

# **THE GENERAL PRACTITIONER'S GUIDE TO FRANCHISING**

**MARK H. MILLER  
Jackson Walker L.L.P.  
112 East Pecan, Suite 2100  
San Antonio, Texas 78205  
(210) 978-7700**

## TABLE OF CONTENTS

I. INTRODUCTION .....	5
A.In General.....	5
B.Federal Franchise Regulation.....	5
C.State Franchise Laws.....	6
D.Business Opportunity Laws.....	6
E.Texas Business Opportunity Act.....	6
F.Relationship Laws .....	6
II. PROSPECTIVE FRANCHISEES .....	6
A.Franchise Purchases Are Different.....	6
1. IN GENERAL .....	6
2. THE CLIENT .....	7
3. THE FRANCHISE AGREEMENT.....	7
4. THE FRANCHISOR.....	7
5. AVAILABLE INFORMATION.....	7
6. SELF PRESERVATION.....	7
B.The Attorney's Role .....	8
1. BE A COUNSELOR.....	8
2. STRESS THAT IT IS A BUSINESS .....	8
C.Educate Yourself About Franchising .....	8
1. PRACTICAL KNOWLEDGE.....	8
2. FRANCHISE ADVANTAGES .....	8
3. FRANCHISE DISADVANTAGES.....	9
D.Initial Interview.....	9
1. FIRST CONTACT .....	10
2. OPENING GAME: COPY AND INTERROGATE.....	10
3. MIDDLE GAME: ANALYZE THE PAPERWORK .....	10
4. END GAME: ASSIGN TASKS .....	10
E.Business Advice .....	11
1. SHOULD THE LAWYER GIVE BUSINESS ADVICE?.....	11
2. BUSINESS ADVICE.....	11
3. QUALIFY THE CLIENT .....	12
F.Negotiating The Franchise Agreement .....	12
1. NEGOTIATING CHANGES .....	12
2. OTHER ISSUES.....	13
G.Other Due Diligence .....	14
1. FRANCHISEE ASSOCIATIONS .....	14
2. VISIT FRANCHISOR'S HEADQUARTERS.....	14
3. OTHER INFORMATION.....	14
III. UNHAPPY FRANCHISEES.....	15
A.Practical Advice .....	15
B.Legal Theories .....	16
1. FRANCHISEE'S GOAL .....	16
2. BUSINESS OPPORTUNITY ACT.....	17
3. DECEPTIVE TRADE PRACTICES ACT .....	17

4. COVENANT NOT TO COMPETE .....	18
5. OTHER THEORIES .....	19
IV. SELLERS WHO DO NOT WANT TO BE FRANCHISORS .....	20
A.Federal Definition Of Franchising .....	20
1. DEFINITION.....	20
2. DISTRIBUTORSHIP EXAMPLE .....	20
B.How To Avoid Being A Federal Franchisor .....	21
1. AVOID THE FRANCHISE DEFINITION .....	21
2. USE EXEMPTIONS AND EXCLUSIONS .....	24
3. DO NOT MISUSE THE TERM "FRANCHISE"Error! Bookmark not defined.	25
C.State Definitions Of Franchising .....	25
1. IN GENERAL .....	25
2. MARKETING PLAN DEFINITION.....	25
3. COMMUNITY OF INTEREST DEFINITION .....	27
4. OTHER DEFINITIONS.....	28
5. EXEMPTIONS AND EXCLUSIONS.....	28
D.Federal Definition Of Business Opportunity .....	28
1. IN GENERAL .....	28
2. DEFINITION.....	29
3. EXAMPLE .....	29
E.State Definitions of Business Opportunity.....	29
1. IN GENERAL .....	29
2. MAJORITY DEFINITION .....	29
3. OTHER STATES .....	31
F.Texas Definition Of Business Opportunity .....	31
1. DEFINITION.....	31
2. THREE PART TEST.....	31
3. TO BEGIN A BUSINESS.....	31
4. INITIAL CONSIDERATION .....	32
5. THRESHOLD REPRESENTATIONS.....	33
6. THE FRANCHISOR EXEMPTION .....	34
7. OTHER EXEMPTIONS .....	36
8. CONSTRUCTION.....	37
V. PROSPECTIVE FRANCHISORS.....	38
A.The Lawyer's Role .....	38
B.Should The Client Franchise?Error! Bookmark not defined. ....	38
C.Full Disclosure .....	39
D.The Franchisor's TrademarkError! Bookmark not defined. ....	40
E.Structuring A Successful System.....	40
1. THE FRANCHISE AGREEMENT .....	40
2. THE OPERATIONS MANUAL .....	41
3. STAFFING UP .....	41
4. GOOD FRANCHISEES.....	41
5. PONZI FRANCHISING .....	42
F.After The Agreement Is Signed.....	42
G.Attorney Liability.....	43

VI. CONCLUSION..... 44

APPENDICES

APPENDIX

**Chart Of Distribution Statutes ..... A ..... K-46**  
**How Review A Franchise Offering ..... B .....K-47**  
**Advice To The Prospective Franchisee ..... C .....K-60**  
**Advice To The Prospective Franchisor ..... D ..... K-66**

**NOTE: This general paper liberally plagiarizes from the author’s prior, more specific papers.**

# FRANCHISING PRIMER

MARK H. MILLER

## I. INTRODUCTION

### A. In General

Franchising is a method of distribution that combines the advantages of a central specialized system with the capital and micro-management of local independent business persons to produce a market competitor with critical mass. Its inherent geographic expansiveness and long term business relationships cause franchising to be affected by an array of dynamic federal, state and local laws.

The application of this collection of laws to franchise relationships is referred to as franchise law.

The Federal Trade Commission ("FTC") promulgated the Franchising and Business Opportunity Ventures Trade Regulation Rule 16 C.F.R. § 436 (The Rule) in 1979 to protect prospective franchisees from deceptive franchise sales practices. Eighteen states now have franchise statutes and twenty-four have business opportunity laws, most requiring written pre-sale disclosure to prospective buyers and some requiring pre-sale registration and regulating the parties' relationship. The Appendix A chart identifies these statutes.

The legal definitions of "franchise" and "business opportunity" are intentionally broad. Trademark licenses, distribution agreements, joint marketing agreements, and plain vanilla business deals are often deemed franchises or business opportunities. Lowell and Dienelt, Drafting Distribution Agreements: The Unwitting Sale of Franchises And Business Opportunities, Del. J. of Corp. L. 725 (1986) and Slade, Applicability of Franchise and Business Opportunity Laws to Distribution and Licensing Agreements, 15 AIPLA Quarterly Journal 1 (1987).

Franchising bundles together many areas of law that are typically only dealt with by specialists in those areas: Federal and state laws

and regulations concerning antitrust, trade dress, Two Pesos, Inc. v. Taco Cabana International, Inc., 112 S.Ct. 2753 (1992), trade secrets, advertising generally, cooperative advertising, franchise advertising, patents, trademarks, copyrights, McGowan and Cone, The Increasing Value of Copyright Protection In a Franchise Context, Franchise, L.J. 1 (Fall 1988), vicarious liability, Compare, Chevron U.S.A. v. Lesh, Bus. Franchise Guide (CCH) Part 9583 (Md. App. 1990) (Plaintiff's belief that service station dealer was an employee of Chevron "not objectively reasonable under all of the circumstances"), with, Hoytt v. Doctor Pet Center., Bus. Franchise Guide (CCH) Part 8723 (N.D. Ill. 1986) (purchaser of mislabeled dog from pet store franchisee had a cause of action against franchisor); Sigalow, Insurance and Indemnification Provisions in Trademark License Agreements, The Licensing Journal 31 (September 1992); Monica, Franchisor Liability To Third Parties, 49 Mo. L. Rev. 309 (1984), bankruptcy, Comment, License and Franchise Agreements as Executory Contracts: A Proposed Amendment to Section 365 of the Bankruptcy Code, 59 U. Col. L. R. 129 (1988); arbitration, Shearson/American Express, Inc. v. McMahan, 107 S. Ct. 2332 (1987); Marble Slab Creamery, Inc. v. Wesic, Inc., 833 S.W.2d 436 (Tex. App. - Houston 1992) (Franchisor waived right to require arbitration), forum selection, conflict of laws, real property, usury, unfair competition, implied covenants of good faith and fair dealing, anti-termination and anti-discrimination laws, and state "baby FTC" acts. The contract and tort law applied by each jurisdiction the franchisor and its franchisees operate in, and local, state and federal regulations affecting the subject line of commerce affect a franchisor. Any can be the downfall of a franchise system.

### B. Federal Franchise Regulation

The Rule defines a franchise as any arrangement which requires the franchisee to pay at least \$500 for the right to operate a business under the franchisor's trade name or sell the franchisor's branded products, if the franchisor provides significant assistance to the franchisee or can exercise significant control over the franchisee's operating methods. The Rule makes it unlawful for a franchisor to not provide prescribed written disclosures to prospective franchisees at the earlier of the first face-to-face meeting between the franchisor and the prospective franchisee for the purpose of discussing the possible sale of a franchise or ten business days prior to executing the franchise agreement. The Rule does not require any governmental filings, just disclosure in the prescribed way. It does not provide a private cause of action.

