



Guiding You Through the Legal Maze.™

THE FRANCHISE DEVELOPMENT PROCESS

– LEGAL PERSPECTIVE

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Step 1 Understanding the Client’s Business and Expansion Goals

You have spent a lot of time and money developing a successful business model. You are ready to take it to the next level. But what does that mean? We will work with you and determine the best way for you to expand your business.

First, we want to have a conversation about your business including the following:

- Type of Business
- History of Business
- Background of Principals
- Business Entity Structure
- Directors, Officers, Owners
- Financial Condition
- Business Plan
- Expansion Plans
- Intellectual Property Rights
- Number of Outlets

There are a number of ways that you may be able to expand your business including company-owned outlets, joint ventures and partnerships; independent sales representatives; licensing; distributorships/dealerships; business opportunities (seller-assisted marketing plans); and franchising. While you may have already concluded that franchising is the best way to expand your business model, we like to take you a step backwards initially and determine exactly where you are and where you would like to go by focusing on the essential business issues leaving the legal ramifications on the back burner. These issues include:

- Capital Available for Expansion
- Managers vs. Owner Operators
- Control Over Business Operations
- Control Over Pricing
- Employees vs. Independent Contractors
- Liability Issues
- Regulatory Issues
- Tax Issues
- Labor Issues
- Branding, Advertising and Marketing Opportunities
- Initial and Ongoing Fees
- Initial and Ongoing Services to be Provided
- Financial Impact of Failures
- Federal and State Law Disclosure and Registration Issues

Assuming the franchising is all or a part of the business expansion program, the following steps should be taken.

Step 2 – Getting Wet in Franchising Without Jumping In

There are certain exemptions under the FTC Franchise Rule that allow you to sell franchises under the franchise agreement we develop with your assistance without having to have a Franchise Disclosure Document, audited financial statements, etc. State franchise laws may be different so they will have to be checked based on the residency of the prospective franchisee and the location of the franchise business.

Fractional Franchise Exemption

The FTC Franchise Rule contains an exemption from disclosure for a “fractional franchise.” A “fractional franchise” is any relationship represented as a franchise in which the franchisee, or any of the current directors or officers of the franchisee, has been in the type of business represented by the franchise relationship for more than 2 years, and under which the parties to the franchise anticipated, or should have anticipated, at the time the franchise relationship was established, that the sales arising from the relationship would represent no more than 20% of the gross sales in dollar volume of the franchisee. You can use the same form of Franchise Agreement that will eventually become an Exhibit to the FDD but with an Affidavit signed by both the franchisor and the franchisee regarding reliance upon the “Fractional Franchise” exemption.

The fractional franchise exemption is not universally available. Hawaii and Washington have no fractional franchise exemption. There is no single “fractional franchise” definition as California, New York, and Virginia have definitions that differ from the federal exemption. California and New York require some type of registration to qualify for the exemption. In California and New York, the 20% threshold is measured annually, so an arrangement that initially is not a franchise because annual sales from the licensed activity constitute less than 20% of total sales could morph into a franchise over time as the licensed activity becomes a bigger piece of the licensee's total revenue.

6-Month Deferral of Initial and Ongoing Fees

One of the 3 elements of a franchise under the FTC Franchise is that the total of “required payments” made to the franchisor or an affiliate during a period from, any time before commencing business operations to 6 months after commencing business operations, is less than \$500. This does not include inventory sold by the franchisor or an affiliate for resale by the franchisee. The FTC has issued several informal advisory opinions confirming that these initial required payments (for example, the Initial Franchise Fee and Royalties) can be deferred and accrue, and become payable in full on the day after the business has been in operation for 6 months. These obligations of the franchisee can be evidenced by a non-negotiable promissory note in favor of the franchisor. I have even had the note secured by an irrevocable letter of credit issued by a bank. This way the franchisor can be paid in full after 6 months of performance. Thereafter, ongoing fees can be paid weekly, monthly, etc. as determined by the franchisor. The franchise agreement can be used but will reflect the deferral of the initial and ongoing fees for 6 months.

