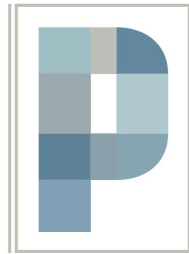




PERKINS



LAW  
PLLC



# FUNDAMENTALS OF FRANCHISING

*\*\*This material is provided for informational purposes only and should not be construed as legal advice. Receipt of this information does not create an attorney-client relationship between the recipient and the author.*

ERIC C. PERKINS, ESQ. 4870 SADLER ROAD SUITE 300 GLEN ALLEN, VA 2306

ERIC@ERICPERKINSLAW.COM WWW.ERICPERKINSLAW.COM PHONE (804) 205.5162 FAX (804) 482.2835

## **OUTLINE OF TOPICS**

- I. What is a Franchise?
- II. Why Buy a Franchise?
- III. Is Franchising Right for You?
- IV. Regulation of Franchising
- V. The FDD
- VI. Tips on Investigating Franchisors
- VII. Tips on Negotiating with Franchisors
- VIII. Getting Help
- IX. Glossary of Franchising Terms

## **IMPORTANT NOTICE**

THE INFORMATION CONTAINED IN THIS OUTLINE IS PRESENTED WITH THE UNDERSTANDING THAT THE AUTHOR IS NOT RENDERING ANY LEGAL, ACCOUNTING, OR OTHER PROFESSIONAL SERVICE TO THE RECIPIENTS OF THIS MATERIAL. THIS OUTLINE IS PROVIDED FOR INFORMATIONAL PURPOSES ONLY. BECAUSE OF THE RAPIDLY CHANGING NATURE OF THE LAW, INFORMATION CONTAINED HEREIN MAY BECOME OUTDATED; THEREFORE, ANYONE READING THIS MATERIAL MUST RESEARCH ORIGINAL SOURCES OF AUTHORITY AND UPDATE INFORMATION TO ENSURE ACCURACY OR SEEK PROFESSIONAL LEGAL ADVICE. IN NO EVENT WILL THE AUTHOR BE LIABLE FOR ANY DIRECT, INDIRECT, OR CONSEQUENTIAL DAMAGES RESULTING FROM THE USE OF THIS MATERIAL FOR ANY PURPOSE.

## **I. What is a Franchise?**

### **A. Common Sense Definitions**

#### **1. Definition by Example**

McDonald's, Wendy's, Dairy Queen, Holiday Inn, Molly Maids, Midas Mufflers, and the other 6,000+ franchise systems operating in the United States.

#### **2. Practical Definition**

Franchising is a method of distributing goods or services. A franchise is a type of business in which someone (the franchisee) agrees to pay certain fees and obey certain rules for the right to sell the goods or services of an established company (the franchisor) and benefit from its business methods, trade secrets, goodwill, professional training, and operating assistance.

#### **3. Elements of a Franchise**

Under federal law and most state franchise statutes, a franchise consists of the following three elements:

- (i) Trademark Element.** The franchisee operates his business under the franchisor's trademark or service mark or distributes goods or services associated with the franchisor's marks.
- (ii) Fee Element.** The franchisee is required to make a payment to the franchisor (or an affiliate of the franchisor) as a condition of obtaining or beginning the franchise operation.
- (iii) Control/Assistance Element.** The franchisee is subject to various requirements imposed by the franchisor, including requirements regarding the location of the franchised business, site design or appearance, hours of operation, sales methods, management systems, marketing, etc.

## **B. Legal Definitions**

### **1. Federal Law: The FTC Rule**

The federal franchise regulation is formally titled “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures” and can be found at 16 Code of Federal Regulations Part 436 (the “FTC Rule”). The FTC Rule defines a “franchise” as follows:

any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

- (1) the franchisee will obtain the right to operate a business identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities identified or associated with the franchisor’s trademark;
- (2) the franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and
- (3) as a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

### **2. State Law: The Virginia Retail Franchising Act**

The Virginia Retail Franchising Act is codified at Sections 13.1-557 through 574 of the Code of Virginia of 1950, as amended (the “Virginia

Franchise Statute”). The Virginia Franchise Statute defines a “franchise” as follows:

a written agreement under which (i) a franchisee is granted the right to sell goods or services at retail (not wholesale) under a marketing plan or system prescribed in substantial part by the franchisor; (ii) franchisee’s business is operated under franchisor’s trademark, trade name, or other commercial symbol designating the franchisor or one of its affiliates; and (iii) the franchisee is required to pay, directly or indirectly, a franchise fee of \$500 or more.

## **C. Common Franchise Types**

### **1. Business Format Franchise**

A business format franchise involves a franchisor offering a franchisee the right to use its business methods and systems in addition to selling the franchisor’s signature goods and services. The business format franchisees use the same procedures, recipes, and practices of the franchisor. Examples include typical restaurant franchises, home cleaning service franchises, and auto repair franchises.

### **2. Product Franchise**

A product franchise is a type of franchise in which a manufacturer of a product contracts with a select number of retailers or wholesalers to distribute its products. The retailer or wholesaler typically gets the right to identify itself as an “authorized dealer” of the franchisor.

## **D. Similar Types of Business Relationships**

### **1. Business Opportunities**

Although precise definitions vary from state to state, a “business opportunity” is commonly defined as the sale of products, equipment, supplies, or services to a purchaser upon payment of an initial fee for the

purpose of enabling such purchaser to start conducting business, and in which the seller represents that he will provide a sales program that will enable the purchaser to derive income from the program exceeding the price paid to the seller. Common examples include vending machine routes, envelope-stuffing programs, automobile cleaning systems, and coin-operated telephones, among others.

The FTC Rule regulates franchises and business opportunities, but most states govern franchises and business opportunities under separate statutes.