### C. State Franchise Laws

State laws define and regulate franchising much differently than The Rule. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oklahoma, Rhode Island, South Dakota, Virginia, Washington, Wisconsin require a registration or notice filing before offering franchises for sale and pre-sale disclosure through a Uniform Franchise Offering Circular ("UFOC"). Oregon requires pre-sale disclosure without a governmental filing. Franchisors may satisfy The Rule's disclosure requirements by delivering a UFOC-format offering circular. Arkansas and Florida also regulate franchising.

### D. Business Opportunity Laws

The Rule and twenty-three states, Alabama, California, Connecticut, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, and Virginia, regulate business opportunities. These laws apply to sellers who offer purchasers the opportunity to begin a business by using the seller's goods or services.

Some states have both franchising and business opportunity laws and some have one and not the other. Business opportunity laws often affect agreements drafted to avoid franchise definitions.

### E. Texas Business Opportunity Act

Texas regulates franchising and business opportunities through the Business Opportunity Act (BOA). Tex. Rev. Civ. Stat. Ann. art. 5069-16.01 et seq. The BOA definition of "business opportunity" is broader than The Rule's definition of "franchise" and "business opportunity". Franchisors who comply with The Rule in all material respects and file an exemption statement are exempt from the BOA.

### F. Relationship Laws

Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Virginia, Washington and Wisconsin have relationship laws which capture more distribution arrangements and require more of the seller than is generally realized. Pitegoff, Franchisee Relationship Laws: A Minefield For Franchisors, 45, *The Business Lawyer*, 289 (Nov. 1989); Colt Industries, Inc. v. Fidelco Pump & Compressor Corp., 844 F. 2d 117 (3rd Cir. 1988). These laws legislate certain most favored nation clauses, Canada Dry v. Nehi Beverage Co., Inc. of Indianapolis, 723 F. 2d, 512 (7th Cir. 1983), regulate the "good cause" reasons a dealer distributor can be terminated or not renewed, the notices required to effect a termination, the effect of the termination, etc. These laws are listed in Appendix Chart A. They are not, however, within the scope of this paper.

## II. PROSPECTIVE FRANCHISEES

### A. Franchise Purchases Are Different

#### 1. IN GENERAL

The purchase of a franchise is similar to other business transactions with two minor exceptions. First, an extensive unconscionable franchise agreement is presented on a take-it-or-leave-it basis. Second, the typical prospective franchisee is committed to buying on the unconscionable terms and is unprepared to accept or pay for an attorney's advice.

This portion of the paper is substantially derived from Charles Cannon and Mark Miller, How To Represent Prospective Franchisees Effectively, Franchise and Distribution Law Committee of the Texas State Bar Intellectual Property Law Section (1992) which gives a more comprehensive treatment of the subject. The author's apparent pro-franchisee bias in this portion of the paper should be balanced against his apparent pro-franchisor bias in Part V.

## **2. THE CLIENT**

Prospective franchises come in all shapes and sizes. Resolutely held prejudices concerning them can hinder you in any given case. The typical prospective franchisee, however, is interested in franchising precisely because he lacks sufficient knowledge, capital or some other needed asset to start the business on his own. Having already decided to buy a specific franchise he wants you to quickly bless the deal for a few hundred dollars so he can make his million dollars. He is in love and wants you to bless the marriage license.

Prospective franchisees typically:

- Lack the business experience and perspective to understand that buying a franchise is comparable to acquiring any business and the sophistication to analyze risk and potential return on investment. He is a consumer making his first major business transaction. Many prospective franchisees are willing to buy a job, i.e. spend, risk, and obligate in exchange for an expected return equal to a safe salaried position.
- Have prematurely emotionally committed to buy the franchise. He has not investigated other franchisors, considered whether he can get into the business without being a franchisee, or prepared a financial plan.

- Have little prior experience with business lawyers. An attorney who questions the deal, their qualifications or the franchisor is viewed as hostile and uncooperative.
- Have budgeted under \$500 for legal fees.

## **3. THE FRANCHISE AGREEMENT**

The franchise agreement is 30 to 60 pages with long paragraphs full of unconscionable terms, boiler plate plagiarized from dissimilar agreements and defined terms which circuitously refer to each other. A thorough comprehension of it will take more hours than your franchisee can afford.

## **4. THE FRANCHISOR**

The franchisor says the law forbids him from varying a single word in the franchise agreement or revealing any information other than that disclosed in its franchise offering circular. Its representatives are otherwise helpful and optimistic. They want to help your client tie up the last remaining franchise for the area before other prospective franchisees do.

## **5. AVAILABLE INFORMATION**

The franchisor's franchise offering circular is twice as long as the franchise agreement and, in the main, regurgitates it. The prospective franchisee has not carefully read either the agreement or the circular. He has, however, been to a franchised store where customers were standing in line and which either has absolutely no competition or has a special method, product, recipe, etc. which gives it a (virtually) unbeatable competitive advantage. He believes most franchises are doing at least as well as the store the franchisor's sales personnel directed him to and that if he can get one of the few remaining available franchises by paying the \$25,000 franchise fee by the end of the month, he will have a guaranteed success.

## **6. SELF PRESERVATION**

From a self-preservation point-of-view, this is a dangerous situation and a dangerous client. If the franchisee fails, he may claim you

failed to adequately advise him of the very dangers he does not want to pay you to investigate.

This paper suggests steps to help you economically provide useful assistance to a prospective franchisee and lessen the chance of him later turning on you.

## **B. The Attorney's Role**

### **1. BE A COUNSELOR**

The described circumstances put the franchisee's attorney in a difficult position. If the franchisee is committed to the purchase, has limited funds for advice, and the franchisor is unwilling to negotiate, where do you fit in?

Your first responsibility is to help the franchisee understand what he is getting into. The investment can be bad because of the client, the franchisor, a bad fit between them, the line of business, the location, the price, other better opportunities, etc. You should help the client evaluate (1) whether he is suited to be a small business owner in this line of business, (2) what he is getting and giving up relative to other options such as paying for training elsewhere, going with another franchise system, opening an independent business, staying put, etc., and (3) the nature of the franchise agreement and the offering circular's disclosures.

Because the client cannot pay you to analyze any of these matters in detail and most are mixed business/law evaluations, it is impossible to complete these tasks in a rigorous manner. There is no alternative but to ration the resource of your time to do as much good as possible for the client. By definition, this will leave many tasks undone. The client should be apprised of this and consent to it.

### **2. STRESS THAT IT IS A BUSINESS**

The single most important thing to impress on prospective franchisees is that, in the main, a franchised business is just like the non-franchised business across the street. Good employees have to be hired, trained, supervised, and paid. A consistent superior product needs

to be delivered to customers who are located, developed, and maintained. Location (location, location) cannot be over-emphasized for most retail businesses. Bad business persons will make bad franchisees.

One way to get the franchisee's attention is to total the cost of the real estate, equipment, leases, etc. he is responsible for over the duration of the franchise agreement. This total obligation is typically several hundred thousand dollars.

## **C. Educate Yourself About Franchising**

### **1. PRACTICAL KNOWLEDGE**

A franchise in any line of commerce will have many similarities to a franchise in any other line of commerce. You should learn enough about franchising generally to know how the subject offering is the same as and different from a typical franchise offering. This will help you ration your time in assisting the client.

The more you know about the line of commerce the better you can advise the client. While it may be useful to tour a similar operating outlet, this will not typically be in the budget.

### **2. FRANCHISE ADVANTAGES**

#### **a. Safe Investment**

Franchisors state that 85% to 90% of franchised businesses survive for more than a year, compared with 30% to 35% of independent start-ups. This is probably true among franchise systems responsible and substantial enough to report their franchise failures. Other studies, however, have found franchisee failure rates of 40%. Introductory Statement by Honorable John J. Lafalce (D. NY) Chairman, Committee on Small Business introducing H.R.5232 and H.R. 5233, May 21, 1992 (Bus. Franchise Guide (CCH) Extra Edition No. 148, May 27, 1992. Further, survival studies do not address whether franchisees achieve the lifestyle they were led to expect. Royalties, high prices for franchisor-controlled supplies, the prospect of termination

and non-competition covenants make some franchisees indentured servants.

Most businesses, independent or franchised, are self-selected for success or failure. Failures usually open without sufficient preparation or capital, are unsuited to the business, select a poor location or incur excessive expenses for items such as rent. Those who succeed prepare for months or years, accumulate capital, select a business for which their capital is adequate, have experience in the line of commerce, keep expenses under control and understand marketing and providing customer satisfaction. Much of franchising's success lies in franchisors' selecting franchisees who would have succeeded anyway.

**b. Proven Business System**

Most franchisors successfully convert the knowledge and experience gained from successful company units into practical franchisee support systems, useful training programs, operations manuals and valuable field assistance. Unfortunately, some overlook the difference between themselves operating a successful business and teaching many others how to operate such a business at great distances. Their training assistance is superficial, unhelpful and not worth the cost.

