

# Franchising 101 – Legal Basics

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# Franchising 101 – Legal Basics

1. Be sure you are well suited to be a franchisee

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2. Check all competing franchises; don't lock in on one

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## 3. Perform thorough Due Diligence

- Read and understand all of the documents
- Attend Discovery Day
- Talk to a large number of franchisees
- Internet research
- Visit existing franchise locations

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## – Read reports of New York and Illinois Attorneys General

- <http://www.ag.ny.gov/sites/default/files/pdfs/publications/What%20to%20Consider%20Before%20Buying%20a%20Franchise.pdf>
- <http://www.ag.state.il.us/publications/pdf/b4ubuy.pdf>

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4. Be sure the numbers work; prepare a pro forma

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5. Don't rely on anything important that's not in the written documents (trust, but verify)

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6. Have enough working capital and a basic business plan



# Franchising 101 – Legal Basics

7. Retain competent advisors (attorney and accountant)

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8. Set up a separate entity (Limited Liability Company or Subchapter S Corporation)

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## 9. Red Flags

- a) No state registration, Franchise Disclosure Document or written Franchise Agreement; claiming no registration is necessary.
- b) Claims made orally to you that are not in the written franchise documents.
- c) Discouraging you from talking to other existing or former franchisees.

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## Red Flags (cont.)

- d) Rushing you to sign the contracts.
- e) Requiring a deposit before giving you required documents to review and waiting 14 days; asking you to backdate or agree to backdating of any documents.
- f) Any financial performance representation not included in Item 19 of the FDD.

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## Red Flags (cont.)

- g) No or highly conditional right to renew; renewal only on payment of substantial fees.
- h) Unaudited, out-dated, or incomplete financial statements.
- i) Recommending against a review by independent advisors such as your attorney or accountant.
- j) Franchisor claiming you can run this business in your spare time.

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## Red Flags (cont.)

- k) Franchisor's preoccupation with selling the franchise, and you paying them fees, and no or very little time spent on your background, experience and fit with the franchisor's system, and the system itself.
- l) Franchisor claiming their products are so popular they sell themselves; you really don't need training; no training manuals.
- m) New franchisor.

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10. Franchises and business opportunities are frequently sold under other names. The name given to the arrangement does not matter; if it meets the statutory definition of a franchise (a written agreement: 1) charging a fee; 2) allowing use of franchisor's trademark; and 3) granting the right to engage in a retail business using franchisor's marketing plan or system) or a business opportunity, it is one. Examples of other names for business arrangements that could be a franchise or a business opportunity:

# Franchising 101 – Legal Basics

- License
- Distributorship
- Consulting Agreement
- Sales Contract
- Contract



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11. All franchises and business opportunities, whether called that or not, must be properly registered with the Commonwealth of Virginia.

State Corporation Commission  
P.O. Box 1197  
Richmond, Virginia 23218  
(800) 552-7945

[www.state.va.us/scc/division/clk/forms/brg.pdf](http://www.state.va.us/scc/division/clk/forms/brg.pdf)

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12. A Whirlwind Tour of the Franchise Disclosure Document (“FDD”)
  - 1) The Franchisor, and any Parents, Predecessors and Affiliates
  - 2) Business Experience
  - 3) Litigation

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## A Whirlwind Tour of the FDD (cont.)

- 4) Bankruptcy
- 5) Initial Fees
- 6) Other Fees
- 7) Your Estimated Initial Investment
- 8) Restrictions on Sources of Products and Services
- 9) Franchisee's Obligations

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## A Whirlwind Tour of the FDD (cont.)

- 10) Financing
- 11) Franchisor's Assistance, Advertising, Computer Systems and Training
- 12) Territory
- 13) Trademarks
- 14) Patents, Copyrights, and Proprietary Information

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## A Whirlwind Tour of the FDD (cont.)

- 15) Obligation to Participate in the Actual Operation of the Franchise Business
- 16) Restrictions on What the Franchisee May Sell
- 17) Renewal, Termination, Transfer and Dispute Resolution
- 18) Public Figures
- 19) Financial Performance Representations

# Franchising 101 – Legal Basics

## A Whirlwind Tour of the FDD (cont.)

- 20) Outlets and Franchisee Information
- 21) Financial Statements
- 22) Contracts
- 23) Receipt

# The Virginian-Pilot

BUSINESS FORUM

## Before investing in a franchise

By Stephen E. Story

Franchising accounts for a significant volume of the goods and services sold in the United States. Franchises generate an estimated \$1 trillion in retail sales annually and employ nearly 8 million people. While you probably think of McDonalds® and Burger King® when you think of franchises, franchises exist in many diverse industries, including, as only a few examples, junk pickup and disposal, home nursing care services, computer services, preschools and dating services. Particularly as corporate downsizing continues and more people look for financial independence, many will explore whether to invest in a franchise.

