

How To Lead Your Clients to the Purchase of a Franchise

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FRANCHISING IS a flexible, tried-and-true method of distributing products and services, and offers business owners an alternative avenue to expand their already successful businesses. In a typical franchise arrangement, franchisees sell or distribute their franchisor's trademarked products or services. Franchisees usually have exclusive, protected territories in which the franchisor will not permit other franchisees to operate or to offer the same products or services. Franchisors generally provide their franchisees with operations manuals containing a system of operations and closely monitor the franchisees for compliance to protect the integrity of their brand and systems. Franchisees rely on their franchisors for advice, training, advertising and marketing assistance.

PROs AND CONs OF BUYING A FRANCHISE •

When clients consider the purchase of a franchise, McDonald's, Subway, and Burger King come to mind. However, there are hundreds of other franchisors in a wide variety of food, retail, and service businesses that are competing with each other to sell their franchises. The benefits to owning a franchise include:

- Access to a proven business system and a wider customer base, greater brand name recognition, and a stronger market presence;
- Group purchasing discounts; professional marketing; research and development benefits; and continuing education and training; and
- Support from the franchisor and other franchisees with similar goals, needs, and challenges.

On the other hand, franchising is not a bed of roses. Its disadvantages include:

- Operating under the myth of independent ownership and operation of the business. Franchisors generally want followers, not innovators, and impose numerous limitations on deviations from their operating procedures and business models;
- Buying a brand-name franchise is often expensive and, in many cases, can exceed the costs to begin the operation of an independent business. Generally, franchisees must pay their franchisors non-refundable advance payments for the opportunity to enter the business and non-refundable continuing royalty payments calculated as a percentage of gross revenue for the franchisor's operations and advertising services; and
- Some franchisors may not provide all the necessary training, guidance and services for the success of a franchise.

WHAT IS A FRANCHISE? • If the elements of a franchise are present in an agreement, the business relationship governed by the agreement is a franchise regardless of the name given to it by the parties. If a business relationship is a franchise, the relationship is highly regulated by federal and state laws in favor of, and to protect, franchise buyers. Under California law¹, a business relationship is a “franchise” if the business will be substantially associated with the franchisor's trademark; the franchisee will directly or indirectly pay a fee to the franchisor for the right to engage in the business and use the franchisor's trademark; and, the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

By way of contrast, true licensing, distributorship and dealership arrangements are not franchises because they lack at least one of the three elements described above. For example, under a

typical licensing arrangement, one company, the licensor, permits another, the licensee, to sell its products or services in exchange for a percentage of the proceeds from the sale without any other involvement on the part of the licensor. The licensee operates under its own trade name and usually buys products or services from the licensor at wholesale prices that the licensee resells to the public. Neither party is substantially involved in the day-to-day business affairs of the other.

REGULATION OF FRANCHISES • Federal law² and the laws of many states require franchisors to provide prospective franchisees with a franchise disclosure document (FDD) before the franchisor may sell a franchise. Thirteen states—California³, Hawaii⁴, Illinois⁵, Indiana⁶, Maryland⁷, Minnesota⁸, New York⁹, North Dakota¹⁰, Rhode Island¹¹, South Dakota¹², Virginia¹³, Washington¹⁴ and Wisconsin¹⁵—require franchisors to provide similar information in their FDD and to submit their FDD for review and registration by a governmental agency before any franchises are sold.

A FDD is an offering prospectus written in plain English that provides prospective franchisees with answers to 23 specific questions about the franchisor and the franchise. Franchisee candidates must have the FDD for at least 14 full days before they can execute a Franchise Agreement or pay the franchisor any money.

2 16 C.F.R. § 436.2

3 Cal. Corp. Code § 31000

4 Haw. Rev. Stat. § 482E-3

5 815 Ill. Comp. Stat. 705/1 et seq.

6 Ind. Code § 23-2-2.5

7 Md. Code Ann., Bus. Reg. § 14-214(a)

8 Minn. Stat. § 80C.01 et seq.

9 N.Y. Gen. Bus. Law § 683

10 N.D. Cent. Code § 51-19-01 et seq.

11 R.I. Gen. Laws § 19-28.15

12 S.D. Codified Laws § 37-5B- et seq.

13 Va. Code § 13.1-557 et seq.

14 Wash. Rev. Code § 19.100.010

15 Wis. Stat. § 553.01 et seq.

1 Cal. Corp. Code § 31005(a)

The FDD must include, among other things:

- Background information and business experience of the franchisor and its executives;
- Litigation and bankruptcy history for the franchisor, its affiliates, and their executives;
- Descriptions of the fees payable from the franchisee to the franchisor;
- The initial investment required to open a franchised business;
- A summary of the primary responsibilities of the franchisor and franchisee;
- An explanation of the franchisor's training requirements and a schedule for classroom and on-the-job training;
- The table of contents of the franchisor's operations manuals;
- Information regarding institutional and local maintenance of any franchisor-managed marketing funds and disbursements from the marketing fund in the preceding year;
- An explanation of the territorial rights that may be granted to franchisees;
- Information regarding the ownership and use of the franchisor's trademarks and patents;
- A description of the franchisees' rights to renew the term of their franchise agreements;
- The grounds for the termination of a franchise agreement by the franchisor and franchisee;
- Detailed information regarding the number of company-owned and franchised units operating, opened, closed, transferred and terminated during the prior three years;
- Contact information for the franchisor's current and former franchisees;
- Samples of the contracts franchisees must sign with their franchisor for their franchised business; and
- In most cases, audited comparative financial statements for the franchisor for the previous three years.