**c. Critical Mass**

Critical mass means the chain has enough company or franchised units, supported by a strong enough franchisor core, to enjoy: (a) economies of scale in purchasing, distribution, training, assistance and advertising, (b) customer name recognition, and (c) a base of knowledge that is transferred from the top of the system to the bottom (and back up). These all require continual work by an intelligent franchisor management team. Franchisees of a system with critical mass enjoy competitive advantages over independents engaged in the same line of business. Not all franchise systems offer all of these advantages.

**3. FRANCHISE DISADVANTAGES**

**a. Payments to Franchisor**

The initial franchise fee and continuing royalties must purchase at least equivalent value for the franchise or he will be unable to survive the intense front line competition with similar independents, franchisees and chains. A 5% royalty on gross sales may equal 50% of a franchisee's net profits. Independent competitors do not have this cost.

**b. Purchasing Requirements**

Franchisees must purchase items according to the franchisor's standards and only from approved suppliers. Central purchasing often produces the critical mass needed to obtain better quality goods at lower prices and keeps the franchisee from losing money by straying from the proven concept. On the other hand, some franchisors charge inflated prices for branded products or keep the supplier's rebates and do not seek discounts, promotions and concessions from brother-in-law approved suppliers.

**c. Franchisor Controls**

Franchisor controls may prevent the franchisee from selling certain goods and services, costing the franchisee those unrealized profits. The franchisor's rules may, however, have been developed over years of trial and error and save the franchisee from expensive mistakes.

**d. Franchisee Temperament**

Strong-willed innovators often cannot fit into a franchise system even if monetarily successful.

**e. Forfeiture Risks**

Franchise agreements are for a limited period of years at best and contain a laundry list of defaults to justify early termination. The franchisee should be aware that he is just renting the business.

**D. Initial Interview**

### **1. FIRST CONTACT**

The typical prospective franchisee is not a long time client. He is an honest, hardworking citizen who has never faced a complicated business commitment and wishes to quickly complete the uncomfortable analysis phase so he can begin working at his new business. Your first contact is usually a telephone call requesting an appointment. Be sure he will bring the franchise offering circular, franchise contracts, any earnings claims statement, sales brochures and franchise application kit to the initial interview. Discussion of your hourly rate will sometimes end the conversation. It is better that this occur now, than later.

### **2. OPENING GAME: COPY AND INTERROGATE**

At the first office conference, immediately obtain the franchisor's UFOC, franchise agreement and related documents from the client and have your secretary immediately begin making a copy. The client should then be encouraged to tell you about himself, his work experience, how he came to be interested in the particular franchise, what investigation of alternative franchises or independent businesses he has made, how far he has gone in investigating the franchise and what he expects the franchisor to do for him. You should be as relaxed and in as a good a humor as possible. Bedside manner is important. By the time this pleasant interrogation concludes, you should have an understanding of who the client is and how prepared he is and your secretary should have returned a copy of the franchisor's documents.

### **3. MIDDLE GAME: ANALYZE THE PAPERWORK**

As unfair as it is, your comments on the franchisor's documents in the next thirty minutes will define your relationship with the client. The client should not purchase if a franchise offering circular has not been provided, as the franchisor will likely eventually succumb to franchisee litigation. Armed with How to Review a

Franchise Offering Circular's, Appendix B, explanation of what you are looking for, quickly review the documents in the client's presence and reveal unrealized important aspects.

For example:

- Have the client read the merger clause out loud ("No promises or representations except as contained in this agreement"), ask him to tell you what he thinks that means and then note that the promises and representations made by the salesman which he related in the first phase of the interview are not in the franchise agreement.
- Discuss the default ("Any breach" justifies termination) and the covenant not-to-compete ("shall not compete for two years") clauses and explain the distressing problem of having a personally guaranteed bank loan and a five year site lease if terminated.
- Explain practical aspects such as how a five percent royalty on gross revenue can equal two hundred percent of net income. He has not considered this.
- Peruse the UFOC and franchise contracts noting the points raised in Attachment B.

You must quickly walk this consumer through the steps an experienced business person would take before entering a business transaction. You should tread gently in pointing out faults, even if it is clearly a franchisee suicide mission. The franchisee is in love with the venture. You must first open his eyes to what to look for, then find the most outrageous items and then discuss their implications. Showing off by quickly reaching a conclusion may make him defend the unjustly accused franchisor rather than impress him with your brilliance.

The goals of the second portion of your interview are to make him aware that (1) he has not yet gathered enough information or sufficiently analyzed the issues to make an intelligent decision and (2) you have the knowledge and experience needed to help him reach and effect his decision.

### **4. END GAME: ASSIGN TASKS**

Agree on a handwritten list of tasks to be accomplished by each of you. Timing and cost should be frankly discussed. Cost considerations typically require that most tasks, even those that are usually counsel's, be delegated to the client. Your main function is to identify things that should be looked into and encouraging the client to do it.

Giving the client a handout organizes the initial interview, makes the client realize you are knowledgeable concerning his problem, gives him something to take home, and helps protect you should the client forget your advice. Appendix C is a sample form. While sophisticated business persons will find it simplistic, each "Rule" is included because the author has seen it violated.

It is unlikely that you will be authorized to bill thousands of dollars on the project. If substantial work will be required of you an engagement agreement setting fees, terms of payment, etc. should be entered into. Otherwise persons unaccustomed to paying a business attorney's hourly rate may dispute their liability for fees or the amount of fees billed. ("I am shocked, shocked to learn there is gambling at this establishment." Major Renault, *Casablanca*, 1943.)

Unfortunately, further advice and consultation with you may be the only thing which can save the client, his spouse and their four children from years of indentured servitude culminating in financial disaster, divorce and related family problems. A prospective franchisee may be a person to whom you, as a member of the bar, should give a little *pro bono* time to by reducing your bill or being lenient in the payment terms.

## E. Business Advice

### 1. SHOULD THE LAWYER GIVE BUSINESS ADVICE?

A business client knows more about his line of commerce than the attorney. You "paper over" his handshake deal. Like anyone in a new situation, however, the prospective franchisee

client, has not yet developed franchising or business common sense to rely on. This puts the lawyer in an awkward position. You may be the only professional the prospective franchisee consults before signing the franchise agreement. If you do not offer sound business advice, he may not get it at all.

Most lawyers give potential franchisees more business advice based on less information, with more decisive effect, for less compensation and at more risk than any other type of client.

### 2. BUSINESS ADVICE

Franchises are purchased or not primarily for economic rather than legal reasons. Some of this economic investigation and analysis often falls to the franchisee's attorney by default. The critical comparison is not only between your client's current situation and where he would be after signing a franchise agreement. It is the difference in value between what he will get from the franchisor and what he could get somewhere else. What assistance does the franchisor give that the franchisee could not get by working for a month in a similar business? Are the franchisor's training or trade secrets really that special? Other than the franchisor's trademark, which may be worthless, can everything else be obtained from other sources without a franchise fee, royalty, and continuing obligations? Buying an existing franchise or converting an existing independent business into a franchised business are alternatives.

Encourage the prospective franchisee to check out alternative franchisors, talk to independent businesses in the line of commerce and call geographically dispersed franchisees of the franchisor. Franchise offering circulars from other franchisors in the subject line of commerce can be obtained for \$20.00 each from the Franchise Division of the Illinois Attorney General's Office. Franchise Division, Office of the Attorney General, 500 South Second Street, Springfield, Illinois 62706, (217) 782-4465. The client should immediately join trade organizations and subscribe to trade journals as they are often the least expensive way of

obtaining information about the line of commerce.

Anyone who is not willing to put together a business plan should not go into business. If the prospective franchisee has not prepared a business plan, send him to the Small Business Administration or similar organization.

The client's banker can be asked to provide the part of Annual Statement Studies published by Robert Morris Associates for lenders which is relevant to the line of commerce for a business plan guide. Most new businesses operate at a loss for weeks or months before turning a profit.

The business plan must take this into account. Leasing rather than buying and borrowing money rather than using the nest egg may be needed to retain enough cash to tough out the slow first year.

Ultimately, all decisions are made by the client. You can, however, help him make informed decisions.

### 3. QUALIFY THE CLIENT

Not everyone should be a business owner or a franchisee. There is little point in the client purchasing the franchise if the operating capital required (a euphemism for "money needed to cover losses until the business becomes profitable, if ever") is more than he has, if the franchisor requires that he move to another state and his wife refuses to leave the family homestead, if the franchise requires herding tribes of teenagers as required at large fast food restaurants and the client is reclusive etc.

Many potential franchisees do not realize that "being your own boss" means working twelve to sixteen hour days, six to seven days a week pleasing customers, keeping employees and personally cleaning the bathrooms and picking up trash from the parking lot if necessary. While it is not strictly your province to advise the client on his suitability, the alternative may be to ignore the fact that he is headed toward utter doom. You should consider the items listed in Part V, paragraph E, subparagraph 4 and help the client inventory himself.