Before investing in a franchise, consider the following:

**Are you suited to be a franchisee?** First, assess whether your personality lends itself to being a franchisee. Franchisors typically establish detailed rules regarding the products or services you may sell, how the products or services must be sold, as well as a variety of detailed legal, accounting and other rules. Unless you are willing to comply with these rules, you should probably forego investing in a franchise.

**Decide on the right franchise.** After you have decided you are suited to be a franchisee, the next question, of course, is what franchise do you pursue? Suitable franchises can be located through such sources as recommendations from current franchisees, library and Internet research, franchise expositions, local professionals and business or franchise brokers.

**Conduct your due diligence.** As with any investment, the burden is upon you to conduct all of your research and due diligence. Because you will have an ongoing relationship with your franchisor, and your success is highly correlated to the value of the business model and services provided by the franchisor, you must thoroughly investigate the franchisor and its track record. The franchisor is required by law to provide you with a Uniform Franchise Offering Circular ("UFOC") before you sign a franchise agreement and invest in the franchised business. Be sure you and your advisors thoroughly review the UFOC and the franchise agreement to ensure the written agreement is totally consistent with



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what you have been told by the franchisor.

You should hire an accountant to help you prepare a financial business plan, including pro forma projections, which will forecast your profitability and the return on your initial investment.

I strongly recommend that prospective franchisees contact many other franchisees in the system. These franchisees can advise you whether they would join the franchise system, knowing what they know now, as well as lessen your learning curve as a new franchisee. A FRANCHISE IS LIKE A MARRIAGE; you need to have a great deal of trust and confidence in the franchisor to become comfortable committing to a long-term relationship. Hearing from satisfied franchisees may help you get over that hurdle.

Finally, after you have settled on a franchise that appears to be a good personal fit and economically viable, consult an experienced franchise attorney to review the documents for matters that may need to be clarified or added to the franchise agreement, including such important issues as territorial protection, termination rights, renewal rights, and the scope of any personal guarantees requested by the franchisor.

After engaging in these steps, you are ready to sign your franchise agreement and join the world of franchising. Good luck.

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# Top 10 Things a Potential Franchisee Should Know About a Franchise Offering

BY STEPHEN E. STORY

**1. Is it registered in the State of Virginia?** All franchises legally sold in the State of Virginia must be registered with the Retail Franchise Division of the State Corporation Commission. You can check a franchisor's registration status online at [www.scc.virginia.gov/](http://www.scc.virginia.gov/).

**2. Do the franchisor's other franchisees recommend the franchise?** Check with a large number of the franchisor's other, preferably local, franchisees. If other franchisees are happy, chances are that you will be happy too.

**3. Do the written documents match what you have been told by the franchisor?** Typically, a court will only enforce the written claims in the Uniform Franchise Offering Circular ("UFOC") or the franchise agreement. If your franchisor makes claims that are not supported by the written franchise documents, this is a clear danger signal to be discussed both with the franchisor and any professional advisors (lawyer and accountant) you may have retained.

**4. Do you have the right to renew the franchise? What additional fees and expenses will you pay?** You should inquire regarding your right to renew the franchise and at what additional expense. Otherwise, after spending five or ten years building a thriving business, you may be unpleasantly surprised to find that you have either no rights to renew or rights to renew that require significant additional payments.

**5. Do the franchise documents require you to litigate or arbitrate disputes out of state?** Out of state litigation or arbitration is almost always more expensive, time consuming and troublesome than resolving a dispute locally. While these provisions are rarely waived by franchisors, you need to be aware of what your obligations will be in the event a dispute arises.

**6. Precisely what help is the franchisor contractually obligated to give you?** The UFOC states that the franchisor is only required to give you the assistance specifically stated in the UFOC and the written franchise agreement. Frequently, this assistance will differ, sometimes substantially, from what you are told by the franchisor. These discrepancies should be explored with the franchisor and your professional advisors.

