How to steer clear of franchise financial disasters

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—By Zac Bissonnette, special to CNBC.com
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Investing in a marque franchise brand is no guarantee of success. Big national chains can get into trouble as easily as small independent businesses due to a wide range of missteps—from overexpansion to excessive debt.

In March, Quiznos, the Denver-based sub chain with 1,600 locations in the U.S. filed for Chapter 11 bankruptcy protection. The same month Radio Shack announced plans to shut 20 percent of its 4,000 stores, including 900 that were operated as franchises.

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Unfortunately, this is not unusual. History is littered with franchise companies that have hit the skids, including Dial-A-Mattress, Benningan's and Bally's Total Fitness.

So what happens to the entrepreneur who is heavily invested in a failing franchise brand that's going broke? Often, the small-business owner feels the trickle-down effect right away but has to soldier on.

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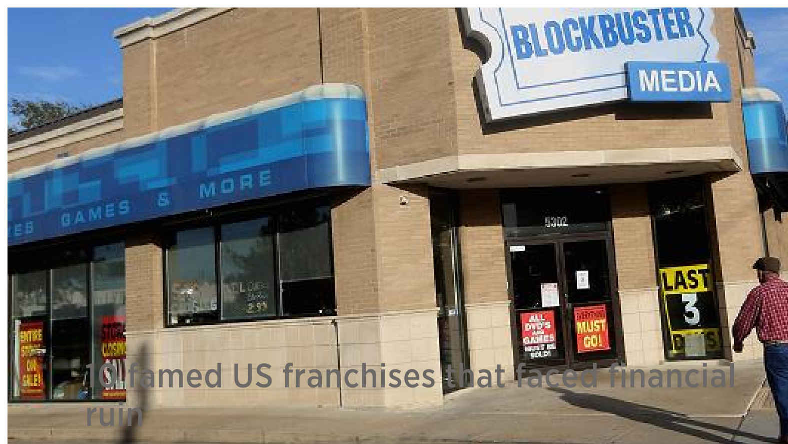
A Quiznos franchisee that spoke to CNBC.com on the condition of anonymity summed up his experience: "There has been a decline in support. The corporate and field office support staff has shrunk. We are having a lot of issues with food quality and consistency."

But even as the operational help at Quiznos has taken a dive, the entrepreneur is still required to pay his royalties as usual. That is taking a toll on his bottom line, since sales are plummeting as Quiznos reduces its national marketing efforts. "I think it would be safe to say that the majority of the franchisees would like to leave if they had a decent exit strategy," the franchisee admitted.

For its part, Quiznos' corporate office told CNBC that it has moved to shore up franchises with various lifelines since emerging from bankruptcy, "and we've seen immediate results."

In a statement, Quiznos said that it was "pleased with the support and initiatives to date and look forward to more success as franchisees better realize results of these changes."

Franchise experts say that too many franchisees go into business without doing enough research into the company they're getting involved with. Here are some tips for avoiding franchise disaster.



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1. Know your franchisor's financial status.

The Federal Trade Commission requires all companies offering franchises to present a franchise disclosure document to any prospective business owner. The documents can run to more than 50 pages—and one of the most important parts is the financial disclosure, in which the company is required to furnish audited financial statements.

But Kevin Murphy, an attorney and the founder of Franchising Foundations, says that only about 1 percent of franchisees bother reading the document all the way through. "A bad financial situation is one of the hugest red flags there is," he said. "Do you want to go out on a voyage across the Atlantic in a ship that's full of holes and ready to sink at any time?" Things to look out for: high debt, little in the way of cash reserves and declining sales and profitability.

2. Check the franchise agreement for obligations.

When a franchisor runs into financial and operational trouble, franchisees often look to head for the exit. Many think that a bankruptcy on the part of the parent company will allow them to part ways with the franchisor—or perhaps cut a deal for a lower royalty rate. But that's not the case. Even if the company starts scrimping on training, marketing, menu updates and connections with suppliers, you likely have little to no recourse.

"A lot of franchise agreements are little more than a license that the franchisee is granted the right to use the marks and system," said attorney David Gurnick, a State Bar of California specialist in franchise and distribution law. "The agreement doesn't say much in the way of things that a franchisor has to do."

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In some cases, he said, disgruntled franchisees have come to him assuming they have a breach of contract case, but when they actually read the contract, they discover that the franchisor didn't promise them much. Gurnick and Murphy both offer the same advice on this: Before you sign up for a franchise, try to get some of the services the franchisor will be providing written into the contract.

3. Look at the SBA loan default rate.

The best predictor of whether a franchise offers a system that works is the ability of the operators to repay the loans they took out to start the business. Quiznos has failed this test spectacularly for some time, with the *Wall Street Journal* reporting last month that between 2004 and 2013 a whopping 29.6 percent of Quiznos franchisees with SBA loans went into default. (Check out this listing of SBA default rates at various franchise companies.)

In its statement, Quiznos insisted that it was taking "immediate steps to change our business model," but added that restaurants were performing better overall.

This will give you a pulse reading on the highest-risk franchises. Keep in mind, franchisors don't have to disclose default rates or average first-year store revenues with potential franchisees. That is why doing due diligence before making an investment is key.

4. Investigate the history of litigation.

Of course, most businesses are involved in lawsuits from time to time. But if a company has a history of litigation with its franchisees, that may be a red flag. You can use Pacer.gov to search for litigation involving the franchisor—although any lawsuits should also be mentioned in the Franchise Disclosure Document as well.

"If the franchisor has a long list of litigation filed by their franchisees, there could be big problems in the system," said the Quiznos franchisee. "Stay away."