## F. Negotiating The Franchise Agreement

### 1. NEGOTIATING CHANGES

Negotiability of franchise agreements is very limited. Concessions to your franchisee may affect the franchisor's dealings in other states. Southland Corp. v. Abram, 560 N.Y.S. 2d 253 (N.Y. Supp. Ct. 1990); Cal. Admin. Code § 310.100.2; Glen, When Do You Have To Amend? When Can You Negotiate? Background And Observations On In Re Southland, 10 *Franchise L. J.* 2 (Fall 1991). Nevertheless, the following points may be useful:

#### a. Territory

The franchisor may not give your franchisee a protected territory, but may be willing to give a right of first refusal for new stores in the area. In negotiating the size of the protected territory, you can compare it to the much larger area the franchisor wants to impose in its post-termination covenant of non-competition.

#### b. Franchise Fee

The franchisor may be unwilling to reduce his franchise fee but may accept partial payment now and the remainder on completion of the training period, upon the unit opening, it turning a profit, etc. If the franchisor insists on full payment up-front, he may agree to a partial refund if the unit never opens, etc.

#### c. Advertising

The franchisor may not reduce the required monthly advertising contribution but may let the franchisee spend all or part of it in his own trade area. The franchisor may agree to incorporate any advertising cooperative your franchisee must join so it operates independently and does not subject your franchisee to liability. Santo Tomas Produce Association v. Mith, 362 P. 2d 977 (N.M. 1961)(incorporated association held agent of members, subjecting them to association's liabilities).

**d. Renewal**

The franchisor may agree that renewal will be on the original agreement rather than on the more burdensome contract he will have at the time of renewal, additional renewals, renewal without a renewal fee, etc.

**e. Lease**

The franchisor can use its control of the premises as a weapon in future disagreements. It may be better for your client to have a direct site lease without provision for assignment to the franchisor except upon nonpayment of the lease.

The franchisor can lawfully tie the franchise to a sublease. Principe v. McDonald's Corp., 631 F.2d 303 (4th Cir. 1980).

**f. Letter Agreement**

One way of creating good evidence and possibly a binding amendment is to have your client, in his own words, put the salesman's representations in a letter and send it to the franchisor together with a check for the franchise fee, the letter making cashing the check conditional on acceptance of the representations.

**g. Market Exclusivity**

The franchisor should be prevented from taking your client's business by placing other franchise or company stores close to your client's store or by marketing similar goods through other channels, such as through the mail, supermarkets, etc. For example, Haagen-Daz franchisees were disappointed when Haagen-Daz began selling its ice cream in local grocery stores. Rosenburg v. Pillsburg Co., 718 F. Supp. 1146 (S.D. N.Y. 1989) ("[R]eliance on defendant's alleged misrepresentation [that Haagen-Daz's ice cream would only be distributed through specialty stores] was unreasonable as a matter of law, because the alleged misrepresentations were not contained in the franchise agreement." *Id.* at 1152).

**h. Good Faith**

Negotiate for a covenant of good faith and fair dealing.

**i. Most Favored Nations**

The franchisor will refuse to make changes to his uniform "standard" franchise agreement. This insistence on uniformity can be used against him by asking that uniformity cut both ways. Request a "most favored nations" provision to the effect that your franchisee gets the benefit of any more favorable terms that other franchisees are able to negotiate.

**j. Transfer**

If the prospective franchisee wants to pass the business on to immediate family or sell out after the business succeeds, try to obtain more freedom to transfer the franchise business than is allowed in the standard agreement.

**k. Corporation**

Franchisors want the franchisee to be personally liable to the franchisor. Many franchisors will, however, permit the franchisee to incorporate if the franchisee personally guarantees the corporation's obligations to the franchisor. Alternatively, the franchise can be sold to the franchisee individually but then assigned to a corporation.

**l. Arbitration And Venue.**

The franchisee may desire mandatory arbitration of disputes in a neutral location. The unaffordability of litigation in franchisor's headquarter's city must be balanced against the loss of a jury and most discovery.

**m. Supplies And Full Line Force.**

The franchisor may permit the franchisee to buy equipment and supplies from other than the franchisor's in-house or brother-in-law approved sources and sell other than designated products. The franchisor can generally lawfully refuse these requests. Martino v. McDonald's Systems, Inc., Bus. Franchise Guide (CCH) Part 8477 (N.D. Ill. 1985) (purchasing restriction); Susser v. Carvel Corp., 332 F.2d 505 (2nd Cir. 1964) (sales restriction).

**2. OTHER ISSUES**

### a. Getting Accepted

To get approval from the best franchisors, the prospective franchisee should clear up any outstanding debts and other problems and prepare a resume and a financial statement in advance. The client should truthfully respond to the franchisor's questions concerning financial capability and background, both because the franchisor will likely check to verify that the prospect is telling the truth and because lying in the application will harm the franchisee in litigation. The franchisee's resume should be massaged to make it most appealing to franchisors by emphasizing supervisory experience and financial knowledge, a willingness to work and an upward trend, even if from bag boy to assistant clerk to clerk.

### b. Create Franchisor Representations

If possible, have the franchisee show his business plan, loan repayment schedule, projections, etc., to the franchisor before the franchise agreement is signed. This will often induce the franchisor to utter some platitude about it appearing reasonable, doable, etc. If the franchisee fails and the business plan was based on the franchisor's representations or invalid assumptions, the franchisee may have fraud, misrepresentation and negligence claims. *Invacare Corp. v. Sperry Corp.*, 612 F. Supp. 448 (N.D. Ohio, 1984); *High v. McLean Financial Corp.*, 659 F. Supp. 1561 (D. D.C. 1987).

It may be useful to not let the franchisor know that the prospective franchisee is represented by counsel. The franchisor may casually agree to promises and representations contained in letters from your client (which are reviewed by you) that the franchisor would not have consented to if prepared in a formal document which screams "prepared by an attorney."

### c. Other Legal Advice

Site leases and related agreements may be important to the business' success and cutting

losses if it fails. The franchisee will likely need general on-going business legal advice concerning corporations, employee relations, premises and product liability, consumer laws, local regulations, disputes with the franchisor, etc. These matters should be discussed if the franchise will be purchased and referred out if beyond the attorney's area of competence.

## G. Other Due Diligence

### 1. FRANCHISEE ASSOCIATIONS

An independent franchisee association or an advisory council helps franchisees share frustrations and explore solutions to common problems. The franchisor should solicit franchisee input on marketing plans, product and service development, etc., either through the franchisee association or a franchisee advisory council.

The client should discuss these points with current franchisees and talk to the association officers and council members concerning organizational structure and effectiveness and to determine if they are the franchisor's favored few or truly representatives of the franchisees.

### 2. VISIT FRANCHISOR'S HEADQUARTERS

The prospective franchisee should be encouraged to visit the franchisor's headquarters and spend a day there. The franchisee relies on people there for future support. Are the staff and facilities directed toward training and support of new and existing franchisees or selling new franchises? Have most employees been with the franchisor for many years or, are they transients? Are they open with the prospective franchisee or, do they seem fearful and secretive? If the franchisee is primed with questions, he may learn a lot from a visit.

### 3. OTHER INFORMATION

If the franchisor is a public company, its filings with the S.E.C. will detail its operations and finances. A computer search for news

articles, on the Lexis/Nexis System, the Dow Jones News Service System, etc., can provide background information. Telephone calls to competitors and the attorneys of litigating franchisees may provide information.

### III. UNHAPPY FRANCHISEES

#### A. Practical Advice

A franchisee should make a continuous effort to keep on good terms with his franchisor and fellow franchisees. A franchisee organization and constant communication among all franchisees are in your client's best interest. Kruezer v. The American of Periodontology, 735 F.2d 1479 (D.C. 1984) (franchisees have the right to form associations.) Advise the client to be friendly with as many fellow franchisees as he can, but to avoid being perceived as a center of resistance to the franchisor.

There is a disincentive to report full sales to the franchisor because royalty payments are proportional to reported revenues. This form of dishonesty should be discouraged. Franchisee under-reporting not only breaches the franchise agreement, it often leads to under-reporting income to the Internal Revenue Service. This is a crime for which your franchisee can go to jail. In a serious conflict with the franchisor, the franchisor can audit your franchisee's books, discover the under-reported income and, like any good citizen, inform the local friendly branch of the Internal Revenue Service.

The most harrowing stories are told by franchisees who have been so abused that contingent fee litigation is their only means of obtaining remedy. The author's experience is that the better the franchisee's case against the franchisor the more likely judgment against the franchisor will be uncollectible. A franchisor's primary assets are its good will and income stream; the better the franchisee's case, the more likely these may disappear overnight. Further, suits against franchisors are often removed to federal court, and transferred to the franchisor's headquarters city, as required by the franchise agreement. Carnival Cruise Lines, Inc. v. Shute,

111 S.Ct. 1522 (1991); Stewart Organization, Inc. v. Ricoh Corp., 108 S. Ct. 2239 (1988); Burger King v. Rudzenisz, 105 S.Ct. 2174 (1985); contra, New Lime International Releasing, Inc. v. Ivex Films, Bus. Franchise Guide (CCH) Part 9997 (S.D. N.Y. 1992) and Krol v. Transmissions, Inc., Bus. Franchise Guide (CCH) Part 9969 (E.D. Pa. 1991).