Business opportunity statutes typically require pertinent information to be disclosed at designated times prior to the sale of a business opportunity. Some business opportunity laws require a seller to obtain a surety bond or establish a trust account prior to making sales. Other statutes also impose registration requirements.

## **2. Distributorships**

A distributorship is a contractual relationship in which a manufacturer or supplier authorizes a distributor to distribute or sell supplies or products to others. The distributor buys the products from the manufacturer or an authorized supplier and often is entitled to identify its business by the supplier's trademark. Distributorships typically will not be classified as franchises under federal or state law unless the manufacturer or supplier provides significant operating assistance or imposes significant control over the distributor in exchange for payment of a fee. Unfortunately, it is all too common for parties to inadvertently structure a distributorship arrangement in such a manner that it constitutes a franchise under applicable law.

## **3. Licensing Relationships**

Owners of trademarks or other intellectual property that have developed a level of public recognition and secondary meaning will often find it advantageous to license such intellectual property to someone else in connection with another line of business. For example, professional sports

leagues regularly license the use of team logos on all types of merchandise.

Structured properly, a single-mark licensing arrangement is a valid alternative to franchising and offers the owner an excellent opportunity to maximize the value of its intellectual property by increasing brand recognition through identification with new products and services at a lower cost to the owner.

A primary risk under a typical licensing arrangement is that the licensor exercises little or no control over the licensee beyond periodic oversight to monitor quality control over the licensee's use of the intellectual property. In other words, a licensor will have significantly less control in a licensing relationship than it would as a franchisor in a franchise relationship.

#### **4. Inadvertent Franchises and the Confusing Interplay of Federal and State Law**

When structuring a licensing relationship, distributorship, or similar type of arrangement, the parties must carefully examine the substance of the underlying relationship to avoid inadvertently creating a franchise relationship. It is also possible for a certain business relationship to be defined as a franchise under the FTC Rule, but not fall within a particular state's definition of a franchise (and vice versa). When a company desires to do business in several states, each state's franchise and business opportunity laws must be examined. What is considered a franchise in Virginia may not be a franchise under Georgia law. A business opportunity under Florida law could be a franchise under North Carolina law and neither a franchise, nor a business opportunity under Mississippi law.

## **II. Why Buy a Franchise?**

### **A. A Brief History of Franchising**

The word “franchise” comes from a medieval French term “francis” which meant to grant rights or privileges to peasants. In the Middle Ages, a local lord would give others the right to hunt, hold markets and fairs, or engage in other activities on his land. These were the earliest franchise relationships and gradually evolved through the common law.

Modern franchising as we know it today was developed by German beer brewmeisters and the Singer Sewing Machine Company in the mid-1800s. Isaac Singer negotiated licensing fees from independent salesmen for the right to sell Singer Sewing Machines in a defined territory. By the Great Depression, franchising was starting to gain momentum with the beginnings of the A & W Root Beer and Dairy Queen franchise systems.

The golden age of franchising really started to take off in the years following World War II and has continued through today. There are several socioeconomic factors that help explain this growth, but that is beyond the scope of this outline. Suffice it to say that society’s increased mobility and desire for predictability and uniformity have fueled the explosive growth of franchising in the U. S.

### **B. Benefits of Franchising**

Franchising has become increasingly popular over the past 30 years. According to the International Franchise Association (“IFA”), franchising’s annual retail sales exceed \$1 trillion. Not only are established franchises expanding, but new industries are franchising on a regular basis. With the evolution of co-branding, franchised businesses are reaching new markets and utilizing new distribution channels (e.g., convenience stores, sports arenas, college campuses, shopping malls, office buildings, amusement parks, etc.).

Many entrepreneurs believe that investing in a franchised business can offer them the following benefits:

1. instant name recognition and reputation;

2. decreased risk of business failure;
3. proven business format;
4. professional training and assistance;
5. mass advertising and purchasing power; and
6. networking opportunities with other franchisees.

### C. **Humble Beginnings of Some Successful Franchises**

1. **Baskin-Robbins.** Irv Robbins opened his first ice cream store in Glendale, California. He named his store “Snowbird” and proudly featured 21 different flavors of ice cream. In 1946, he teamed up with his brother-in-law and competitor, Burt Baskin, to form Baskin-Robbins. After opening six successful locations, the two businessmen started licensing their business format to others, thus giving birth to the world’s first ice cream franchise.
2. **Pizza Hut.** While Frank and Don Carney were in college, a friend convinced them in 1958 to open a pizza parlor in Wichita, Kansas. They borrowed \$600 from their mother to buy some used equipment, rented a small building, and opened the first Pizza Hut. The first franchised Pizza Hut opened the following year. By 1968, there were over 300 Pizza Hut locations serving over 1 million customers each week. The growth and popularity of the franchise continued throughout the rest of the century.
3. **Holiday Inn.** Kemmons Wilson opened the first Holiday Inn in Memphis, Tennessee in 1952. Special features introduced for the first time included a “children stay free” feature, swimming pool, air conditioning, telephones, free parking, and a restaurant. Wilson soon started selling franchises at a time which coincided with the massive expansion of the U.S. interstate highway system. By 1968, there were over 1,000 Holiday Inns across the United States.
4. **Midas Mufflers.** Nate Sherman opened the first store in Macon, Georgia in 1956, introducing the lifetime muffler warranty. Within a year, there were 100 locations. The first international location opened in Canada in 1961. The franchise steadily grew and by the 1980s there were over 2,000 Midas Muffler locations.

5. **Subway.** Frank DeLuca was 17 when a family friend, Dr. Peter Buck, convinced him to open a submarine sandwich shop. They joined forces to open “Peter’s Super Submarines” in 1965 in Bridgeport, Connecticut. They quickly opened several other locations as they plotted an aggressive growth strategy. The name was changed to “Subway” and they began selling franchises in 1974. Subway now has thousands of franchised locations all over the world.

