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# **WHY YOU NEED A LAWYER WHEN BUYING A FRANCHISE**

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## **WHY YOU NEED A LAWYER WHEN BUYING A FRANCHISE**

The purchase of a franchise may be one of the largest investments in your life. You should base your decision to buy a franchise on sound business principles, not on your emotions. It is not like buying a car. A prospective buyer needs to consider a variety of important issues at the time of purchase, and the more "due diligence" you can bring to a deal, the lower your chances of failure.

Attending a franchise show is a good way to begin the process of determining if franchising is right for you and which industry and company (franchisor) in that industry is your likely candidate. You will receive information from many companies and, after the show, follow-up calls from salespeople. A franchisor must provide you with its Franchise Disclosure Document that contains important information regarding their franchise opportunity before they can sell you a franchise. There are also franchise brokers who represent many franchisors and try to determine what franchise would be best for you. But remember they get paid by the franchisor if he or she sells a franchise.

How do you go about making an informed investment decision?

There are a number of issues, which you should consider at the time of purchase, where an attorney can render valuable assistance to you.

- Evaluate various franchise opportunities including a review of each franchisor's Franchise Disclosure Document, which discloses information regarding the franchisor, its principals, the cost and terms of the franchise, financial information and information regarding existing franchisees.
- Once you make a decision to purchase a particular franchise opportunity, you need to negotiate and finalize the franchise agreement and other agreements. These agreements are one-sided in favor of the franchisor.
- You must consider forming a corporation or limited liability company to be the franchisee to limit your personal liability in operating the business.
- You must negotiate to eliminate or reduce the scope of a personal guaranty.
- You should consider your estate planning opportunities such as an "estate freeze."
- You may be involved in real estate acquisition and construction and/or lease negotiation.
- You will have to comply with fictitious, assumed or trade name statutes.
- You may have other special legal issues such as licensing relating to the operation of the franchised business.

## **ANALYSIS OF YOURSELF, AN INDUSTRY AND A FRANCHISOR**

Franchising is not for everyone. You need to be able to follow the system prescribed by the franchisor. If you are a very independent, entrepreneurial person, franchising may not be right for you. On the opposite end of the spectrum, you must possess good management, organizational and leadership skills to run the business. Running a business is not easy. You must wear many hats. It is not a passive investment like investing in the stock market. You will not make money if you only show up once a day to look at the cash register tapes.

Is the industry you are planning to enter on its way up? Stagnant? On its way down? Analyze what effect technology, changing lifestyles and changing demographics may have on the industry over the next 20 years. Once you have targeted an industry, compare the various franchise offerings of the competitors in that industry to see which opportunity will survive in the long run, if a franchise is available in your locality, the cost and the amount of service and support given by the franchisor.

An attorney can assist you in doing a comparative analysis of various franchise opportunities by reviewing the Franchise Disclosure Document of each franchisor so that you can do a comparative analysis of your various rights and obligations and the strengths and weaknesses of each franchise opportunity. However, the best advice an attorney can give you in this regard is not legal advice but common sense advice discussed next.

## **TALK TO EXISTING AND PREVIOUS FRANCHISEES**

As part of your due diligence investigation, the best thing you can do is visit and talk to as many franchisees as possible to see how they are doing. They are already down the road you are thinking of traveling. Are they making money? How long did it take them to break even? Did the franchisor fulfill its promises? If the franchisees could do it all over again, would they still buy the franchise? It may also be wise to visit the home office or regional office of the franchisor to get a feel for the quality of the operation first hand, and to make sure there are real and knowledgeable people to service and support you and not just one person operating out of a post office box.