While The Rule has lessened the perceived need for states to protect franchisees the reality is that the FTC is very unlikely to be of assistance to your franchisee if the FTC has not received numerous prior complaints against the franchisor. The Rule does not create a private right of action. Layton v. AAMCO Transmissions, Inc., 717 F.Supp. 368 (D.Md. 1989).

If a franchisor overreaches its franchisees, their strongest weapon is a multi-plaintiff declaratory judgment action involving many franchisees. In addition to a money war chest and moral support, this may assist in getting the testimony of several disgruntled franchisees into evidence. West Coast Video Enterprises, Inc. v. Ponce de Leon, 1991 W.L. 49566 (N.D. Ill. 1991) (other franchisees' testimony excluded in part and admitted in part). Seeking a declaratory judgment lessens the risk as the franchisee can continue operating within the franchisee agreement in case he loses the suit.

Docket the franchise agreement's shortened statutes of limitations and prerequisites to suit such as complaining in writing within a given period of the franchisor's breach. The franchisee may otherwise waive his right to complain of these problems. Hayes v. Mobil Oil Corp., Bus. Franchise Guide (CCH) Part 9832 (1st Cir. 1991) (Massachusetts baby FTC act claim barred by one-year contractual limitations clause). Chico's Pizza Franchises, Inc. v. Sizemore, Bus. Franchise Guide (CCH) Part 8041 (E.D. Wash. 1983).

The franchisor's statute of limitations defense may be avoided by pleading counterclaims within 30 days of answering its

claims or counterclaims. Tex. Civ. Prac. & Rem. Code, §16.069.

Alternative dispute resolution methods, such as mediation and arbitration, are often a better choice than litigation, particularly if the client wants to stay in the system. While a jury may be a more favorable fact finder than an arbitrator who is an Anglo, male, middle-aged business lawyer, the client may not be able to afford to get to the jury.

## B. Legal Theories

### 1. FRANCHISEE'S GOAL

The unhappy franchisee's typical goal is to be returned to the position he would have been in if he had not purchased the franchise plus enhanced damages. John Lewis, Franchise Litigation in Texas; Analyzing Claims and Defenses, 19 St. Mary's L.J. 663 (1988). While rescission is available under the Deceptive Trade Practices Act ("DTPA"), Bonanza Restaurants v. Uncle Pete's, Inc., 757 S.W. 2d 445 (Tex. App. (Dallas) 1988), it is not available for minor breaches. Texas Cookie v. Hendricks & Peralta, 747 S.W. 2d 873 (Tex. Civ. App. - Corpus Christi 1988). Freeman Oldsmobile Mazda Co. v. Penson, 580 S.W.2d 112, 114 (Tex. Civ. App. - Eastland, n.r.e.) (DTPA rescission requires proof of substantial impairment in value).

Minor breaches of the franchise agreement by the franchisor will not achieve the franchisee's goal. The franchisee's focus, therefore, is usually on substantial pre-purchase misrepresentations and post-purchase complete failures to assist. The BOA and the DTPA provide a statutory basis for attacking a franchisor's pre-sale misconduct. The franchisee will assert that the franchisor should have disclosed all material information even if not required by the UFOC. Williams v. Dresser Industries, Inc., \_\_ F.Supp \_\_ (N.D. Geo. 1992).

The franchisor's defensive goals, other than winning on the facts, are to first, use the franchise agreement's many layers of defenses to entirely bar the franchisee's claim (Texas lawyers, weaned on the DTPA, forget that other

claims can be waived, Physicians Weight Loss Centers of America v. Creighton, Bus. Franchise Guide (CCH) Part 9829 (D. Ore. 1991) (integration clause barred misrepresentation claim), Contra, Est Coast Video Enterprises, Inc. v. Ponce de Leon, Bus. Franchise Guide (CCH) Part 10, 102 (N.D. Ill. 1991)) and second, either limit damages to the lessened value of the business due to the misrepresentations or to the monies paid by the franchisee for it. Woo v. Great Southwestern Acceptance Corp., 565 S.W.2d 290, 298 (Tex. Civ. App. - Waco 1978), writ ref'd n.r.e. (damages based on net value paid for distributorship); C.F. City of Marshall v. Bryant Air Conditioning Co., 650 F.2d 724, 726 (5th Cir. 1981) (Plaintiff must prove DPTA damages.)

The franchisor's typical arguments are that its disclosure of UFOC required information satisfied its duty. O'Neal v. Burger Chef System, Inc., 860 F.2d 1341 (6th Cir. 1988), the unmade disclosures were unnecessary because the substance of the information was disclosed informally, Dunkin Donuts, Inc. v. H.W.T. Associates, Inc., Bus. Franchise Guide (CCH) Part 9986 (2nd Dept. 1992), the franchisee had sufficient information to make an informed judgment, the franchisee had notice he could not rely on the representation, State of Wisconsin v. The KIS Corp., Bus. Franchise Guide (CCH) Part 9886 (Wis. Cir. Ct. 1991) ("Profit Planner" had disclaimer), and that the franchisee's decision to purchase would not have changed had he been formally apprised of the non-disclosed information.

Although "any" violation of state franchise registration statutes may justify rescission, some courts have relied on public policy arguments to let substantial disclosure defeat a franchisee's technical violation claim. Video Update, Inc. v. Ronald N. Guenther, Bus. Franchise Guide (CCH) Part 9694 (Dist. Ct. Minn. 1990), contra, My Pie International v. Debould, Inc., 687 F.2d 919 (1982) (Franchisee's purchase of employee T-shirts from

franchisor within seven days of delivering UFOC justified rescission).

If the franchisor's representations relate to future rather than present facts, recovery will be difficult if the DTPA is not applicable. Crim Truck & Tractor v. Navistar Intern, 823 S.W. 2d 591 (Tex. 1992) (no evidence that Navistar did not intend to perform when representation made). Puffing or opinion might not support a claim for fraud or DTPA claim. Autohaus, Inc. v. Aguilar, 794 S.W. 2d 459 (Tex. App. - Dallas 1990), aff'd, 800 S.W. 853 (Tex. 1991), "Without approving or disapproving the analysis of the Court of Appeals"). Not all omissions support a claim for fraud. Vaughn v. General Foods Corp., 797 F.2d 1403 (7th Circuit 1986), cert. den'd 107 S.C. 1293 (1987); O'Neal v. The Burger Chef Systems 860 F 2d 1341 (6th Circuit 1988). The issue of what disclosure obligations the franchisor has after the franchisee's purchase of the franchise but while the franchisee is making additional investments is unclear. Wulff, "Post Sale Disclosure Obligations After Vaughn and O'Neal: a Cat With Nine Lives?" 8 Franchise L.J. 4 (Spring, 1989).

In sum, the franchisee litigant generally starts with most contract and many tort avenues blocked and only limited practicable chances of obtaining meaningful relief.

## **2. BUSINESS OPPORTUNITY ACT**

Franchisors rarely comply with the BOA's filing and disclosure requirements, choosing instead to rely on the exemption based on compliance with The Rule. If the franchisor then fails to comply with The Rule, the franchisee can claim a BOA violation. This provides the franchisee plaintiff with an additional DTPA § 17.46(b) "laundry list" jury question together with a platform for arguing that what happened was exactly the kind of abuse this special statute was enacted to prevent.

To prove anything beyond a nominal violation of the BOA due to the Franchisor failing to provide a formal disclosure statement, however, the franchisee needs to examine what BOA disclosures the franchisor failed to make that

actually were a producing cause of damages. Because the BOA's disclosure requirements are poorly designed and provide mostly merely formal information even if complied with, the BOA is not as much help as would appear at first glance.

The BOA's requirement of financial disclosure by the seller "updated to reflect material changes in seller's financial condition" § 16.09(5) is a typical basis for attack. Since most franchisors orally make "any statement concerning sales or earnings that may be made through this business opportunity," the disclosure requirements this triggers provide a basis for attack. § 16.09(10). Miksch and M.I.K., Inc. v. T-shirts Plus, Inc. No. 85 AP-517 Slip Opinion 1985 W.L. 4154 (Ohio App. December 3, 1985) (T-shirts Plus presented the prospective franchisee with a chart containing sales, costs and net profit ranges for six hypothetical stores. This was held an earnings claim because it was an "oral, written or visual representation to a prospective purchaser concerning potential sales, income or gross or net profit . . ." [Interpreting "earnings claim" under the Ohio Business Opportunity Protection Act.] Bailey Employment Systems, Inc. v. Hohn, 545 F. Supp. 62 (D Conn. 1982) (Statement of average annual sales volume was an earnings claim.) If the franchisor provides prospective purchasers with reprints of favorable media articles, he will likely be found to have adopted any statements made in the articles as its own.

Because the DTPA's remedies are adopted by the BOA, the applicable statute of limitations is two years.