### **III. Is Franchising Right for You?**

Before you consider investing in a franchised business, you should first do a little soul searching and self-analysis. You should consider your goals, abilities, personality traits (both positive and negative), personal interests, and expertise. Your chances of achieving success in business are greater if you enjoy your job.

In proceeding through the franchise selection process, you should be very deliberate and thorough in your research of each franchise opportunity. Avoid making decisions based on emotion rather than facts.

#### **A. Misconceptions About Franchising**

Common misconceptions about franchising include:

MYTH: Financial success is practically guaranteed.

REALITY: Franchises are like any other business, hard work and sound business judgment are the keys to success.

MYTH: A franchisee owns his or her franchise forever.

REALITY: Franchise agreements last for a specific term of years. If not renewed, then the franchisee’s rights to the franchised business expire (if not terminated sooner under the terms of the franchise agreement).

MYTH: My franchisor would not open a franchise near my location or allow any other franchisee to intrude on my territory.

REALITY: Subject to the specific limitations in your franchise agreement, your franchisor (or another franchisee) might open a competing franchise location near your business. You must carefully read your franchise agreement to determine the extent of your protected territory, if any.

## **B. Personality Profile: Questions to Ask Yourself**

Whether franchising is right for you is really a two-part question. First, you have to ask yourself whether you have the mindset of an entrepreneur. Second, you have to decide whether your goals are better suited to operation of a franchise or an independent business. Being an entrepreneur generally means several years of long hours, hard work, personal and financial sacrifice, and high risk of failure. Being a successful franchisee requires these same characteristics, but there are also some key distinctions. Franchisees must give up a degree of independence in complying with a particular franchise system. On the other hand, many franchisees experience a lower risk of failure than independent entrepreneurs.

To conclude whether going into business for yourself as a franchisee is the right career move for you, you should be able to answer “YES” to most, if not all, of the following questions:

1. Are you capable of solving well-defined problems in a timely and creative fashion?
2. Do you regularly take initiative in your personal and business matters?
3. Do you like working with other people?
4. Do you have work experience with small businesses?
5. Are you willing to risk most of your personal savings on a business venture?

6. Do you become totally involved in your work, making it a top priority in your life?
7. Are you prepared to work 80 or more hours a week for an indefinite period of time to make your business successful?
8. Do you enjoy competition?
9. Can you simultaneously juggle several assignments and tasks?
10. Do you consider yourself an efficient and well-organized individual?
11. Are you able to quickly and effectively deal with conflict?
12. Are you prepared to seek professional legal and accounting assistance during the early stages of your business?
13. Do you have good health and a high energy level?
14. Are you prepared to leave the comfort and security of your current job?
15. Are you willing to accept and abide by a franchisor's business model, practices, methods, and procedures?

#### **IV. Regulation of Franchising**

There are both federal and state laws that regulate the sale of franchises. These laws first appeared in the 1970s after widespread reports concerning fraudulent start-your-own-business opportunities throughout the United States. Authorities discovered that most victims were first time investors who had minimal business knowledge or experience.

After receiving hundreds of complaints, the FTC took a close look at this growing trend of unfair and deceptive business practices and concluded that a primary source of these problems was the informational imbalance between franchisors and prospective franchisees. As a result, the FTC concluded that prospective franchisees should be provided more complete information about franchise opportunities. These findings and conclusions gave rise to the franchise disclosure laws in effect today.

## **A. Federal Law: The FTC Rule**

The FTC Rule was promulgated in 1979 after years of investigations and hearings concerning the widespread deception and unfair trade practices of unscrupulous franchisors. Today, every franchise offered for sale in the United States is subject to the FTC Rule, which was most recently amended in 2007.

The FTC Rule requires franchisors to provide a minimum level of pre-sale disclosure to prospective franchisees.

- a. Information Requirements.** The FTC Rule requires franchisors to provide prospective franchisees with information about the franchisor and the franchised business being offered for sale. Each category of the required disclosure document is described later.
- b. Delivery Deadline.** An FDD must be given to a prospective franchisee at the earlier of: (i) at least fourteen (14) calendar days before the execution of any agreement, or (ii) at least fourteen (14) calendar days before money changes hands. Second, if a franchisor makes any unilateral changes to the form of franchise agreement (or other agreement between the parties) initially provided to the prospective franchisee, it must deliver the revised versions to the prospective franchisee at least seven (7) calendar days before execution.
- c. Penalties.** The FTC has the power to impose the following penalties for violations of the FTC Rule:
  - i. civil penalties of up to \$11,000 per day for each violation of the FTC Rule or an FTC cease and desist order;
  - ii. FTC may compel rescission or reformation of contracts, refunds, return of property, payment of damages, and public notification of violations;

iii. FTC may issue cease and desist orders requiring a party to refrain engaging in any unfair method of competition or deceptive act or practice in or affecting commerce.<sup>1</sup>

- d. **No Private Right of Action.** Private citizens cannot sue franchisors for violations of the FTC Rule. Only the FTC can take any action to enforce the FTC Rule. An aggrieved franchisee may benefit as a result of FTC enforcement action (as referenced in (c) above) or he may have available causes of action and remedies under state law, but it is important for franchisees to understand that they have no private rights to enforce the FTC Rule.

## **B. State Regulation**

The FTC Rule does not require franchisors to file or register with any federal or state government agency. Some states, including Virginia, have franchise statutes that impose numerous restrictions, requirements, and other controls on the offer and sale of franchises. Some state franchise laws also control certain aspects of the franchise relationship, including termination and renewal rights.

### **1. State Registration Laws**

There currently are 13 states (including Virginia) with statutes specifically requiring registration of an FDD and other materials prior to an offer or sale of a franchise in that particular state. Other states impose less onerous notice filing requirements.

