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Thinking about Buying a Franchise?

If you're considering buying a franchise, you're probably overwhelmed by the size of the Franchise Disclosure Document (or, as it's colloquially called, the "FDD") and firmly believe that the franchisor's lawyer gets paid by the word (no, we don't).

Before you engage a lawyer to help you understand the FDD and what you're getting into, here are some things you should do to check out the system. The results of these initial steps may encourage or discourage your investment, or steer you in a different direction. At a minimum, you will be a more-informed franchisee with reasonable expectations of your franchised investment.

1. **Read the Franchise Agreement.** Although most of my clients would prefer not to, it is very important for a prospective franchisee to read the Franchise Agreement and understand the business terms of the deal, as well as the parties' respective rights and obligations. To help you in your review, you should know the following:

- Franchise agreements are written by the franchisor's attorney to protect the franchise system. For example, if one of the franchisees is operating a bad unit (such as failure to comply with system health and sanitation requirements), the franchisor needs the right to "encourage" that franchisee to comply by threatening termination or other consequences. As the owner of the unit adjacent to that franchisee's unit, you would be in favor of the franchisor taking prompt action; otherwise the good will of your unit could be adversely affected. As the noncompliant franchisee, however, you may feel that the franchisor's action was unfair.

- Franchise agreements are written by the franchisor's attorney for the benefit of the franchisor and to avoid potential litigation by franchisees. For example, on the whole, most franchise agreement doesn't contain "the parties' respective rights and obligations." The phrase "the franchisor's rights and the franchisee's obligations" is typically more accurate. Although you will not be able to negotiate the franchise agreement to a point that you believe it is fair and even-handed, you or your attorney should be able to negotiate the franchise agreement to address your key concerns. The franchisor's response to your reasonable requests prior to signing the franchise agreement will telegraph to you its response to your reasonable requests in connection with your business operations.

- Franchise agreements typically have an initial term, followed by a renewal term. The initial term should be long enough to permit you to receive a reasonable return on your investment. The common practice among franchisors these days is to require you to sign a release and a new franchise agreement upon renewal; the terms of the new franchise agreement will most likely be more franchisor-beneficial and the fees (such as royalties and advertising fees) may be higher. Note that you or your attorney may be able to negotiate modifications to the renewal requirements.

- Franchisors typically require the franchisee's principals to personally guarantee the franchisee's obligations under the franchise agreement. Unless the franchisee entity is well-capitalized, it may be impossible to eliminate the guaranty requirement.

- Franchisors typically require the franchisee, its principals and its management team to sign confidentiality and noncompetition agreements, which typically extend beyond the termination of the franchise agreement. Note that noncompetition agreements may be negotiable and are increasingly disfavored by the courts.

- Some franchisors require you to purchase certain equipment, inventory, etc. from them or their affiliates and such purchases may be profit centers for the franchisor. Some franchisors require you to purchase certain equipment, inventory, etc. from approved vendors and suppliers pursuant to negotiated deals that result in rebates to franchisors. In either case, the franchisor should give you some comfort that your cost will not exceed what you would typically pay on a fair market value basis. In addition, if the franchisor is receiving rebates, will they be additional profit to the franchisor or be paid into the advertising fund that benefits the franchise system?

2. **Read the FDD.** Again, although most clients would prefer not to read the FDD, it is very important for a prospective franchisee to know who he's doing business with and to understand the franchised business and the franchise system. For example, Item 2 should disclose the past five years' business history of the key management team. Does it appear that they actually have the experience you're relying upon? Item 3 should disclose the litigation history of the franchisor, its affiliates and the management team. Are there pages and pages of litigation? Are a number of current or prior franchisees claiming misrepresentation, fraud or breach of contract? Item 4 should disclose the bankruptcy history of the franchisor, its affiliates and the management team. Are the key people financially irresponsible or was a sole vice president the victim of the recession? Item 20 should disclose terminations and transfers of franchised units. Are a multitude of franchisees leaving the system or is there an occasional termination due to a bad apple or an occasional transfer for personal reasons?

3. **Talk to Current and Former Franchisees.** Call as many current franchisees listed in Item 20 of the FDD as you can; if you cannot call them all, select a representative sample of new and long-term franchisees in various geographic areas and other categories. Ask them about their experience with the franchisor, the franchise system and operating the business. Did the franchisor do all that it promised? Did the training program provide all of the training necessary to operate the business successfully? Is the business profitable? When did it break even? (Although franchisors typically do not provide this information, franchisees can be a wealth of information.) Would they purchase the franchise again? Call all of the former franchisees listed in Item 20 of the FDD. Take what they say with a grain of salt, but if you're consistently hearing certain claims or complaints, they may have merit.

4. **Talk to a Business Accountant.** Item 7 of the FDD should include the franchisor's estimate of your initial investment. Item 19 of the FDD may include financial performance representations. The FDD or the franchisor's other materials may include certain cost information. A business accountant or other qualified financial advisor can help you evaluate all of that information and generate projections. You can then ascertain the capital requirements, the cash flow, the financial viability of the franchised business' operations and the potential return on your investment. You can then consider the fiscal wisdom of purchasing the franchise.

5. **Check out the Competition.** How does this franchise opportunity compare to other franchise opportunities in the same industry? Are the franchise fees and estimated initial investment significantly higher or lower? Does the franchisor provide more or fewer of the necessary services? Is this franchise system the new kid on the block or the mature, developed system? How does this franchise opportunity compare to other franchise or business opportunities in other industries that require the same capital or time investment?

If you've taken those steps and you're still interested in purchasing a franchise, have an experienced franchise lawyer review the FDD, including the Franchise Agreement. Franchise investments and franchise agreements are unique and general commercial/business attorneys don't know what to look for, what is typical or what may or may not be negotiable. Your franchisor is not going to be happy with a five-page letter from an inexperienced lawyer of requested changes and write you off as a potential problem franchisee. In addition, you're not going to be happy with your lawyer's legal fees. An experienced franchise lawyer should be able to review your FDD in between one and three hours and then discuss it with you for an additional one to three hours.

Susan E. Wells is a partner with the Phoenix law firm of Wells & Gerstman PLLC. Her corporate and business practice encompasses all aspects of business transactions and commercial relationships in numerous industries, including representing franchisors, franchisees and landlords in connection with their leases with franchisees.