Large Investment Exemption

Where the franchisee's estimated investment in the franchised business exceeds \$1,000,000, excluding financing or monies received from the franchisor or an affiliate, and real estate costs.

Sophisticated Franchisee Exemption

A business entity franchisee having been in business for at least 5 years and a net worth of at least \$5,000,000 is considered "sophisticated" and does not need an FDD to assist it in determine to make an informed investment decision.

Insider Exemption

Where a person owning at least 50% of the equity interest of a business entity franchisee within 60 days of the sale has been an officer, director, general partner or individual with management responsibility of the franchisor's franchise sales program or the administration of its network, or has been an owner of at least 25% interest in the franchisor.

Step 3 Organizational Structure for Implementing a Franchise Program

Assuming that franchising is part of the expansion program, we will initially focus on the existing organizational structure and what should be accomplished a part of creating the franchise business model, the terms of the Franchise Agreement and the information to be disclosed in the Franchise Disclosure Document. Here is advice we give to our clients regarding the franchise registration and disclosure laws and how best to structure the franchise program from a legal and accounting standpoint.

Formation of a New Business Entity to Act as the Franchisor

We frequently advise our start-up franchisor clients to form a new business entity to act as the franchisor. This is due to a number of factors including (i) protecting the individuals and the existing business entity from the potential liability in engaging in selling and servicing franchisees; (ii) avoid having audited financial statements for activities unrelated to selling franchises such as existing company-owned outlets; and (iii) protecting the trade name other intellectual property, if the franchise program is not successful. This new business entity will usually be a limited liability company or an S corporation to avoid double-taxation and have limited liability. A more thorough discussion of the various business entities that may be available such as a sole proprietorship; general partnership; limited partnership; joint venture; "C" corporation; "S" corporation; and limited liability company can be found by clicking on the article "Determining the Business Entity Best for Your Business." Kanouse & Walker, P.A. can assist your business attorney or act as your business attorney in creating the new business entity.

Financial Reporting Requirements

The FTC Franchise Rule requires that a franchisor have audited financial statements for each fiscal year and include the last 3 years' audited financial statements in its Franchise Disclosure document. A start-up franchisor that does not yet have audited financial statements may phase-in

the use of audited financial statements by providing, at a minimum, the following statements at the indicated times:

Franchisor's first or full fiscal year selling franchises	Unaudited opening balance sheet
Franchisor's second fiscal year selling franchises	Audited balance sheet opinion as of the end of the first partial or full fiscal year selling franchises
Franchisor's third and subsequent fiscal years selling franchises	All required financial statements for the previous fiscal year, plus any previously disclosed audited statements that still must be disclosed according to paragraphs (u)(1)(i) and (ii) of this Section.

Start-up franchisors may phase-in the disclosure of audited financial statements, provided the franchisor:

- (a) Prepares audited financial statements as soon as practicable.
- (b) Prepares unaudited statements in a format that conforms as closely as possible to audited statements.
- (c) Includes one or more years of unaudited financial statements or clearly and conspicuously discloses in this section that the franchisor has not been in business for 3 years or more, and cannot include all financial statements required in paragraphs (u)(1)(i) and (ii) of this section.

While a start-up franchisor may be allowed to phase-in audited financial statements under the FTC Franchise Rule, there are certain states that have a different requirement that must be satisfied as part of the state approval process.

- Minnesota, New York and Virginia do not permit phase-in by a start-up franchisor, who must have an audited opening balance sheet,
- Maryland, North Dakota and Rhode Island permit phase-in by a start-up franchisor, but will automatically impose a financial assurance condition.
- California sometimes permits reviewed financials by a start-up, but it depends on the examiner,
- Hawaii, Illinois and Washington permit phase-in by a start-up franchisor.