### **2. State Business Opportunity Laws**

In many states without franchise statutes, and in some states that do have franchise statutes, there are business opportunity statutes. These laws generally concern the typical self-employment, “get rich quick” schemes like vending machine routes where the seller promises that a certain level of profit will be made or that all purchases are fully refundable.

---

<sup>1</sup> 16 C.F.R. §436.1; 15 U.S.C. §45.

### 3. State Franchise Relationship Laws

Some state franchise laws impose certain substantive requirements on the contractual relationship between franchisors and franchisees. Examples of such provisions under the Virginia Franchise Statute include:

- a. **Section 13.1-564.** This provision prohibits the cancellation or termination of a franchise agreement by a franchisor without “reasonable cause.” This provision also prohibits franchisors from exerting undue influence to encourage franchisees to surrender their rights under the Virginia Franchise Statute.
- b. **Section 13.1-565(b).** This provision requires that all provisions of a franchise agreement must be negotiable to the extent that such negotiations will not hurt the uniform image or quality standards of the franchise.

## VII. The FDD

### A. What is an FDD?

The FDD is the disclosure document required by federal and state franchise laws to be given to prospective franchisees. This document describes the franchise being offered for sale in a standardized, plain English format. The standard format of the FDD enables individuals to efficiently compare one franchise with another.

A franchisor’s FDD is not subject to prior review or approval by the federal government. A number of states have registration requirements which provide for prior state approval of a franchisor’s FDD before franchise sales can take place, but such approval does not mean the state endorses or recommends a particular franchise opportunity.

As stated above, the FTC Rule requires franchisors to provide prospective franchisees with copies of the FDD at least 14 calendar days prior to any contracts being signed. This “waiting period” feature protects franchisees in two ways:

1. The waiting period provides the franchisee an opportunity to thoroughly review the documents with legal counsel and to understand all of his rights and obligations under the franchise agreement and related agreements.
2. The waiting period provides the franchisee a limited mechanism to get out of a franchise agreement if the disclosure documents were not delivered in a timely fashion under the FTC Rule and applicable state law.

Most franchisors will send potential franchisees disclosure documents upon request, although many implement a pre-screening process so that only serious candidates get access to disclosure documents.

## **B. Breakdown of an FDD**

The FDD format consists of 23 categories of information about the franchisor and the franchise opportunity being offered for sale. These categories are summarized below in the order in which they appear in the FDD.

### **1. The Franchisor and any Parents, Predecessors, and Affiliates**

This section of the FDD summarizes the history of the franchisor and the franchise system being offered for sale. It will also describe the organizational structure of the franchisor, including affiliated entities (some of which might offer other franchises for sale).

This section also will include a description of the market for the franchisor's products and services and a general discussion about the franchisor's competitors.

### **2. Business Experience**

This section will generally describe the employment histories of the franchisor's officers, directors, and other key executives with management responsibility related to the sale and operation of franchises.

### **3. Litigation**

This section will summarize important litigation involving the franchisor, including franchisor-initiated litigation against its franchisees. This might include disputes with franchisees, customers, suppliers, or competing franchisors.

### **4. Bankruptcy**

This section of the FDD describes any bankruptcy of the franchisor, its affiliates, officers, or directors during the last ten years.

### **5. Initial Fees**

This section describes the initial franchise fee or fees payable to the franchisor or its affiliates related to the purchase of a franchise. The initial franchise fee will vary greatly, depending upon a number of factors, including the term of the franchise, the services offered by the franchisor, and the protected territory, if any, of the franchise granted to the franchisee.

### **6. Other Fees**

Section 6 of the FDD will describe all fees the franchisor will collect from the franchisee for itself or third parties on an ongoing basis. These fees might include operating royalties, advertising fund royalties, lease negotiation fees, site selection fees, permitting fees, training fees, audit fees, transfer fees, and renewal fees.

### **7. Estimated Initial Investment**

This section describes the costs a new franchisee will likely incur to start its business. This information generally comes from data gathered by other franchisees' experiences in recent years. This is valuable information for prospective franchisees who need to carefully plan budgets and business plans, obtain financing, etc.

## **8. Restrictions on Sources of Products and Services**

This section summarizes the methods by which the franchisor attempts to preserve uniformity from franchisee to franchisee across the United States. Consistency of products and services is the essence of a successful franchise program. Therefore, a franchisor will typically have very specific requirements concerning what a franchisee can sell and where a franchisee can buy its supplies and inventory. Some franchisors require franchisees to buy certain supplies and inventory from the franchisor or affiliates of the franchisor. These sorts of relationships must be disclosed in the FDD, including the income derived by the franchisor or its affiliates from these types of requirements.

## **9. Franchisee's Obligations**

This important section of the FDD lists the duties and obligations of the franchisee under the franchise agreement.

## **10. Financing**

If the franchisor offers financing programs to assist its franchisees, this section of the FDD will describe the terms of such financing. If the franchisor leases equipment to franchisees, the terms of such programs will be described in this section.

## **11. Franchisor's Assistance, Advertising, Computer Systems, and Training**

This section summarizes what services the franchisor will provide the franchisee during the term of the franchise agreement. For a prospective franchisee, this section is very important and should be studied carefully and compared with the FDDs of different franchisors. Details of the franchisor's initial training and ongoing assistance programs will appear in this section. Franchisors must offer prospective franchisees a reasonable opportunity to review any applicable operations manual or include the table of contents in the FDD.

## **12. Territory**

This section defines the type of territorial protection (if any) the franchisor offers its franchisees. In other words, a franchisor must describe any and all limitations on its right to directly or indirectly compete with franchisees in any way. For example, many franchisors reserve the right to sell franchised goods and services through alternative channels of distribution such as convenience stores or grocery stores. Many franchisors also reserve the right to open competing locations very close to another franchisee's location. A specific disclaimer must be included if no exclusive territory is offered.