**7. Can you sell your franchise? If so, on what terms?** Franchise agreements almost universally restrict sales (transfers) to substitute franchisees approved by the



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franchisor, and impose conditions on the transfer. These provisions may restrict your free transfer of your franchise to a potential purchaser, and can cost you significant time and money.

**8. What is the franchisor's track record?** The UFOC requires the franchisor to disclose material litigation, any prior bankruptcy of the franchisor or its principals, and the names, addresses and telephone numbers of terminated or non-renewing franchisees. (Don't forget to speak to those who have failed or not renewed, if possible, to find out why.) This information is a potential gold mine, allowing you to learn of the franchisor's past track record.

**9. Does the franchisor make any earnings claim?** Any earnings claims (e.g. – you will net \$100,000 per year) must be specifically disclosed in Item 19 of the UFOC. Otherwise, the franchisor may not legally make any earnings claims, and you will not be entitled to rely on such claims, in the event they prove incorrect.

**10. Have you conducted your own due diligence?** There are a number of very good resources explaining, in greater detail, how to conduct your due diligence of a potential franchise offering. Some of these resources can be found following the article entitled "[Before Investing in a Franchise](#)". I also strongly recommend hiring a franchise lawyer to review the UFOC and franchise agreement.

Stephen E. Story is a partner in the law firm of Kaufman & Canoles where he chairs its Franchise Practice Group, representing franchisors and franchisees. He is a member of the ABA Forum on Franchising and the IFA Supplier Forum. Mr. Story has previously participated as a speaker at the IFA Annual Legal Symposium and the ABA Forum on Franchising, and is a member of the IFA Legal/Legislative Committee. He is a former chair of the Virginia State Bar Antitrust and Franchise and Trade Regulation Committee. Mr. Story can be reached at (757) 624.3257 or [sestory@kaufcan.com](mailto:sestory@kaufcan.com).



## FRANCHISING TIPS

Franchises give you the opportunity to cash in on instant name recognition by aligning with some of the most recognized brands in the nation — McDonald's, Subway, KFC, Midas, The UPS Store, Huntington Learning Center and many others. They also give you the security and support of a proven business model, one that's so successful, it's been duplicated on one street corner after another.

For someone looking to start a new business, these two reasons alone—instant name recognition and a well-paved business plan—are often enough to entice them into entering a franchise agreement. But franchises are a lot more complicated than just firing up the grills and serving sodas under your very own golden arches.

### Here are 10 things to consider before signing on the dotted line:

#### 1. Are you a rule maker or a rule breaker?

"Are you suited to be a franchisee?" asks Stephen E. Story, an attorney with Kaufman & Canoles, who specializes in franchise deals. "First, assess whether your personality lends itself to being a franchisee. Franchisors typically establish detailed rules regarding the products or services you may sell, how the products or services must be sold, as well as a variety of detailed legal, accounting and other rules. Unless you are willing to comply with these rules, you should probably forego investing in a franchise."

#### 2. Picking a franchise that's right for you

If you're good at following directions, the next step is deciding which franchise is right for you. According to Robin Smith, managing partner of The Entrepreneur's Source, there are more than 5,000 franchises in the United States. "Only eight percent have more than 500 locations. Ninety-two percent are going to be franchises you've never heard of," says Smith.

When most people start researching franchises, they tend to gravitate toward those businesses that everyone has heard of. Yes, food service and hospitality businesses are big, but is that necessarily a good thing? Have you ever heard of the term 'market saturation'?

Smith equates it to people buying Microsoft stock at today's prices. "It's not a bad thing to buy Microsoft stock today, but wouldn't you have rather bought it 15 years ago?"

"People tend to limit themselves," continues Smith. "Don't be scared of something because you've never heard of it before."

When considering franchise opportunities, look at trends. Anything dealing with the aging population right now is hot as the Baby Boomers reach retirement. Home improvement is also big.

"Do not look only for a franchise that sells products or services that you personally would buy," says James Wilson of Wilson Stoyanoff, PLC, "but consider whether your friends would buy the products/services and whether people from different backgrounds (social, economic, age group, etc.) would buy them."

