

BUYING A FRANCHISE

I. Introduction. Franchising is one of the largest growth industries in the United States. Nearly 50% of all retail sales today are made from franchised outlets. What started out in the hospitality industry (hotels, motels and restaurants) and petroleum market, franchising has expanded to almost every conceivable type of business, including retail sales and service industries. The growth of franchising has given prospective franchisees a myriad of choices in purchasing a franchise. The purchase of a franchise is a significant investment decision that should not be made without careful consideration and investigation. What follows is an outline of factors to consider before investing in a franchise.

II. Advantages of Buying a Franchise

A. When comparing the purchase of a franchise with the commencement of a new independent business, the following factors weigh in favor of purchasing a franchise:

1. The use of a recognized trade name or trademark
2. The sale of a known and proven product or service
3. The use of a comprehensive system for operating the business
4. In-depth training on all aspects of the business
5. The use of a confidential operations manual
6. National and/or regional marketing programs

B. The disadvantages of operating a franchise versus an independent business include the following:

1. Payment of a franchise fee and ongoing royalty or service fees
2. Mandatory advertising contributions which may be spent outside your market
3. Inability to offer any products or services for sale which are not approved by the franchisor
4. Very little flexibility in the operation of the business
5. Restrictions on transferability
6. Limitations on sources of supplies
7. Territorial restrictions on where you can establish and operate your business

III. Is Franchising Right For You?

A. Not everyone is well-suited to be a franchisee. The ideal franchisee has certain personality traits which allow him or her to follow a rigid system yet retain an entrepreneurial spirit to operate a business independently. The following characteristics are found in the "ideal franchisee":

1. The capacity to take financial risks.
2. The ability to work within a system and follow directions.
3. Leadership qualities and the ability to hire, train and manage a staff of employees.
4. The enthusiasm to work long hours to be successful.
5. The inclination to take responsibility for the success or failure of the business or any aspect of the business.
6. Discipline and organization skills - the aptitude to work efficiently without supervision.
7. Salesmanship
8. Persistence

B. If you do not have most or all of the qualities described above, you are not a good candidate for franchising. To put in another way, if you have the following character traits, you are probably not going to make a good franchisee:

1. Aversion to financial risk-taking
2. The need to control every aspect of your business
3. Inability to lead, hire or fire employees
4. Poor organizational skills and lack of self-discipline

IV. Types of Franchises

A. The most common form of franchising is known as a Business Format Franchise, where the franchisor licenses the use of its trademark, logo and trade secrets, and provides standardized marketing and operating procedures. An example of a business format franchise is a fast food restaurant.

B. Another form of franchising is called a Product Distribution Franchise, which includes vending machines, display racks, etc.

C. Today, franchising has invaded virtually all business sectors, including retail stores, service businesses, businesses that can be operated from home, and businesses that can be operated on a part-time basis. Similarly, the investment required for each business varies considerably. One of the threshold issues one must address is the amount of funds available to invest in a business. Next, one must decide what industries would be appropriate given the individual's background, interest and abilities. For example, if you are not mechanically inclined, I would not recommend an auto repair business, and if you are not good with paperwork and organization, I would not recommend an employee payroll business. You should choose a business that fits your personality, interest, ability, time commitment and budget. There are many resources available to obtain a list of available franchises, including the International Franchise Association, Bond's Franchising Guide, The Franchise Handbook, Franchise Opportunities Guide, Entrepreneur Magazine, and numerous internet web sites. Once you have narrowed your focus to one or two industries, you will need to compare the different franchises available in those industries (there are generally more than one franchise system in each industry).

V. Selecting a Franchisor

A. The publications mentioned above, such as Franchise Opportunities Guide, The Franchise Handbook, and Bond's Franchising Guide, provide a good start for basic information on different franchisors, including the number of franchisees in the system, the initial investment, the royalty fees charged, and the contact person for more information. Once you have selected an industry, you should contact several franchisors and request their franchise offering circulars. For a discussion of the franchise offering circular, see section VI below.

B. One consideration in selecting a franchisor is the length of time the franchisor has operated a business of the type being franchised and the length of time they have been offering franchises for sale. While a franchisor with a long track record may appear more attractive, there are also some benefits of getting involved with a new franchisor. Typically a new franchisor will be more flexible in negotiating the franchise agreement, including such important provisions as royalty fees, the size of an exclusive territory, rights of first refusal on additional territories, etc. A new franchisor may also provide more personalized training and support than its more established counterpart. However, there is probably a greater risk of failure in dealing with a relatively new franchisor, particularly if they have not been operating a business of the type being franchised for a long time.

C. Once you have selected an industry and narrowed your focus to a limited number of franchisors, and have obtained franchise offering circulars from those franchisors, a careful review of the offering circular and interviews with existing franchisees will enable you to intelligently compare the different franchise systems.

VI. Reviewing the Offering Circular

A. The Federal Trade Commission Rule on Franchising and various state laws require a franchisor to provide a prospective franchisee with an offering circular at the earlier of the first personal meeting or at least ten business days before any money is paid or an agreement is signed. The offering circular can take one of two formats; the FTC format, or the Uniform Franchise Offering Circular. Most franchisors utilize the Uniform Franchise Offering Circular which contains 23 items of information regarding the franchisor, the investment required, the rights and obligations of the franchisor and franchisee under the franchise agreement, and other information

useful to an investigation of the franchisor and comparison of different franchise systems.

