agreement as written.

This does not mean that many, or even most, franchisors will not operate in good faith. But it is simply unwise, from the franchisee's perspective, to make a substantial investment and to sign on to substantial contract obligations with fingers crossed and little else. Some franchisors will negotiate. Others will not. Sometimes, developed systems are more resistant to making amendments than newer systems. Amendments are granted more easily, however, when special circumstances relating to a specific franchisee suggest that changes due to a particular business situation warrant a different approach. Whatever system is being reviewed or whatever the circumstances, the prospective franchisee has absolutely nothing to lose and everything to gain by conducting a thorough review of the franchise agreement and requesting desired revisions.

Among the many provisions that should be considered and addressed are

- Do the termination provisions permit a sufficient period of time in which to cure defaults? Does the franchisor have the power to terminate the franchisee for relatively minor infractions?

- Are there any limits on future increases in fees or expenses, including the royalty, advertising fee, or expenses relating to major system changes?

- Is the assistance and training contractually required by the franchisor sufficient to educate the franchisee and enable him or her to commence the business? Is there adequate post-training consultation and support, including on-site assistance?

- Are the dispute resolution provisions one-sided? Are there adverse remedial restrictions such as onerous liquidated damages provisions?

The prospect must understand the ramifications of the personal guarantee, which is required by most franchise systems. The risks associated with these guarantees should be evaluated, particularly in connection with indemnification provisions and liquidated damages provisions. Sometimes, these can be negotiated. If the franchise agreement contains a minimum royalty and does not allow the franchisee to terminate the agreement, franchisees with minimal or no operations can find themselves personally owing these royalties to the franchisor.

Finally, a prospect must be aware of the adverse effect that the noncompete provisions of the franchise agreement may have on his or her ability to conduct business if the agreement is terminated. Even if a franchisee was in the same or a similar business prior to purchasing the franchise, a broadly crafted noncompete provision may prevent him or her from continuing in that business after a termination of the franchise. Similarly, many franchise agreements contain a post-term collateral lease assignment to the franchisor and/or option of the franchisor to purchase certain assets of a franchisee. Such provisions permit the franchisor to succeed to the franchisee's business with little or no compensation to the franchisee. These provisions can have a devastating effect on the terminated franchisee. They should be examined and negotiated to allow the franchisee enough security to continue in his or her profession if the franchised business is not successful.

Conclusion

Prospective franchisees must exercise diligence in evaluating and investigating franchise opportunities. They should not let themselves be persuaded into making quick decisions that could have disastrous long-term effects. Rather, they should invest the time and resources necessary to evaluate competing opportunities thoroughly.

Competent counsel is essential to this mission, to both evaluate each offering and represent the prospect in negotiations with the franchisor. For most clients, the decision to buy a franchise and establish a franchised business is monumental, much like the decision to purchase a home. Counsel for the franchisor is typically able and experienced in franchise law. Prospective franchisees deserve comparable expertise. Their lawyers should educate themselves in franchise law matters or direct the prospect to a lawyer who is knowledgeable in the area.

Avoiding the Accidental Franchise Malpractice Traps

April 14, 2010 | 1:00 PM-2:00 PM Eastern

Your client wants to expand their business by issuing licenses or distributorships to independent contractors who will invest their own money and hire their own employees to sell your client's goods or services. After discussing business objectives with your client, you draft the license or distribution agreement. A year later, the client receives a demand letter from an unhappy licensee or distributor alleging that the licensing or distribution program is really a franchise relationship

which they now wish to unwind. The licensee or distributor has also complained to its local consumer protection agency, which has sent your client a demand letter inquiring into the specifics of the relationship. Your client wants you to explain why the licensing or distribution program is not a franchise and seeks advice on how to respond to the unhappy licensee or distributor as well as to the state regulator.

This teleconference and live audio webcast will examine the meaning of the "accidental franchise" and the implications to you and your client for creating one.

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