## **13. Trademarks**

This section discloses the franchisor's ownership interest in the primary trademarks, service marks, and trade names under which the franchisor operates. These are the marks that a franchisee will be allowed to use in operating its franchised business. The franchisor's trademarks embody the franchise system's goodwill, recognizability, and uniformity. If a primary trademark is not federally registered, the FDD must include a specific disclaimer to that effect.

## **14. Patents, Copyrights, and Proprietary Information**

This section is relatively unimportant in many cases because not many franchisors own patents that are material to the franchise system. For those franchisors who have developed patented processes or inventions, these patents will be described in this section of the FDD.

Most franchisors claim copyright protection for their operations manuals and computer software used in the operation of the franchised business. Franchisors will also strive to protect other trade secrets and proprietary information. Franchisees will be prohibited from disclosing or using such information for any purpose other than operation of the franchise system.

**15. Obligation to Participate in the Actual Operation of the Franchised Business**

As a general rule, franchisors believe that franchised units will be more successful if the owner of the franchise unit is directly involved in the business. Thus, many franchisors require an owner of the franchised unit to be involved in the day-to-day operation of the business (i.e., passive investors will be rejected as candidates for franchised units).

**16. Restrictions on What the Franchisee May Sell**

This section describes what are usually very specific restrictions on what products and services franchisees can sell. These restrictions are necessary to preserve the uniformity, consistency, and integrity of the franchise system. While these restrictions may seem strict to an individual franchisor, the fact that all franchisees in a given franchise system must comply with the same restrictions benefits each and every franchisee.

**17. Renewal, Termination, Transfer, and Dispute Resolution**

This section describes important provisions of the franchise agreement concerning if and how the franchise agreement can be renewed, terminated, or transferred. A franchisee does not actually “buy” a franchise but, instead, is awarded a temporary right or license to use a franchisor’s business systems, products, and services for a specific period of time. These rights are not perpetual. In fact, some franchisees do not fully comprehend this concept and are surprised to learn that they have breached the agreement and their franchise is on the verge of being terminated.

While most franchise agreements give the franchisor the right to terminate the franchise agreement in several situations, franchisees typically have very limited, if any, rights to terminate the franchise agreement before its stated expiration date.

This section also describes the methods and procedures by which disputes between the franchisor and franchisee will be resolved. In many cases, all disputes must first be submitted for mediation or arbitration in the franchisor's home state. This requirement can be very burdensome to franchisees and, in effect, deter the franchisee from ever attempting to enforce its rights under a franchise agreement.

**18. Public Figures**

If a well-known personality (actor, pro athlete, musician, etc.) is involved with the franchise or endorses the franchise, such relationships must be described in the FDD.

**19. Financial Performance Representations**

This optional section of the FDD discloses historical information about the income and earnings of franchise units and company-owned units. This section also includes forecasts of future earnings. Due to the risk of liability, most franchisors do not make earnings claims. Note, however, that cost and expense information is not considered a financial performance representation under the FTC Rule; therefore, franchisors may provide that type of information to prospective franchisees.

**20. Outlets and Franchisee Information**

This section contains a series of statistical charts listing the number of franchised units opened, closed, transferred, terminated, non-renewed, reacquired, and projected to be opened (not including foreign units). Disclosure requirements also include providing a five-year ownership history for previously owned franchise units now under franchisor control. Confidentiality agreements with current or former franchisees must also be disclosed.

**21. Financial Statements**

Franchisors are required to disclose their audited financial statements for the prior two years. Under the FTC Rule, a start-up franchise system may

phase in the use of audited financial statements, but some registration states may nonetheless require audited financials.

## **22. Contracts**

This section of the FDD identifies all standard contracts the franchisor typically requires its franchisees to sign. Leases, guarantees, and promissory notes are common examples.

## **23. Receipts**

The final page of the FDD is a receipt which is signed by the prospective franchisee to document that he received the FDD on a particular date. The franchisor will retain this receipt as proof that it complied with the disclosure requirements under the FTC Rule and applicable state law. The receipt must also be signed by any “franchise seller,” a term defined as any “person that offers for sale, sells, or arranges for the sale of a franchise.”

# **VI. Tips on Investigating Franchisors**

In addition to reviewing the franchisor’s FDD, obtaining professional assistance, and following the other suggestions mentioned in this outline, set forth below are a few special tips on navigating the franchise selection process.

## **A. Due Diligence**

Either alone or with your attorney, you may desire to investigate the franchise system’s legal, economic, and business condition. As part of this investigation, you should focus on the following issues:

1. If the franchisor makes financial performance representations in its FDD, ask for explanations about any qualifications to, or assumptions made as part of, those earnings claims.
2. You can conduct a trademark search to confirm the validity of the franchisor’s trademarks and service marks. For many franchise systems,

their trade name or logo is the “heart and soul” of the franchise. If those rights are jeopardized, the future of the franchise system could be in doubt.

3. You should investigate the franchisor’s current “field service” or franchisee inspection policies. Try to identify who would be assigned to your franchise location and obtain a resume of this advisor’s background. If possible, interview the advisor to learn about his or her personality, demeanor, competence, and commitment to the franchisee’s success.
4. You should take a close look at the franchisor’s marketing and advertising programs. Obtain copies of current marketing materials and assess their impact on the public market. If franchisees are required to contribute to a collective advertising fund, ask to see a recent disbursement statement to find out where this money is being spent. Find out how many people are employed in the franchisor’s marketing department and try to meet these individuals to get a sense of their competence and commitment to the franchise system.
5. You should also inquire as to whether the franchisor plans on any major acquisitions or other transactions in the near future. This conversation could give you valuable insight into the franchise system’s future plans.