## **3. DECEPTIVE TRADE PRACTICES ACT**

The DTPA is applicable to franchising. Bonanza Restaurants v. Uncle Pete's, Inc., 757 S.W.2d 445 (Tex. App. - 1988); Wheeler v. Box, 671 S.W. 2d 75 (Tex. Civ. App. - Dallas 1984, no writ); Woo v. Great Southwestern Acceptance Corp., 565 S.W. 2 290 (Tex. Civ. App. - Waco 1978, writ ref. n.r.e.); contra, Meineke Discount Muffler Shops, Inc. v. Wesley

Jaynes, Bus. Franchise Guide (CCH) Part 9959 (S.D. Tex. 1991) (It is not clear whether the holding is broadly [and erroneously] that a franchise is not a good or service as a matter of law or that the subject franchisee purchased a trademark license (the franchise) from a prior franchisee and not the franchisor as a finding of fact); Crossland v. Canteen Corporation, 711 F. 2d 714 (5th Cir. 1983) (intangible contract rights not a "good" or a "service" Id. at 721).

The § 17.46(b)(23) prohibition against "failing to disclose" is a strong weapon against franchisors who fail to provide a disclosure statement if presented to the jury together with The Rules' disclosure requirements. Some courts accept evidence of violations of The Rule as relevant to whether there has been a violation of the DTPA. Texas Cookie Co. v. Hendricks & Peralta, 747 S.W. 2d 873, 877 (Tex. App. -- Corpus Christi 1988); Rodopoulous v. Sam Piki Ent., Inc., Bus. Franchise Guide (CCH) Part 9741 (Ala. S.Ct. 1990) (jury permitted to consider FTC Rule in determining franchisor's duty of disclosure); Morgan v. Air Brook Limousine, Inc., 510 A.2d 1197 (N.J. Super. L. 1986) (violation of The Rule violated New Jersey's Consumers Fraud Act); c.f. Big H Auto Auction, Inc. v. Saenz Motors, 665 S.W. 2d 756 (Tex 1984), contra, LeBlanc v. Delt Center, Inc., 509 So.2d 134 (La. App. 1st Cir. 1987); Symes v. Bahama Joe's, Inc., Bus. Franchise Guide (CCH) Part 9192 (D. Mass. 1988); Church's Fried Chicken, Inc. v. McNeely; Cause No. SA88CA0062 (W.D. Tex. 1988) (Jury heard evidence of The Rule's requirements but franchisee not allowed jury questions or instructions concerning it).

Many §17.46(b) representations do not require intent to deceive or knowledge of their falsity. Pennington v. Singleton, 606 S.W. 2d 682, 689-90 (Tex. 1980); Concorde Limousines v. Loloney Coachbuilders, Bus. Franchise Guide (CCH) Part 9027 (5th Cir. 1987) (Seller's subjective understanding of the meaning of his statement is irrelevant); Allais v. Donaldson, Lufkin & Jenrette, 532 F. Supp. 749, 751-752 (S.D. Tex 1982). Thus, standard sales

representations may be DTPA violations if they do not prove true for the particular plaintiff franchisee.

DTPA § 17-50(a)(3). Unconscionable conduct counts are difficult but may sometimes get to the jury. Segura v. Abbott Laboratories, \_\_\_ S.W.2d \_\_\_ (Tex.App. - Austin 1994).

#### 4. COVENANT NOT TO COMPETE

The key litigation issue is often enforceability of the franchisor's covenant not-to-compete against the franchisee because preliminary enforcement of it will end the franchisee's ability to afford further litigation.

The first issue is often which state law controls. DeSantis v. Wackenhut Corp., 793 S.W.2d 670 (Tex. 1990) (Texas law applicable to Texas covenant not-to-compete notwithstanding a Florida contractual choice of law clause). Klufeld, Covenants Against Competition in Franchise Agreements, Forum on Franchising A.B.A. (1992).

The second issue is whether the franchise agreement is a "personal services" contract under Tex. Bus. & Comm. Code § 15.50(a) O.V. Marketing Associates, Inc. v. Carter, 766 F. Supp. 966, Bus. Franchise Guide (CCH) Part 9857 (D. Kan 1991) ("The franchise agreement is more akin to an employment contract than a contract for the sale of a business"); South Bend Consumers Club v. United Consumers Club, 572 F. Supp. 209 (N.D. Ind. 1983), appeal dismissed, ("a restrictive covenant ancillary to a franchise agreement is generally treated by courts in the same manner as a restrictive covenant ancillary to a contract of employment"); and H&R Bloc, Inc. v. Lovelace, 493 P 2d 205 (Kan. 1972), placing the burden of proof on the franchisor or whether it is not, placing the burden of proof on the franchisee. Butts Retail, Inc. v. Diversifoods, Inc., 840 S.W. 2d 770 (Tex. App. - Beaumont 1992) (stating without discussion that franchisee had "burden of proof in showing that the covenant not-to-compete . . . was unenforceable"). The pre § 15.50 case of Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168 (Tex. 1987) has language helpful to the franchisee on

this topic. See, Winston Franchise Corp. v. Williams, Bus. Franchise Guide (CCH) Part 9940 (S.D. N.H. 1992) (holding that the franchisee's noncompetition covenant was neither a business sale nor a personal services agreement but a third category, "commercial contract" judged according to the rule of reason).

The third issue is what, if any, legitimate business interest the franchisor has to support the covenant. Peat Marwick Main & Co. v. Haass, 818 S.W. 2d 381 (Tex. 1991); Alphagraphics Franchising, Inc. v. Babbet, 1989 W.L. 2427 (Tex. App. - Houston [1st Dist] 1989) (Not for publication opinion affirming denial of temporary injunction to enforce franchisee's noncompetition covenant due to lack of imparted "special training or knowledge from Alphagraphics").

The final issue is the reasonableness of the time, geographical area and the scope of activity restraints necessary to protect those legitimate business interests. Butts Retail, Inc. v. Diversifoods, Inc., 840 S.W.2d 770 (Tex. App. - Beaumont 1992); Meineke Discount Muffler Shops v. Jaycees, Bus. Franchise Guide (CCH) Part 9959 (S.D. Tex. 1991). The equities of the case, probability of successes on the merits of the claims, etc. are factors.

Because the franchisee is typically personally obligated on a real estate lease tying him to a specific location, any enforcement of the covenant not-to-compete is often fatal. All citations of legal authorities and effective presentation of facts to the contrary, covenant-not-to-compete enforcement ultimately rests on the judge's sense of fairness and is unpredictable.

## 5. OTHER THEORIES

Choice of law is often a key issue. CCS-Wisconsin Office v. Houston Satellite Systems, Inc., Bus. Franchise Guide (CCH) Part 9955 (E.D. Wisc. 1991) (choice of Texas law concerning *construction* of the contract did not control franchisee's claim concerning *enforcement* of it); DeSantis v. Wackenhut Corp., 793 S.W.2d 670 (Tex. 1990) (State's

fundamental policies preempt parties' choice of law); Instructional Systems, Inc. v. Computer Curriculum Corp., 614 A.2d 124 (N.J. 1992).

The issues of fiduciary duty, confidential relationship, unconscionability, implied and expressed representations, promissory estoppel, quasi estoppel, fraud, Ralston Purina Co. v. McKendrick, 850 S.W.2d 629 (Tex.App - San Antonio 1993, writ denied) (fraudulent nondisclosure), negligent misrepresentation, collateral estoppel, Universal American Barge Corp. v. J-Chem, Inc., 946 F.2d 1131, 1136 (5th Cir. 1991); See R.E. Spriggs Co. v. Adolph Coors Co., 156 Cal. Rptr. 738, 743-45 (Ct. App. 1979), cert. denied, 444 U.S. 1076 (1980), conversion, economic duress, Lee v. Wal-Mart Stores, Inc., 943 F.2d 554 (5th Cir. 1991) (Texas recognizes the tort of economic duress. Id at 560, note 11), Bain v. Champlin Petroleum, 692 F. 2d 43, 48 (8th Cir. 1982), interference with actual and prospective beneficial contractual relationships, reformation (to what the franchisor's representatives stated the agreement provided), Racketeer Influenced and Corrupt Organizations (RICO) claims, and breach of express and implied warranty are often raised in franchise litigation. While Eastman Kodak Co. v. Image Technical Services, Inc., 112 S.Ct. 2097, Bus. Franchise Guide (CCH) Part 10,017 (1992) (holding that a tie-in might exist in Kodak's repair parts in spite of its lack of market power in the new copier market) has revived interest in antitrust tie-in attacks on franchisor required purchases, the requirement that the franchisee show antitrust injury may blunt it. Town Sounds and Custom Tops, Inc. v. Chrysler Motors Corp., Bus. Franchise Guide (CCH) Part 9983 (3rd Cir. 1992).

Some states impose a tort duty of good faith and fair dealing in franchise relationships. Rau, Implied Obligations in Franchising: Beyond Terminations, The Business Lawyer, Vol. 47, No. 3, page 53 (1992); Carvel Corp. v. Diversified Management Group, Inc., Bus. Franchise Guide (CCH) Part 9794 (2nd Cir. 1991); West Court Video Enterprises, Inc. v. Ponce de Leon, 1991 W.L. 49566 (N.D. Ill.