B. For an in-depth discussion of reviewing a franchise offering circular from a franchisee's prospective, see the attached article which I wrote for a Florida Bar Association seminar on franchising.

C. In addition to the specific information that can be utilized in analyzing an offering circular, the following factors should be considered:

1. Does the demeanor of the franchisor's salesperson and staff demonstrate a high degree of professionalism?

2. Does the franchisor conduct a thorough investigation of the prospective franchisee?

3. Does the franchisor have a recognized trade name or trademark in the geographic area in which you intend to operate the franchise?

4. Does the franchisor have an established marketing program?

5. Does the franchisor appear to have the infrastructure necessary to adequately support you in your territory as well as other franchisees wherever they may be located?

6. Does the franchisor have a sufficient and competent staff to assist in site location assistance if this is important to the particular franchise?

7. Does the franchisor provide any written or verbal financial information regarding the franchise, such as potential revenues, expenses or net earnings which are not set forth in Item 19 of the offering circular?

8. Does the franchisor encourage or discourage you from contacting existing franchisees?

9. Does the franchisor encourage or discourage you from retaining an attorney and/or accountant to review the offering circular and franchise agreement?

10. Does the franchisor make any promises not specifically set forth in the offering circular?

D. In my opinion, the single most effective means of conducting due diligence on a franchisor is to interview as many existing and former franchisees of that system as reasonably possible. The franchisor is required to give you a list of the names, addresses and telephone number of existing and former franchisees.

VII. Negotiating the Franchise Agreement

A. In more mature franchise systems, the franchise agreement may not be negotiable (although one state, Virginia, requires that the franchisor negotiate in good faith). However, in many franchise systems, especially new systems, the terms of the franchise agreement may be negotiable.

B. Often, a franchisor will tell you that the franchise laws do not permit them to negotiate the franchise fee or royalty fee; this is not true. Nevertheless, most franchisors will not negotiate the franchise fee or royalty fees. In some cases, however, a franchisor may permit you to defer a portion of the franchise fee, and may waive the royalty for a short period of time (i.e. the first three months of operation).

C. One area of the franchise agreement that may be negotiable is the territory in which you are permitted to operate your franchise, or your exclusive territory if one is granted. You must read the franchise agreement very carefully to determine the true nature of any territorial exclusivity. Many franchisors reserve the right to offer competing products or services through "different channels of distribution". An example would be where Carvel agrees not to open a competing ice cream store in your area, but is permitted to sell ice cream to the supermarket next door to your outlet.

D. A relatively new franchisor may grant you a right of first refusal to open additional outlets or expand into additional territories. This will be very important if you intend to expand your business beyond the initial outlet or territory.

E. Review carefully the provisions relating to renewal and transfers. A franchise agreement is often for a period of ten years or more with a right to renew for one or more terms of

ten years each. However, many franchisors require that you sign the “then current form of franchise agreement” for the renewal terms, which new agreement may contain higher royalty fees, higher advertising requirements, and other unfavorable terms. Also, many things can happen in a ten or twenty year period and you may want or need to sell the business at some point during the term of the agreement; therefore, the ability to transfer the franchise can be very important.

F. Franchise agreements are typically one-sided in favor of the franchisor. One area that is often strongly in favor of the franchisor is the issue of termination upon a default by either party. My general inclination on these matters is to try to obtain, at a minimum, reasonable notice and opportunity to cure any alleged default.

G. Restrictive covenants (covenants not to compete) are often a critically important provision in franchise agreements for franchisors and are often not negotiable. My best advice here is just to make sure you understand the nature and extent of the restrictions, and to try to narrow the scope of the restriction to the greatest extent possible.

VIII. Choice of Entity

While a discussion of the choice of entity can only be dealt adequately on a case by case basis and is beyond the scope of this article, I would like to point out that there are different forms of entities through which you can operate a business, including sole proprietorships, corporations, limited liability companies, general partnerships, limited partnerships, etc. Any choice of entity will usually focus on liability issues and tax consequences. My strong recommendation is to choose a form of entity which will give you the most protection against personal liability. With the different options available today, this can usually be accomplished while retaining the most advantageous tax treatment.

IX. Lease Negotiation

A. Some franchisors will provide site approval and lease negotiation assistance. Some franchisors will even negotiate the lease of your business premises for you. This is not always in your best interest since the franchisor’s concerns under the lease may not be the same as yours. Also, some franchisors lease the business location directly from the landlord and sublet the premises to the franchisee. In either event, I recommend you obtain legal counsel to review your lease. A lease is often critical to the viability of the business.

B. Attached is a Lease Negotiation Checklist which I use when reviewing leases, which highlights some of the key legal and business issues.

X. Financing

A. Although some franchisors offer financing, the terms of which can be found in Item 10 of the Uniform Franchise Offering Circular, many franchisors do not. One source of financing which has become increasingly available is the Small Business Administration (“SBA”). In fact, the SBA now has a special financing program just for franchises. Contact your local bank or Small Business Development Center for more information.

B. If financing will be a concern to you, you should make the franchise agreement contingent upon you obtaining financing on terms and conditions satisfactory to you within a certain period of time (i.e. 60 days) after signing the franchise agreement.

XI. Conclusion

For many people, the decision to invest in a franchise will be the most significant financial decision of their business careers. Any such decision should only be made after careful and thorough investigation of all the factors described above. A competent and experienced attorney and accountant should be consulted when making such a decision. Use all of the resources at your disposal and GOOD LUCK!