## **B. The Operations Manual**

The heart and soul of a franchise system is the operations manual. Most franchisors provide their franchisees with a detailed manual that provides specific step-by-step guidance on the franchise system’s operating procedures, methods, guidelines, and recipes. A summary or table of contents should be disclosed in the FDD but, for obvious reasons, a franchisor will not divulge its trade secrets in the FDD. This information, however, is generally set forth in the operations manual.

Operations manuals are beneficial in many ways. Besides being a key information resource for franchisees, the operations manual is useful in resolving disputes over operating procedures and standards.

An important point to remember about an operations manual is that it usually is subject to amendment at any time in the sole discretion of the franchisor. Major

aspects of the franchise system can be unilaterally changed by the franchisor and the franchisees will be required to comply with those changes. From the franchisor's perspective, this flexibility is necessary to allow the franchise system to grow and evolve to meet ever-changing consumer demand. From the franchisee's perspective, this flexibility can be burdensome and the source of unexpected expense.

For example, it will often become necessary for a franchisor to compel its franchisees to make additional capital expenditures (e.g., new signs, fixtures, or computer systems). This requirement generally will be disclosed in either the franchise agreement or the operations manual.

### **C. Visit the Franchisor**

At some point before actually signing a franchise agreement with a selected franchisor, you should schedule a visit to the franchisor's main office. Plan to spend at least one full day, if not two. Most franchisors require such a "Discovery Day" visit.

Except for very large franchise companies, you should expect to meet briefly with several senior officers of the franchisor. Your first impression of the franchisor's main office and its top executives can be very important. Ask each officer about his or her vision for the future of the franchise.

If there is a company-owned location or franchisee training center nearby, ask to sit in on a few classes or training sessions to get an idea of what to expect as a new franchisee. Take notes during your visit to analyze later as part of your overall evaluation of the franchise.

### **D. Talk to Other Franchisees**

As part of your investigation of a particular franchise system, you should plan to interview at least ten current and/or former franchisees. In essence, these discussions should focus on a single theme, "Would you buy this franchise again?"

To begin your investigation, you should look at Item 20 of the FDD for the address list of franchisees. You should interview franchisees in your same

geographic area, with the understanding that if you call franchisees very close to your probable site, you should probably expect a lukewarm reception (at best) since the existing franchisee may be less than thrilled with the prospect of competing with you for the same customers. The information you will likely obtain will perhaps be the most valuable information you have regarding the franchise-selection process. If any franchisees are having problems with the franchisor, they will most likely be willing to tell you about it in vivid detail.

Some franchisees might invite you to visit their locations. You should accept as many of these invitations as possible. If there is a franchisee association office nearby, you should visit it as well.

If a franchisor's FDD does not contain a list of franchisee addresses, then one of two negative things must be true. If there are no other franchisees, then you may not want to invest your life savings in a "rookie" franchise system. If there are other franchises, then you should wonder how the franchisor could overlook such an important detail in preparing its FDD.

#### **E. Sample Questions for Franchisee Interviews**

As discussed above, a great way to learn about a franchisor is to call current and former franchisees and ask them about the franchisor and the franchise system. Set forth below is a short list of important questions to ask current franchisees.

1. How long have you been a franchisee?
2. How many franchised locations do you operate?
3. What other franchises did you consider and why did you choose this one?
4. How is your business doing?
5. Are you satisfied with the performance of your franchise? If you had an opportunity to do it over again, would you?
6. Do you work full-time in the business?

7. What is your estimated annual growth rate?
8. Are there any competing franchised units nearby your business? How close? Were you notified in advance?
9. Does the franchisor provide you with useful marketing and promotional programs and support?
10. Have you had any major problems with the franchisor?
11. Are you aware of any franchisees who have had major problems with the franchisor?
12. Is there an active franchisee council or association? If so, what sorts of things does it do?
13. For what purpose is your average monthly expenditure:
  - a. rent?
  - b. utilities?
  - c. advertising and promotions?
  - d. labor costs?
  - e. insurance?
14. When you first became a franchisee, were you able to negotiate any special changes to the standard franchise agreement?
15. Is the franchisor responsive to your questions and concerns?
16. How long after you began your franchised business did it take you to begin operating on a break-even or profitable basis?
17. How often are you in contact with the franchisor?
18. How much money did you originally invest?
19. What assistance did the franchisor provide you during your initial start-up phase?

20. Does the franchisor conduct periodic inspections of your business? Do you get useful feedback?

## VII. Tips on Negotiating with Franchisors

As referenced above, Virginia law requires franchisors to negotiate with franchisees regarding most terms of the franchise relationship. This does not mean, however, that a franchisor has to agree to anything a prospective franchisee proposes. The reality of franchising is that there is a severe imbalance of bargaining power between the typical franchisor and the typical franchisee. Consequently, most franchise agreements are contracts of adhesion (i.e., “take it or leave it” deals) for practical purposes. In addition, with a popular and successful franchise system, there are likely many prospects ready and willing to sign anything “as is,” thus you should not expect to be able to negotiate many (if any) changes to the franchise agreement. However, there are always points worth negotiating. You should never be afraid to ask for something; you might just get what you asked for!

On the other hand, you should worry if a franchisor seems so eager to sell franchises that it will agree to material alterations to its franchise agreement. Remember, the essence of a successful franchise system is its uniformity and consistency.

With careful planning and negotiation, there are some provisions that may be more conducive to successful negotiation than others. You should identify issues that will be “deal killers” for you as well as a list of issues that you would like to negotiate but would be willing to concede. A few examples of contract terms potentially subject to negotiation include:

1. **Territory.** As a franchisee, you generally would want as large a protected territory as possible. You do not want to compete with another member of your franchise family in the same area. The franchisor, on the other hand, will generally keep your protected territory to a minimum so as to maintain maximum flexibility for the future growth of its franchise system. Thus, the franchisor will want the right to open a competing location right next door or across the street from your franchise unit if it feels the local market can absorb another unit (or if it can sell another franchise unit for that location). At the very least, you should push the franchisor to define your protected territory as clearly as possible in the franchise agreement so there is no ambiguity.