1991) (holding that special relationship necessarily exists between franchisor and franchisee due to Illinois Franchise Disclosure Act [analogous to Texas' BOA]); Larese v. Creamland Dairies, Inc., 767 F. 2d 716 (10th Cir. 1985); *contra*, Walner v. Baskin-Robbins Ice Cream Company, 514 F. Supp. 1028 (N.D. Tex. 1981)(applying Texas law).

This is distinguished from the contract duty of good faith and fair dealing. Central Savings & Loan Assoc. v. Stemmons Northwest Bank N.A., \_\_\_ S.W.2d \_\_\_ (Tex. App. - Dallas 1992). See, Brattleboro Auto Sales, Inc. v. Suburu of New England, Inc., 633 F.2d 649, 651 (2nd Cir. 1980) (Dealer failed to establish standard of fair dealing). Most states permit express contractual terms to override the duty of good faith. Phillips v. Chevron U.S.A., Inc., 792 F. 2d 521 (5th Cir. 1986) (applying Mississippi law); Tulsa Trailer & Body, Inc. v. Trailmobile, Inc., Bus. Franchise Guide (CCH) Part 8,615 (N.D. Okla. 1986). Upon bad facts, however, even express terms can be waived and a duty of good faith found. Burger King Corp. v. Weaver, Bus. Franchise Guide (CCH) Part 10,019 (S.D. Fla. 1992); B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp., Bus. Franchise Guide (CCH) Part 9920 (D. Mass. 1991) (course of conduct created implied covenant of good faith which overrode express contract term); Exxon Corp. v. Atlantic Richfield Co., 678 S.W.2d 944 (Tex. 1984); Delta Truck and Tractor, Inc. v. J.I. Case Company, 975 F.2d 1192 (5th Cir. 1992).

Texas requires proof of a special relationship as a prerequisite to imposing a tort duty of good faith. Arnold v. National County Mutual Fire Insurance Co., 725 S.W. 2d 165 (Tex. 1987). In Texas, franchise relationships do not, as such, impose fiduciary responsibilities or a tort duty of good faith and fair dealing. Crim Truck & Tractor Co. v. Navistar International Transportation Corp., 823 S.W. 2d 591 (Tex. 1992); Adolph Coors Co. v. Rodriguez, 780 S.W.2d 477 (Tex. App. - Corpus Christi 1989, writ denied).

The franchisee's attorney will examine whether the facts justify imposition of these duties in his particular case. This may include attempting to introduce the International Franchise Association's Code of Ethics (ex. "Franchisors shall conduct their business professionally, with truth, accuracy, fairness and responsibility") into evidence and measuring the franchisor's conduct against that standard.

#### IV. SELLERS WHO DO NOT WANT TO BE FRANCHISORS

##### A. Federal Definition Of Franchising

###### 1. DEFINITION

A relationship is a franchise under The Rule if it meets the requirements of 16 C.F.R. § 436.2(a)(1)(i) and is not otherwise exempt or excluded. § 436.2(a)(1)(i) may be summarized to yield a three part test:

- Common Trademark or Format. (Examples: double arches over the restaurant, AJAX Bicycle Shop.) § 436(a)(1)(i)(A).
- Significant Control or Assistance. (Examples: only AJAX bicycles can be sold, or we will train you to repair bicycles or we will show you how to market bicycles.) § 436(a)(1)(i)(B), and
- Required Payment of \$500. Required payment to the seller or its affiliate during the first six months for "other than reasonable quantities of wholesale goods purchased for resale" at required minimum order of supplies or a requirement to buy goods for more than the cost of similar goods elsewhere or a requirement to buy services § 436(a)(2) and (3)(ii).

###### 2. DISTRIBUTORSHIP EXAMPLE

If you sell me an AJAX Bicycle distributorship that lets me be the only authorized "AJAX store" in town, then The Rule's elements 1 (AJAX trademark and trade name) and 2 (assistance via protected territory) are met. If I do not pay an up-front fee and only

pay a *bona fide* wholesale price for a reasonable quantity of bicycles, then the third prong of the franchise definition (required payment) is not met. We do not have a franchise relationship.

Alternatively, if (1) I have to pay you at least \$500 for the privilege of being your distributor, sing your trademark, or having a protected territory, or (2) I have to purchase more bicycles than reasonably necessary to open the store, Marathon Petroleum Co. v. Lobosco, 623 F.Supp. 129, 134 (N.D. Ill. 1985) (construing Illinois franchise regulations) or (3) the price of bicycles to me is higher than the *bona fide* wholesale price for similar bicycles elsewhere, or (4) I have to buy \$500 of required advertising materials or the large AJAX sign from you, then the third element is met and we have a franchise.

## B. How To Avoid Being A Federal Franchisor

### 1. AVOID THE FRANCHISE DEFINITION

#### a. Offer No Trademark

Expressly prohibit the distributor's use of the supplier's trademark.

The Rules' Final Guidelines at 49,966 state, "This element will be satisfied only when the franchisee is given the right to distribute goods and services which bear the franchisor's trademark, service mark, trade name, advertising or other commercial symbol ("the mark"). The most common instances occur when either the goods or services being distributed by the franchisee are associated with the franchisor's mark or when (i) the franchisee must conform to quality standards established by the franchisor with respect to the goods or services being distributed, and (ii) the franchisee operates under a name that includes, in whole or in part, the franchisor's mark."

The determining factor with respect to this element *should be* whether the buyer had a reasonable belief that customer perception of, a substantial association between the buyer and the

seller would occur and that this customer perception would be valuable enough to be a material fact inducing the buyer to enter into the seller/buyer agreement. C.f., Instructional Systems, Inc. v. Computer Curriculum Corp., Bus. Franchise Guide (CCH) Part 10,119 (N.J. S.Ct. 1992) (Exclusive dealer a franchisee in spite of no trademark license because use of the trademark created "a reasonable belief on the part of the consuming public that there is a connection between the trade name licensor and licensee by which the licensor vouches, as it were, for the activity of the licensee in respect of the subject of [sic] trade name.") Colt Industries, Inc. v. Fidelco Pump & Compressor Corp., Bus. Franchise Guide (CCH) Part 9095 (3rd Cir. 1988)(The dissent should be noted.).

Case law, however, does not provide reliable guidance on this point both because there is not an agreed construction of this requirement and because similar facts often produce contrary holdings. Compare, Master Abrasives Corp. v. Dean Williams, Bus. Franchise Guide (CCH) Part 8247 (Ct. App. Ind. 1984)("The distributor sold products `private labeled Master Abrasives under our trademark' supports a finding the business would be substantially associated with Master's trademark." Id. at p. 14,790 [applying Indiana law]), with, Colt Industries, Inc. v. Fidelco Pump & Compressor Corp., Bus. Franchise Guide (CCH Part 9095 (3rd Cir. 1988)("The Colt-Fidelco agreement provided that Fidelco could use the Quincy name only in a limited sense and that the Quincy brand name could not be used in Fidelco's business name . . . in our view, if this limited agreement constitutes a license to use a trademark, then any business selling a name brand product would, under New Jersey law, necessarily be considered as holding a license . . . the agreement did not constitute a grant of a trademark license to Fidelco". Id. at Page 18,804 [applying New Jersey law]).

Any use by the buyer of the seller's marks will create an issue concerning whether this element is met. The only safe harbor is to contractually prohibit the buyer from using any

of the seller's marks and to enforce the prohibition. "[T]he supplier may avoid coverage under the rule by expressly prohibiting the use of its mark by the distributor." Final Guidelines at 49,966, Permagraphics Int'l., Inc., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH) Part 6433 (Sept. 21, 1982); Powerbrand Prods., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH) Part 6438 (May 13, 1983) (Mere silence is not enough, U.S. Marble, Inc., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH) Part 6424 (Oct. 9, 1980). However, on bad facts the trademark element has been held met even if the licensee is contractually barred from using the licensor's mark. Kim v. Servosnox, Inc., Bus. Franchise Guide (CCH) Part 10,124 (Cal. Ct. App. 1992); Instructional Systems, Inc. v. Computer Curriculum Corp., 614 A.2d 124 (N.J. 1992).

#### **b. Offer No Assistance Or Control**

The Rules' Final Guidelines at 49967 state, "Among the significant types of controls over the franchisee's method of operation are those involving (a) site approval for unestablished businesses, (b) site design or appearance requirements, (c) hours of operation, (d) production techniques, (e) accounting practices, (f) personnel policies and practices, (g) promotional campaigns requiring franchisee participation or financial contribution, (h) restrictions on customers, and (i) location or sales area restrictions. Among the significant types of promises of assistance to the franchisee's method of operation are (a) formal sales, repair or business training programs, (b) establishing accounting systems, (c) furnishing management, marketing or personnel advice, (d) selecting site locations, and (e) furnishing a detailed operating manual. In addition to the above listed elements -- the presence of any of which would suggest the existence of "significant control or assistance" -- the following additional elements will, to a lesser extent, be considered when determining whether "significant" control or assistance is present in a

relationship; (a) a requirement that a franchisee service or repair a product (except warrant work), (b) inventory controls, (c) required displays of goods and (d) on-the-job assistance in sales or repairs."