The FDD (ITEM 20) will contain the names, addresses and telephone numbers of all or at least 100 existing franchisees closest to you. Many franchisors include all existing franchisees in their FDD. The franchisor must also include in its FDD the names, addresses and telephone numbers of every franchisee whose franchise was terminated, canceled, not renewed or ceased doing business within the previous fiscal year or has not communicated with the franchisor within the last 10 weeks before the effective date of the FDD. The franchisor must also state the number of franchises that, within the previous 3 years, were canceled or terminated, were not renewed or were reacquired by the franchisor. Get their names, addresses and telephone numbers. You may want to know what they have to say. Also, check ITEM 3 of the FDD for pending or past litigation involving franchisees and ITEM 4 relating to any bankruptcy of the officers and managerial personnel of the franchisor. Talk to these people. You should now have both sides of the story to form your own opinion.

## DEVELOP A BUSINESS PLAN OR FINANCIAL PROJECTION

The reason you buy a franchise is to earn a living. How much are you going to make? When will you hit break-even? Surprisingly, the franchise laws do not require franchisors to tell you the most important information you want to know - how much can you reasonably expect to make based on the profitability of the other franchisees that are already operating the Franchise Business? This is a "discretionary" disclosure requirement called a Financial Performance Representation ("FPR") that, if the franchisor makes an FPR, it must be contained in ITEM 19 of the FDD. Only a minority of franchisors make such disclosure. If a franchisor does not make an FPR, I would be concerned that maybe the franchisor does not do this because it does not have a good story to tell.

How can you then determine your return on investment if the franchisor does not make an FPR? I recommend that you talk with as many of the existing franchisees who ask if they will share with you their numbers as to initial investment, gross and net income, and their experience with the franchisor, if they are willing to do so. The FDD in ITEM 7 will detail the franchisor's estimate of your total investment to get the business opened and operating for its initial phase, usually the first 3 to 6 months of operation, but don't stop there. Develop a business plan of your own. **Hire an accountant to help you with this including preparing a financial forecast of your future operations.** Most businesses lose money in the beginning. Don't spend your last dollar on getting the business open. You must have sufficient working capital to fund start-up losses as well as support yourself and your family until the business becomes profitable. A business plan will help you understand why -- so that you will be prepared both emotionally and financially -- and not panic. The business plan will also increase your chances of obtaining a loan if you need financing to purchase and open the franchise business.

## LAWS THAT PROTECT YOU

**Federal Franchise Law.** The Federal Trade Commission's Franchise Rule requires a franchisor to provide you with a pre-sale disclosure document ("Franchise Disclosure Document" or "FDD") which gives detailed information about the franchise offering and includes a copy of all documents you will be required to sign, including the franchise agreement. When you receive the FDD, you are asked to acknowledge its receipt by signing and returning to the franchisor a Receipt (ITEM 23 of the FDD). The franchisor cannot require you pay any money (even in escrow or as a refundable deposit) or sign any agreement (other than a nondisclosure or confidentiality agreement) until after you have had the FDD for at least 14 days. In addition, you must have the completed franchise agreement with all the material terms filled in at least 7 business days before you are required to sign it or give the franchisor any money. This 7-day rule can run within the 14-day rule.

**State Franchise Laws.** In addition, certain states have laws requiring the franchisor to register its franchise offering with a state agency and obtain approval or file a notice of exemption with the state before the franchisor can sell franchises to be operated in such state or to a resident of such state regardless of where the franchise is to be operated. These states are California, Florida, Hawaii, Illinois, Indiana, Kentucky, Maryland, Michigan, Minnesota, Nebraska, New York, North Dakota, Rhode Island, South Dakota, Texas, Virginia, Washington and Wisconsin. In addition, if the franchisor does not have a federally registered trademark, it must also register as a business opportunity seller in the states of Connecticut, Maine and North Carolina. If the franchisor does not have a federally registered or state-registered trademark, the franchisor must also register as a business opportunity seller in the states of Georgia, Louisiana, Nebraska, South Carolina and Utah. If you are a resident of one of these states and/or your franchise is to be located in one of these states,

your FDD may have special state-specific pages contained in an exhibit or addendum. **Approval by a state or filing with a state does not mean the state believes it is a good investment or that you will be successful.** That is up to you to investigate.

