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Thinking About Buying A Franchise? What To Do Before Making Your Investment

by

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In the current climate of down-sizing in corporate America, owning one's own business can appear very attractive. Being personally responsible for your own destiny, rather than having your job subject to the vicissitudes of your company's stock price, is both empowering and frightening at the same time. It is empowering because your financial reward will depend upon your own efforts; and it's frightening because you probably have never started or operated your own business before.

The first part of this article provides a general overview of the franchise relationship and articulates some of the reasons why franchising might be a good option for someone looking to start his or her own business. The second part of the article discusses the importance of thoroughly investigating the franchise opportunity.

Finally, the article addresses the legal aspects of the franchisor/franchisee relationship and provides some reasons why it is important to consult an experienced lawyer before signing a franchise agreement.

The Franchise System.

Owning a franchise can provide the empowerment of business ownership while tempering somewhat the "fear factor" of going at it alone. Franchises provide a number of advantages over starting your own business from scratch.

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A good franchisor has spent a great deal of time and money developing a proven operating system for its particular type of business. The franchisor has studied the particular market and has developed routines and practices that a new business owner in that particular business might take years to learn. The “system” is the main reason that starting a franchised business can be so much less frightening than doing it on your own. Following the franchisor’s system takes a lot of the trial-and-error out of owning your own business.

In addition to a proven business operating system, many franchisors have developed strong trademarks, such as business names, catch phrases, and logos, that are associated with their businesses and that are recognizable in the marketplace. The franchisor licenses these trademarks to its franchisees, allowing franchisees to use these recognizable names or phrases in their own businesses. The franchise agreement contains provisions protecting these trademarks from misuse and maintaining their value to the system.

Franchisors often provide detailed policy and procedure manuals that address many of the day-to-day problems associated with owning your own business. These manuals may include personnel policies, instructions on proper payroll practices and proper bookkeeping practices and they often address most of the day-to-day operational issues that plague new business owners. Franchisors regularly offer training in these policies and procedures, enabling the franchise owner to quickly get up to speed on business operations.

The franchise system also provides a means by which new ideas can be tested at the local level before being adopted system-wide. Many improvements to a franchise system originate with franchise owners who see how things work “in the trenches” and bring proven techniques to the attention of the franchisor. This network of fellow franchisees can also be an important source of support for new franchise owners.

Investigating the Franchise Opportunity.

The franchisee is often making a very significant investment in his or her franchise. That investment should not be made without a thorough investigation of the franchisor and an understanding of the strength or weakness of the particular franchise opportunity. A weak franchise – one in which the trademarks are not particularly strong or well-known, or in which the franchisor does not have the financial resources to support its franchisees – can be a very poor investment.

Fortunately, there are many resources available to assist the prospective franchisee with his or her investigation of the franchisor. The first step is to thoroughly read the franchise disclosure document (“FDD”). While it may seem like an impenetrable document, there is really no better single source of information about the franchise system and the franchisor. The contents of the FDD are to a high degree dictated by the federal franchise regulations² and it is a rich source of

² The Federal Trade Commission website has some excellent information for those considering buying a franchise. See: <http://www.ftc.gov/bcp/menus/consumer/invest/business.shtm>



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information about the franchisor and the strength (or weakness) of the franchise. The FDD and its associated tables, charts and appendices can tell the prospective franchisee a great deal about the background and financial strength of the franchisor. If a potential franchisee does not understand the financial information in the FDD, he or she should engage an experienced business accountant to review the FDD and advise him or her on the financial strengths and weaknesses of the franchisor.

The FDD should also contain the identity and contact information of other franchisees in the system. The prospective franchisee should contact several current and former franchisees, who are in perhaps the best position to provide inside knowledge about the pros and cons of the system. The prospective franchisee should ask current and former franchisees about their experiences with the system and their perceived strength of the franchisor. Questions should include whether the franchisor provided adequate training in the business system, whether the operations manuals are helpful and easy to follow, and whether the franchisees think that the system added value that would not be available to a similar business operating outside such a system.

Finally, because often much of the value of a franchise is associated with the strength of the franchisor's trademarks/service marks or trade names, the prospective franchisee should conduct a search on the US Patent and Trademark Office website³ to confirm that the franchisor's trademarks are properly registered. If the franchise is not particularly well-known or well-established, an experienced attorney can assist with this process and can advise a prospective franchisee of the strength or weakness of a franchisor's trademarks.