#### 3. Begin with the end in mind

"Prospective franchisees need to spend a great deal of time compiling a list of attributes that complete this sentence: 'To meet my personal and professional goals, my business must...'. This list must go much further than 'enable me to make \$100,000/year.' It should include issues such as 'provide time with family,' 'offer a creative outlet,' 'allow me to manage the

business, not run it day-to-day,' etc. Until that list is complete, they really do not know what they want and cannot possibly begin looking," advises Tom Lawrence, president of Frannet of Richmond. "The best question one can ask is, 'When my business is successful, what will my life be like?'"

Smith agrees. "If your goal is to have time for your family, no matter how passionate you are about the sports bar, it's not going to give you the time you're looking for. Look at the facts of the business. Don't just look at the product or service, but look at how the business is going to be run and then see if that aligns with your skills and what you're trying to accomplish."



"Talk to the other owners. Don't be afraid to ask questions about income, lifestyle, what kind of support they are getting."

#### 4. Money, money, money

"Understand your money. Franchises are going to qualify you based on your net worth and liquid assets," explains Smith. It sounds basic, but figure out how much money it takes to run your household per month. "How will you cover your own personal finances during start-up, because start-up costs don't include an owner's salary. They are assuming the owner is not taking any kind of salary," says Smith. Typically, it takes anywhere from three months to two years for franchises to "break even."

"Do not assume you can get to 'break even' sooner than the average [franchisee] or that you can get by with less capital. You cannot!" insists Lawrence.

"There is no franchise that is immediately profitable," continues Lawrence. "It is imperative, once you isolate an opportunity of interest, to find out how long is it going to take [you] to get to 'break even.' Do not rely on what the franchisor tells you; talk to people who have gone through it."

#### 5. Know what you're buying

By law, all franchisors must provide prospective franchisees with a Uniform Franchise Offering Circular (UFOC), which includes contact information for all of the company's existing franchisees and those who have left the company within the last 12 months. "Talk to the other owners," advises Smith. "Don't be afraid to ask questions about income, lifestyle, what kind of support they are getting. Franchises will often give you a list of 5 to 6 picks. Start with them."

"But compare answers to specific questions from other franchisees," adds Wilson. "If a franchisor specifically tells you not to talk to a particular franchisee, talk to that franchisee. Keep calling franchisees in the system until you think you are getting good, in-depth information about the franchise business, not just information that encourages you to buy."

Ten is a good number to contact, says Smith.

"The calls to the franchisees are of utmost importance,"

says Lawrence. "These are the people who know the realities of that particular business and the best source of information on what you're really buying."

#### 6. Don't be afraid to ask questions

"There are literally thousands of things to learn about a franchise before the purchase is made. Ask, ask, ask and ask some more," advises Lawrence. "If a feeling develops that some things are being left unclear, the warning bells should be ringing."

#### 7. Don't just accept lip service

We all know some salesmen will say anything to make the sale. That's also true when it comes to franchises. "If your franchisor makes claims that are not supported by the written franchise documents, this is a clear danger signal to be discussed both with the franchisor and any professional advisors you may have retained," warns Story.

This is particularly important when it comes to money. "Any earnings claims must be specifically disclosed in the UFOC. Otherwise, the franchisor may not legally make any earnings claims, and you will not be entitled to rely on such claims in the event they prove incorrect."

#### 8. Work the system

Part of the reason you buy a franchise is because it has a proven record of success. "In spite of that, a major reason people fail is that they simply do not follow that system," says Lawrence. "If one cannot be sure they 'buy in' to the system, they should not buy the franchise."

"You want to understand any restrictions," adds Smith. "If you can't see yourself following those rules, then it might not be the right franchise for you. That's what they've built their success on. Don't think they're going to change the rules for you."

#### 9. Don't go it alone

"You should hire an accountant to help you prepare a financial business plan, including pro forma projections, which will forecast your profitability and the return on your investment," advises Story. "After you have settled on a franchise that appears to be a good personal fit and economically viable, consult an experienced franchise attorney to review the documents for matters that may need to be clarified or added to the franchise agreement, including such important issues as territorial protection, termination rights, renewal rights, and the scope of any personal guarantees requested by the franchisor."

#### 10. The bumpy road ahead

"It seems that no matter what they are told, people always underestimate how hard it is going to be to start their business," relates Lawrence. "As one who has done it several times, take my advice: This is going to be harder than you imagined. You may be smarter, more experienced, more talented than most. It will still be harder than you think."

"But if you are successful," continues Lawrence, "owning your own business can reward you beyond your wildest expectations." □ BY DONNA C. GREGORY