#### HIRE AN ATTORNEY KNOWLEDGEABLE IN FRANCHISING

Once you have selected a particular franchise opportunity, an attorney can explain to you your rights and obligations under the franchise agreement. During the 14-day period, you should read the FDD, especially the Franchise Agreement, completely and carefully. A franchise agreement is a very complex, lengthy and imposing legal document - particularly for the average person. It governs your legal relationship with the franchisor over the life of the franchise. Retaining a lawyer knowledgeable about franchising is very important. A franchise attorney can assist you in understanding the franchisor (we)/franchisee (you) relationship and the parties' respective rights and obligations under the franchise agreement. You should understand that there is limited ability for your attorney to "negotiate" the deal on your behalf unlike other types of business transactions. Most franchise offerings, particularly in established franchise systems, are offered virtually on a "take it or leave it" basis. This is due to a number of factors including: (i) a natural reluctance to negotiate; (ii) a desire for uniformity; (iii) the franchisor's obligation to disclose the franchise terms (stating whether any terms are negotiable or non-negotiable) to all prospective franchisees; (iv) certain state laws prohibiting discrimination among franchisees; and (v) certain state registration laws which require the franchisor's registration be amended before any negotiated changes can take place. You may be able to negotiate somewhat with a start-up franchisor.

This also does not mean that you should not attempt to "renegotiate" what the franchisor perceives to be standard boilerplate provisions, particularly where they appear to be unreasonable from your perspective. There are many issues, which you need to understand and discuss with your attorney, including (in alphabetical order):

- Advertising Obligations
- Arbitration and Mediation of Disputes
- Attorneys' Fees
- Contingencies (so you can get your money back)
- Covenants Not to Compete (during and after the Franchise Agreement)
- Default
- Force Majeure
- Integration Clause
- Jurisdiction and Venue
- Liquidated Damages
- Location of Your Outlet
- Obligations of You
- Obligations of the Franchisor
- Payments to the Franchisor
- Post-Termination/Expiration Obligations of You
- Renovation of the Premises
- Reporting Requirements to the Franchisor
- Sales Restrictions on the Franchise Business
- Sale or Transfer of the Franchised Business by You
- Term and Renewal Rights
- Trademarks
- Transfer by the Franchisor

## **BUSINESS FORMATION**

If you operate the franchised business as a sole proprietor, your personal assets are at risk for the debts and liabilities of the franchise business. You should seriously consider forming a corporation or limited liability company to operate the business. Although the franchisor, your landlord and your banker may require a personal guarantee, you may insulate yourself to third parties, such as vendors, suppliers, your customers and the general public by forming and operating the franchise business as a corporation. While a corporation is a separate tax paying entity, double taxation can be avoided by electing Subchapter "S" status. A shareholder of a corporation is generally not liable for the debts or other liabilities of the corporation, except to the extent of the money contributed to the corporation. You should also consider a limited liability company for the same purposes.

While a sole proprietorship is the simplest form of ownership, a sole proprietor has his or her personal assets at risk for any liability in connection with the operation of the franchised business. In a partnership, the partners are jointly and individually liable for the liabilities of the partnership and for the actions of the other partners acting within the scope of the partnership. With a corporation, a shareholder generally will not be liable for the liabilities of the corporation except to the extent of the shareholder's capital contribution. A shareholder's personal assets are protected. Although the franchisor may require a personal guarantee from the owners of a corporate franchisee and your banker may want a personal guarantee as well, particularly when the corporation is newly formed and not well capitalized, you may insulate yourself from liabilities to other third parties such as vendors, suppliers, your customers and the general public (*for example*, slip and fall at the premises) by forming a corporation. While a corporation is a separate tax-paying entity, double-taxation can be avoided by electing Subchapter "S" status or by paying earnings to shareholders in the form of salaries, bonuses, interest and/or rent for a "C" corporation. A new type of business entity that is becoming increasingly popular is a limited liability company. It has the advantages of limited liability for its owners but is not taxed at the entity level. This entity should be explored, particularly if "S" corporation status is unavailable.