The Legal Relationship Between Franchisee & Franchisor: The Franchise Agreement.

The prospective franchisee must have a full understanding of the legal relationship between the franchisor and the franchisee, which is embodied in the franchise agreement.

Once the prospective franchisee has read (and re-read) the FDD and has satisfied him or herself of the strength of the franchisor and its trademarks, the final step is to carefully read the franchise agreement and engage a qualified attorney to review it.

For the most part, franchise agreements are largely non-negotiable. If that is true – if it is truly a take-it-or-leave-it proposition, why pay a lawyer to review the franchise agreement? First, because there are probably going to be provisions that the prospective franchisee simply does not understand. An experienced attorney can explain in plain English some of the more technical legal provisions. Second, there are some circumstances when the franchise agreement, or at least portions of it, are in fact negotiable.

The degree to which a contract is negotiable is usually related to the relative bargaining power of the parties involved. Many of us regularly enter into contracts wherein the other party to the contract has a great deal more bargaining power than we do -- credit card agreements and auto

³ Go to <http://www.uspto.gov>



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insurance policies come readily to mind. In the franchise context, the franchisor has all the bargaining power, and the franchisee must simply sign the agreement if he or she wishes to buy the franchise. A general rule of thumb is that the more well-known and well-established the franchise, the less likely the franchisor will be willing to make any changes to the franchise agreement. In fact, one of the signs of a weak franchise is when the franchise agreement is open to a great deal of negotiation. But a moderately strong franchisor may be willing to make certain concessions under certain circumstances.

Assuming a relatively strong and well-established franchisor, what are some provisions that an experienced attorney may be able to negotiate? Of course, the answer varies with the circumstances, but following are some of the limited areas in which franchisors may be willing to make concessions in the franchise agreement:

Notice Provisions. There are many places in a franchise agreement where the franchisor has the right to exercise certain remedies upon a default by the franchisee. Sometimes the franchisee can insert provisions requiring advance notice and an opportunity to cure such defaults before the franchisor may exercise its remedies.

Limiting the Franchisor's Discretion. Franchise agreements often contain provisions requiring a franchisee to obtain the franchisor's consent to do certain things. Franchisees should try to ensure that the franchisor does not have absolute, unfettered discretion to deny its consent when giving such consent would be reasonable based upon verifiable facts.

Trademark Protections. Much of the value in the franchise system is attributed to the trademarks that the franchisor licenses to the franchisee. The franchisor should be willing to stand behind its trademarks and defend them in the event they are challenged by third parties. Consequently, the franchisor should be willing to indemnify the franchisee in the event the franchisee is sued on the basis of trademark infringement.

Adjoining Territories. Sometimes the franchisor is willing to grant a strong (generally that means well-financed) franchisee a right of first refusal to purchase the territories that are contiguous with his or her own and which have not yet been assigned to other franchisees. A franchisee might even be able to negotiate a reduced price for such additional territories.

Indemnification Provisions. Franchise agreements sometimes contain unreasonable indemnification provisions. Under an indemnification clause, one party is required to hold harmless the other for certain losses or damages. It certainly makes sense for the franchisee to indemnify the franchisor for losses or damages that the franchisor suffers as a direct result of the wrongful acts of the franchisee or its employees. But occasionally the indemnification provisions are written much more broadly to favor the franchisor and such provisions need to be cut back.

Advertising Requirements. A franchisee may want to request that the franchisor loosen the requirements that the franchisee spend a certain dollar amount or percent of gross sales on advertising, particularly during the first several months of operation. Some franchisors will



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lower these requirements during the first six months to a year, in recognition that revenue is usually very tight during the start-up stage of the business.

Sale of the Franchise. All franchise agreements set conditions on a franchisee's ability to sell or transfer the franchise. These provisions are sometimes negotiable with respect to the assignment of the franchise to family members and with respect to the franchisor's ability to exercise a right of first refusal. Since most franchise agreements have a term of 10 to 20 years, it is imperative that the franchisee understands the restrictions on his or her ability to sell the franchise.

Conclusion.

Investing in a franchise can be a very rewarding decision. It can also be an unmitigated disaster if the prospective franchisee does not understand what he or she is getting into. The decision to invest in a franchise should be made only after a thorough investigation of the franchisor and careful study of the franchise agreement. An experienced attorney can help take some of the uncertainty out of the process and can ensure that the franchisee is going into the deal with a complete understanding of his or her rights and responsibilities.