If you have sufficient business experience and bargaining strength, you might be able to negotiate a right of first refusal on any new franchised locations within close proximity to your existing location. This type of provision protects both parties' interests in that the franchisee has the right to protect its territory while the franchisor retains the flexibility to grow.

2. **Termination/Opportunity to Cure.** Because most franchise agreements contain many clauses that, if violated, give the franchisor the right to terminate the franchise agreement, an unsuspecting franchisee who has not studied his or her franchise agreement carefully can all too easily breach the agreement without even knowing it. As a result, it would be in the best interests of a franchisee to ask for a provision that would allow it to cure a breach of the franchise agreement before the franchisor could terminate the agreement. A grace period of at least five (5) days would reduce the risk of termination and protect the franchisee's investment in the franchised business.
3. **Capital Expenditure Caps.** As the franchise system grows and evolves to meet consumer demand, you may be required to make certain changes to your franchised business. New decorations, signs, menus, computer systems, and employee uniforms are just a few examples of periodic expenditures a franchisor might require you to make. From time to time, such unexpected expenditures could put a financial strain on your business. To provide you with some protection, you could ask for a monetary limit on the amount the franchisor can require you to spend on capital improvements in any given year.
4. **Renewal.** Franchise agreements are for a specific term of years. When that term expires, the franchise relationship theoretically ends and both parties go their separate ways. Considering the franchisee's enormous investment in the franchised business, he or she will likely be very interested in continuing to operate the franchised business, thus renewing the franchise agreement will be essential. Unless there is language in the franchise agreement providing renewal rights, the franchisee will not have a legal right to renew the agreement and stay in business. Thus, it is important to verify that the agreement contains language giving the franchisee the right to renew the franchise agreement upon the expiration of the initial term, either upon the same terms (typically more favorable

to the franchisee) or upon terms then offered by the franchisor to new franchisees (usually less favorable to the franchisee).

## **VIII. Getting Help**

Purchasing a franchised business will likely be one of the most expensive investments of your life. Such a monumental decision should not be made on a whim based upon an effective sales presentation. Sound business judgment, thorough research and analysis, and common sense should be your guide in choosing the right franchise. Even with careful research and preparation, professional assistance is a must.

### **A. Legal Assistance**

An experienced franchise law attorney can provide invaluable assistance with the many legal and business issues involved with purchasing and operating a franchised business. For example, you should not sign a contract unless you clearly understand the terms, conditions, and legal and practical ramifications of each provision in the contract. Unfortunately, many prospective franchisees do not thoroughly review franchise agreements before signing them. Those who do take the time to read the contract often do not fully understand their rights and obligations under the franchise agreement. A franchise lawyer can explain the terms of a contract to you in plain English.

A franchise attorney can assist you in comparing various franchise opportunities by reviewing the FDDs of different franchise opportunities and comparing the relative advantages and disadvantages of each franchise.

A franchise attorney can assist you with the planning and formation of a business entity or entities through which you will conduct your business. Using a corporation or limited liability company can help protect your personal assets against debts and liabilities arising from the business.

A franchise attorney can also assist with real estate acquisition or leasing issues. When starting a new business, there will also be a number of employment law, tax, and estate planning needs to consider.

## **B. Financing Assistance**

There are many conventional sources for financing the acquisition and development of a franchised business. Many banks, savings and loans, and venture capital funds have programs specifically tailored for franchising. Special government programs also provide financing assistance to entrepreneurs and small business owners, including the following:

1. **SBA Loans.** The Small Business Administration (“SBA”), an agency of the federal government, offers several financing programs for small businesses. Under one popular program, the SBA will guarantee intermediate and long-term loans to small companies. The SBA has developed a special registry of franchise companies that greatly facilitates the loan approval process for many franchisees. There are special loan programs for military veterans and minority business owners as well.
2. **EDA Loans.** The Economic Development Administration (“EDA”) of the U.S. Department of Commerce makes direct loans and offers loan guarantees to certain qualifying businesses that operate in low income areas.
3. **RECDS Loans.** The Rural Economic and Community Development Service (“RECDS”) is another federal agency that offers insured and guaranteed loans to develop business and industry in rural areas with populations under 50,000 people.

## **C. Accounting Assistance**

An experienced accountant is equally important in investigating franchise opportunities and then operating a franchised business. An accountant can review and analyze the financial statements in the FDD and explain the key issues to you. An accountant can also give you useful advice about financing your new business and help you prepare an effective business plan.

An accountant can also give you practical advice on what to expect financially as a franchisee, including anticipated rates of return on your investment, whether the franchisee fee and length of the franchise term are reasonable, and other business

issues. An experienced accountant can help educate you on the many federal, state, and local tax issues with which you must comply.

#### **D. Useful Sources of Information**

##### **A. Books**

1. Tomzack, Mary E., *Tips and Traps When Buying a Franchise*, Source Book Publications (1999).
2. Meaney, James A., *How to Buy a Franchise*, Pilot Books (1999).
3. Keup, Erwin J., *The Franchise Bible*, Oasis Press (1995).
4. Bradach, Jeffrey L., *Franchise Organizations*, Harvard Business School Press (1998).
5. *Bond's Franchise Guide*, published annually by Source Book Publications.