If a start-up franchisor wants to offer franchises on a national basis, we recommend obtaining an audited opening balance sheet and having the first full audit completed at the end of the first fiscal year.

The franchise filing states also require current (dated within 90 days of filing with a state) interim unaudited financial statements that can be internally prepared by the franchisor provided they are prepared in accordance with generally accepted accounting standards (GAAP).

Principal Trademark and Intra-Company License Agreement

Since each company-owned outlet and franchised outlet will be operating under a common trade name, you should obtain a federally registered trademark if you have not already done so. We can recommend experienced trademark counsel with whom we have previously worked for other clients if you request. A federal, state and common law trademark search should be performed to determine if any other person has senior rights to the mark and the likelihood that your application will be accepted for registration. The entire federal registration process can take longer than a year. During this interim, we recommend that you obtain a state trademark registration in the state of your principal office. This trademark registration can be obtained quickly and inexpensively. We recommend this not for the value of the trademark but to fall under an exemption from registration as a business opportunity seller pursuant to the business opportunity laws of a number of states. These laws provide for an exemption for franchisors provided they have a registered trademark either federal or state.

Usually, the owner of the trademark is the existing company or maybe one of its principals. The owner will continue to own the mark and would be the applicant in any trademark registration. As part of the franchise development process, we will prepare a License Agreement between the trademark owner and the franchisor granting the franchisor the right to use the trademark and other intellectual property and to sublicense the intellectual property to franchisees pursuant to the Franchise Agreement. We will discuss with you the extent that the franchisor will pay the trademark owner an initial license fee and/or ongoing license fees.

To assist you and us with these issues we will send you the first questionnaire. You will complete this questionnaire to the best of your ability primarily with discussion and input with us.

Step 4 Creating the Franchise Business Model and Terms of Franchise Agreement

To assist you and us in creating the franchise business model and the terms of the Franchise Agreement we will be sending you a second questionnaire. The franchise laws are merely disclosure laws. They do not regulate the business terms. You can create whatever franchise program you desire so long as the franchised business complies with all applicable laws and regulations. You can provide whatever initial and ongoing services you desire. You can charge those initial and ongoing fees you deem appropriate including initial franchise fees, ongoing fees and royalties, wholesale prices for products and services to your franchisees, rebates based on your franchisee's purchases, training fees, renewal fees, transfer fees, etc.

You will complete this questionnaire to the best of your ability primarily with discussion and input with us. We will then draft the Franchise Agreement for review and input by you. We will also draft the other contracts that you will require a franchisee to sign at the time the Franchise Agreement is signed. The other contracts may include one or more of the following depending on the nature and structure of the franchise model:

- Confidentiality Agreement

- Deposit Agreement
- Site Selection Addendum
- Conversion Addendum
- Guarantee Of Franchisee's Obligations
- Software License Agreement
- Agreement With Landlord
- Telephone Number And Directory Advertising Assignment Agreement
- UCC-1 Financing Statement And Rider
- Sublease
- Franchisee Closing Questionnaire
- General Release
- Development Agreement
- Area Representative Agreement
- State Addenda To Franchise, Development And Area Representative Agreements
- Purchase Order
- Any other special document that may be required

Step 5 Information for Disclosure in the Franchise Disclosure Document

There is additional information regarding the franchise program to be disclosed in the Franchise Disclosure Document beyond the terms of the Franchise Agreement regarding the franchise concept, the franchise company and its principals, initial investment estimates, litigation and bankruptcy history, financing opportunities, public figure involvement, etc. Our third questionnaire addresses these issues. You will complete this questionnaire to the best of your ability primarily with discussion and input with us.

We will then draft the Franchise Disclosure Document for review and input by you. The franchise documents will then be finalized along with the financial statements to allow you to begin selling immediately the franchise in the 31 states having no franchise laws. There is no registration or approval of the franchise offering or the FDD by the Federal Trade Commission or any other federal agency. We will send you a memo of the requirements of each of the 50 states.

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