## **FICTITIOUS NAME COMPLIANCE**

Regardless of what entity you use to operate the franchise business, under most franchise agreements, you cannot use the franchisor's trade name as part of your corporate, limited liability company or other business entity's name (*for example*, Cheeburger Cheeburger of Anytown, U.S.A., Inc.). But your franchise business will operate under the franchisor's trade name and you will have to comply with your state's fictitious name, assumed name or doing business name statute (*for example*, John Jones d/b/a Cheeburger Cheeburger or XYZ Corp. d/b/a Cheeburger Cheeburger).

In Florida, Section 865.09 of the Florida Statutes requires the one-time publication of a legal notice of the fictitious name in a newspaper in the county where the principal place of the franchise business of the franchisee will be located (such as the *Daily Business Review*). After publication, the newspaper sends you a proof of publication. Upon receipt of the proof of publication, you must file of a fictitious name registration with the Florida Department of State. Section 865.09 of the Florida Statutes provides that

A person may not engage in business under a fictitious name unless the person first registers the name with the division by filing a sworn statement listing:

- (a) The name to be registered.
- (b) The mailing address of the business.
- (c) The name and address of each owner and, if a business entity, its federal employer's identification number and Florida incorporation, organization or registration number.
- (d) Certification by the applicant that the intention to register such fictitious name has been advertised at least once in a newspaper as defined in chapter 50 in the county where the principal place of business of the applicant will be located.

Such statement shall be accompanied by the applicable processing fee (currently, \$50)

Notwithstanding any other provision of law to the contrary, a fictitious name registered as provided in this section for a corporation, limited liability company, limited liability partnership, or limited partnership is not required to contain the designation of the type of legal entity in which the person or business is organized, including the terms "corporation," "limited liability company," "limited liability partnership," "limited partnership," or any abbreviation or derivative thereof.

#### **LEASE OF PREMISES**

If the franchised business you are buying is not home-based, you probably will have to lease space in an office building or shopping center. You must take signing a lease very seriously, as you are committing to pay many thousands of dollars in rent and other expenses over many years - a liability, for which you will, in all likelihood, be required to personally guarantee.

As you may know, the landlord's standard lease was prepared by the landlord's attorneys to protect the interest of the landlord, not your interest. Certain provisions need to be negotiated and finalized by you and the landlord such as the description of the premises, lease term, rent, security deposit, build-out, etc. Other provisions, which the landlord considers standard boilerplate, need to be negotiated by you. In addition, your franchise agreement may require you to add certain provisions to your lease for the benefit of the franchisor. You should retain an attorney qualified in real estate and leasing matters to represent your interest and to assist you in your negotiations with the landlord.

#### **ESTATE PLANNING CONSIDERATIONS**

Many times it is the parents who are purchasing a franchise for their children. If you have a substantial estate, you may want to consider certain estate planning opportunities to shift any appreciation in the value of the franchise business to your children or grandchildren to reduce your estate tax liability. This can be accomplished without relinquishing control over the operation of the franchise by having different classes of stock. The estate planning should be done at the time of incorporation as certain planning may preclude you from Subchapter "S" status (*for example*, you can't have two classes of stock) but a limited liability company may work.



### **SPECIAL ISSUES**

Depending on the nature of the franchised business and the laws of your state there may be additional legal requirements with which you must comply, such as special licenses or permits.

### **CONCLUSION**

Buying a franchise and opening a business is not a piece of cake. You are making a substantial initial investment and obligating yourself to substantial future liability under the franchise agreement, lease, loan documents, equipment lease documents and other contracts. Remember to old FRAM oil filter commercials – “You can pay me now pay me later.” If you retain a franchise lawyer that is a business attorney before you purchase, the cost is not significant in relation to your risk and the amount you invest, much like an oil change. If you end up in arbitration or litigation with your franchisor after you have lost everything, the litigation costs will be more like an engine job. Do not be “penny-wise and pound-foolish” in trying to skim on costs such as a franchise attorney and an accountant before you invest. These professionals will end up saving you more money and aggravation in the long run.

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