##### **B. Periodicals**

1. Franchise Times (6 issues per year)  
2500 Cleveland Ave., N. Ste. D So.  
Roseville, MN 55113-2728  
(651) 631-4995  
[www.franchisetimes.com](http://www.franchisetimes.com)
2. Entrepreneur Magazine (12 issues per year)  
(800) 274-6229  
[www.entrepreneurmag.com](http://www.entrepreneurmag.com)
3. Inc. Magazine (12 issues per year)  
P.O. Box 54129  
Boulder, CO 80322-4129  
(800) 234-0999

4. Franchise Law Journal (4 issues per year)  
ABA Forum on Franchising  
750 North Lake Shore Drive  
Chicago, IL 60611  
(312) 988-6101  
[www.abanet.org](http://www.abanet.org)
5. Leader's Franchising Business & Law Alert (12 issues per year)  
Leader Publications  
345 Park Avenue South  
New York, NY 10010  
(800) 888-8300 (ext. 6170)

**C. Internet**

1. Federal Trade Commission ([www.ftc.gov](http://www.ftc.gov))
2. Small Business Administration ([www.sba.gov](http://www.sba.gov))
3. International Franchise Association ([www.franchise.org](http://www.franchise.org))
4. American Franchise Association ([www.franchisee.org](http://www.franchisee.org))
5. American Association of Franchisees and Dealers ([www.aafd.org](http://www.aafd.org))

**IX. Glossary of Basic Franchising Terms**

**Approved Supplier.** A designated source from which franchise owners may purchase supplies, equipment, ingredients, inventory, and other materials for use in operating the franchise business.

**Arbitration.** A method of dispute resolution commonly required in franchise agreements whereby a dispute is determined by an independent person or persons. Arbitration is typically faster and cheaper than litigation. The arbitrators are often experts in franchise law or the particular industry in question. Depending upon the terms of the franchise agreement, the arbitrator's decision may be final and binding.

**Area Representative.** An employee or representative of the franchisor whose job it is to supervise and assist franchisees in a particular geographic area. Area representatives may, among other things, inspect franchise locations for quality and cleanliness, help franchisors solve management and technical problems, mediate disputes between the franchisor and a franchisee, and coordinate regional and local advertising and marketing efforts.

**Business Format Franchising.** A type of franchise whereby a franchisor sells to a franchisee a total blueprint for doing business including, without limitation, trademark and service mark licenses, operational guidelines, site selection assistance, assistance with permits and licenses, training, and ongoing supervision and assistance. Common examples of business format franchises include fast-food restaurants, convenience stores, motels, and car rental businesses.

**Business Opportunity Laws.** Laws regulating the sale of non-franchised business opportunities, common examples of which include vending machine routes, envelope stuffing schemes, and worm farming businesses. States that have such statutes typically exempt franchise systems that have federally registered trademarks or service marks or franchise systems that are already covered by franchise statutes and regulations of that state.

**Buy-Back Option.** A common term in franchise agreements whereby the franchisor has the right (not the obligation) to buy back all of the franchisee's equipment and inventory if the franchisee goes out of business or commits a serious breach of the franchise agreement entitling the franchisor to terminate the agreement.

**Company-Owned Outlet.** A franchise location owned by the franchisor. These locations typically serve as models or examples for franchisees to follow. They also serve as training facilities where new franchisees learn about the franchisor's operating methods and systems.

**Default.** A breach or violation of the franchise agreement by one of the parties.

**Development Agreement.** An agreement whereby a franchisor sells to a subfranchisor the exclusive right to establish, market, and/or sell franchises in a specified geographic area for a specified period of time, usually in accordance with a specified development schedule.

**Encroachment.** Action taken by a franchisor to invade the exclusive territory of a franchisee by selling products or services within the territory or opening franchisor-owned locations within the territory.

**Federal Trade Commission (the “FTC”).** An independent agency of the federal government consisting of five commissioners. The FTC is responsible for investigating and bringing enforcement actions against illegal business practices in interstate commerce.

**Franchise Disclosure Document (“FDD”).** The required disclosure document describing important aspects and details of franchise opportunities that must be given to prospective franchisees at least 14 days prior to the execution of any agreement or payment of money.

**Franchise Fee or Initial Fee.** A sum of money paid by the franchisee to the franchisor, usually at the time the franchise agreement is signed. The initial franchise fee may cover a variety of expenses and services including training costs and assorted start-up costs as well as the right to use the franchisor’s trademarks and business methods. This fee generally does not include inventory or equipment.

**Good Cause or Reasonable Cause.** A contract law term that means having legally sufficient grounds to support the actions of a party to a franchise agreement, typically in the case of a franchisor’s decision to terminate or not renew a franchise agreement.

**Goodwill.** The positive public reputation, trust, image, or loyalty which a franchisor has developed. A franchisor’s goodwill cannot be accurately measured in monetary terms, but is often a franchisor’s most valuable asset.

**Multi-Unit Franchising.** A type of franchise relationship where a single franchisee purchases two or more franchise locations from a franchisor.

**Operations Manual.** The confidential document detailing the trade secrets and operating methods of a particular franchise, including such topics as quality control requirements, required hours of operation, required food preparation procedures, recipes, product or service specifications, required uses and restrictions on the franchisor’s

trademarks and other intellectual property, and other operational issues related to the franchised business.

**Subfranchising.** A type of franchise relationship where one party (the “subfranchisor”) enters into a master franchise agreement with a franchisor which provides that the subfranchisor is responsible for soliciting others (the “subfranchisees”) to open new franchise locations within a specific geographic area. In some cases, the franchisor retains various rights and controls over the subfranchisees, but in other cases, most rights and controls over subfranchisees rest with the subfranchisor. Either or both the franchisor and the subfranchisor provide ongoing supervision and assistance to the subfranchisees.

**Turn-Key Operation.** A term used to describe a franchise package offered by a franchisor that comes fully equipped and all-inclusive so that a new franchisee practically needs only to “turn the key” to start business.