PURCHASE GUIDELINES • Here are some guidelines that franchisee counsel and their clients should keep in mind when considering the purchase of a franchise:

- The clients should look for a business in which the typical daily activity aligns with what they like to do and avoid those that will require activity they dislike;
- The clients should not jump into businesses that are completely new and different to them. They will greatly enhance their chance of success by selling products or services they understand;
- The clients should consider their own strengths, weaknesses, and comfort levels. If they are happiest when following orders, buying a franchise could be a wise choice. On the other hand, if they insist on going their own way at every turn, they should consider how long it will take before they chafe at the highly supervised nature of the franchisor/franchisee relationship;
- Is the business model profitable for the franchisor and its franchisees, and, if so, to what degree? Your client's business must have the potential to succeed;
- Is the business sustainable in the marketplace? Franchises built on fad products or services rarely survive. To be sustainable, the business concept should be unique enough to withstand competition, and also be one that potential franchisees are willing to pay to learn;

- The clients should be realistic about the costs of becoming a franchisee and should look for a franchise that matches his/her resources;
- The clients should be sure to get a current FDD from the franchisor. A franchisor without an FDD is generally not a franchisor to consider;
- Due diligence is vital. You and your clients should learn everything possible about the franchisor and the franchise. Your clients should talk to every current and former franchisee they can find. One of the most important signs of a healthy franchise system is a high level of satisfaction among current franchisees;
- The clients should investigate the franchisor's management team. A system with leaders who have substantial experience in the franchised business and industry is preferred over a system whose management team's experience is weak or in other industries;
- The clients should ask themselves whether the franchisor's staff, who will be their primary contacts, as well as other franchisees in the system, conduct themselves as they would. The character of the people your clients will work with must match up with their own standards;
- Franchise Agreements tend to favor franchisors to maintain system uniformity. However, Franchise Agreements that are too one-sided place franchisees at the mercy of the franchisor's whims and judgments. Your clients should find a system where the Franchise Agreement is balanced, either in its inception or through negotiation.

LEGAL PROTECTION • Once a franchise is purchased, the parties must adhere to the terms of their franchise agreement as well as applicable law.¹⁶ While reliance on applicable law is not a wise

alternative to effective pre-purchase due diligence, California and 17 other states have franchise relationship laws that restrict a franchisor's right to terminate or refuse to renew or consent to a transfer of a franchise without good cause.

California¹⁷ recently expanded the termination, transfer and renewal rights for franchisees under franchise agreements entered into or renewed on or after January 1, 2016, and for franchise arrangements with an indefinite duration that permit either party to terminate a franchise agreement without cause. The new law increases the required cure period for franchisee defaults from 30 to at least 60 days, but no more than 75 days, unless the parties mutually agree on a longer cure period, and, includes a new 60-day notice of default/termination requirement.

In addition, the amendment imposes a new "substantial noncompliance" standard on actions and inactions that may constitute "good cause" for termination and non-renewals. Its goal is to eliminate terminations and non-renewals for non-material violations of the franchise agreement. However, despite these new notice and cure requirements, franchisors may, if their agreements allow them to do so, still terminate a franchisee with no opportunity to cure in the case of bankruptcy, abandonment, mutual agreement, material misrepresentation, illegal activity, repeated non-compliance with the franchise agreement or imminent danger to the public.

The new law prohibits a sale, transfer, or assignment of a franchise; all or substantially all of the assets of a franchise business; or a controlling or non-controlling interest in the franchise business, without the franchisor's written consent. However, franchisors cannot prevent such a transfer to a purchaser who meets the franchisor's then-existing standards for new and renewing franchisees. The new law also creates a framework for the notice and information a selling franchisee must provide its franchisor on a proposed sale. Now, a franchisor must, "as soon as practicable" after receiving

16 16 C.F.R. § 436.2

17 Cal. Bus. & Prof. Code §§ 20000-20043.

a franchisee's notice, inform the franchisee of any additional information it requires and issue its approval or disapproval, with reasons, within 60 days or any shorter period provided in the franchise agreement. A franchisor that fails to do so will be deemed to have approved the transfer.

In addition, with some exceptions, even when a franchise agreement is properly terminated or legally not renewed, a franchisor must purchase from the franchisee, at its original price less depreciation, all inventory, supplies, equipment, fixtures and furnishings that the franchisee purchased from

the franchisor or a franchisor-approved supplier. And, in addition to any other damages, franchisees now may be awarded the fair market value of the franchised business and franchise assets following a wrongful termination or non-renewal.

CONCLUSION • The purchase of a franchise is a complicated process since there are certainly many factors to consider before doing so. Overall, the wise clients and the attorneys who advise them should be fully educated about franchise law and the franchised business before an investment is made.

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