While deliberately not providing the buyer with any assistance or control is available in theory, almost any assistance or control not required to protect the mark or for public health and safety meet the assistance or control element. United States v. Solar Indus., Inc., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH) Part 6411 (Apr. 25, 1980) (advertising the availability of training can be an offer of significant assistance); Con-Wall Corp., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH) Part 6427 (Feb. 17, 1981) (restricting a franchisee's operation to a specific geographical region is significant control.) United States v. Technical Communications Industries, Inc., Bus. Franchise Guide (CCH) Part 8737 (E.D. N.C. 1986) ("The defendants meet the second requirement because they . . . they would provide marketing assistance and on-site training in the use of equipment. Defendant T.C.I. also promised that franchises would receive business from T.C.I.'s contracts with nationally known companies".

#### **c. Have No Required Payment**

##### **(1) GENERALLY**

Require no payments from the buyer to the seller or any affiliate during the buyer's first six months of operation other than for reasonable amounts of inventory at *bona fide* wholesale prices.

The Rules' Final Guidelines at 49,968 state, "The Commission's objective in interpreting the term "required payment" is to capture all sources of revenue which the franchisee must pay to the franchisor or its affiliate for the right to associate with the franchisor and market its goods or services. Often, required payments are not limited to a simple franchise fee, but entail other payments which the franchisee is required to pay to the

franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments are initial franchise fees as well as those for rent, advertising, assistance, required equipment and supplies - including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases - training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental, and continuing royalties on sales.

"The payments may be required either by contract or by practical necessity. Payments required by contract would include not only those required by the franchise agreement, but also those required in any company contracts which the parties may execute, such as a real estate lease. Payments made by practical necessity include, among others, those for equipment which can only be obtained, in fact, from the franchisor or its affiliate. A buyer commences operations when he first makes his goods or services available for sale." Notes subject to certain defenses and payable after the six month period do not count toward the threshold \$500. In re Automobile Importers of America, Inc., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH) Part 6385 (August 9, 1979).

## (2) WHOLESALE GOODS EXCEPTION

"Inventory payments" comprised of *bona fide* wholesale prices for reasonable quantities of inventory are not "required payments." The Rules' Final Guidelines state, "Questions have been raised as to where, within the foregoing scheme, fall payments for inventory sold at a bona fide wholesale price. The Commission recognizes that it is, as a practical matter, virtually impossible to draw a clear line between start-up inventory that is purchased at the franchisee's option, and that which is purchased as a matter of practical or contractual necessity. In order to minimize ambiguity in this respect, but consistent with the Commission's objective that "required payment" capture all sources of

hidden franchise fees, the Commission will not construe as "required payments" any payments made by a person at a bona fide wholesale price for reasonable amounts of merchandise to be used for resale. The Commission will construe "reasonable amounts" to mean amounts not in excess of those which a reasonable businessman normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply." Flynn Beverage, Inc. v. Joseph E. Seram and Sons, Inc., Bus. Franchise Guide (CCH) Part 10, 237 (C.d. Ill. 1993) (Requirement to purchase unreasonably large amounts of inventory for a franchisee fee).

## (3) CAVEAT

It is more difficult to avoid the required payment element than appears at first glance. All payments, notes and commitments from the buyer to seller and its affiliates during the first six months need to be examined. FTC informal staff advisory opinions concerning this point should be read before relying on this method of avoidance. E.g. In re General Motors Corp., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide, (CCH) Part 6384 (August 7, 1979); In re American Motors Corp., FTC Informal Staff Advisory Opinion, Bus. Franchise Guide.

The *bona fide* wholesale price exclusion only applies to "goods." It does not apply to payments for services, fixtures, leases, etc. Thus reasonable payments for training, advertising, warranty service, on site assistance, etc. may be a franchise fee.

### d. Use Agents

Agency relationships in which independent agents, compensated by commission, sell goods or services (e.g. insurance salespersons) are excluded, since there is no "required payment." Final Guidelines at 49,967.

### e. Sell Through Established Dealerships

Traditional dealership systems lack one of the three franchise elements. Typically the

dealer does not pay for the dealership, he buys from the manufacturer at a wholesale price, and he may carry competitive products. He may or may not have an exclusive territory. A hardware store carrying several brands of lawn mowers or perhaps having an exclusive territory for a single line of lawn mowers is an example.

**f. Offer Joint Ventures**

True general or limited partnerships are exempt § 436.2(a)(4)(i). Few national companies, however, want to form dozens of general partnerships, and a multiplicity of limited partnerships raises state and federal securities problems.

**g. Grant Equity Ownership**

Some companies establish separate legal entities in different markets, and either grant the manager a minority equity interest together with a share of the profits, or simply enter into an agreement with the manager guaranteeing him or her a share of the profits. These arrangements typically provide for repurchase or termination upon the manager's termination of his relationship with the company. If the manager pays any money for the equity or the profit sharing rights, takes reduced compensation, etc., both franchise and security laws may be triggered.

**2. USE EXEMPTIONS AND EXCLUSIONS**

The Rule exempts certain relationships that otherwise fall within the franchise definition.

**a. Fractional Franchise**

The product or service purchased from the seller by the buyer accounts for no more than twenty percent of the buyer's dollar volume of sales and the buyer or any of its current officers or executive officers has at least two years prior experience in the same or similar business. § 436.2(a)(3)(i); § 436.2(h); In re Kinetic Industries Corporation, FTC Informal Staff Advisory Opinion, Bus. Franchise Guide (CCH)

Part 6440 (August 19, 1983). For example, an exclusive buying agreement from a tire manufacturer to a service station dealer would not be a franchise if the tires comprise less than twenty percent of the dealer's sales and the dealer has been in business for two years. Thus, you can avoid franchising by only approaching established dealers and offering your product as an addition to their preexisting business.

**b. Leased Department**

An independent retailer sells its own goods and services from premises leased from a larger retailer in the larger retailer's store. For example, ABC department store grants a license to Florsheim Shoes to sell footwear in a portion of the department store. This exemption is not applicable if the retailer must purchase its goods or services from suppliers required or approved by the department store.

**c. Oral Agreements**

No material term of the agreement is in writing. "Where there is no writing evidences any material term or aspect of the relationship or arrangement". § 436.2(a)(3)(iv). This exemption is strictly construed. Even a purchase invoice is considered to include material terms.

**d. Employer/Employee And General Partner Relationships**

The traditional "right of control" test is used to determine whether an employment relationship exists; e.g., whether a salary is paid, whether the employee can be discharged without further liability on the part of the principal, whether the employee must invest any money before being hired, etc. The partnership exclusion only applies if everyone is a general partner. § 436.2(a)(4)(i); "The relationship between an employer and an employee, or among general business partners".

**e. Other Assertions**

Also exempt are certain retailer and agricultural cooperatives § 436.3(a)(4)(ii). Certain groups which license their mark to

anyone who complies with a standard and pays the fee (i.e. the testing services of United Laboratories which licenses permission to use "UL" on products which meet its standards) are excluded § 436.2(a)(4)(iii). The license of a trademark to only one licensee § 436.2(a)(4)(iv).

Use of a licensed mark collaterally to that for which the mark is primarily known. Final Guidelines at 49,969. For example: a license of the mark COCA-COLA for use on T-shirts; and, a license issued as a result of trademark infringement litigation.

### **3. DO NOT MISUSE THE TERM "FRANCHISE" ERROR! BOOKMARK NOT DEFINED.**

A distributorship in which the seller offers the buyer significant assistance and "which is represented either orally or in writing to be a franchise" is deemed a franchise subject to The Rule. § 436.2(a)(5). The term "franchise" should be deleted from all sales literature, correspondence and agreements if you do not want the relationship to be a franchise.

## **C. State Definitions Of Franchising**

### **1. IN GENERAL**

Fifteen states (California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Oregon) specifically regulate franchise sales. Since none of these statutes are identical each must be separately examined to see if your client's method of doing business is covered in the subject state.

To reduce conflicts between state franchise laws, the Midwest Securities Commissioners Association created and has periodically revised a Uniform Franchise Offering Circular (UFOC). Bus. Franchise Guide (CCH) Parts 5794, 5750 and 8862. While The Rule preempts the UFOC, the FTC authorizes use of the UFOC with certain exceptions. Final Guidelines at 49,971. A franchisor can choose which format to use in

states that do not specifically require use of the UFOC. The FTC format requires less disclosure, particularly for a new franchisor. The states are not uniform as to what UFOC version is acceptable.

## **2. MARKETING PLAN DEFINITION**

### **a. Definition**

California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, Virginia, and Wisconsin generally define "franchise" as: "A contract or agreement, either express or implied, whether oral or written, between two or more persons by which:

(1) a franchise is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed ("or suggested" in some states) in substantial part by a franchisor; and

(2) the operation of the franchisee's business pursuant to such plan or system substantially associated with the franchisor's trademark, service mark, trade name, logo, advertising, or other commercial symbol designating the franchisor's affiliate; and

(3) the franchisee is required to pay, directly or indirectly, a franchise fee [amount varies by state or is not required]."

This definition is for discussion purposes only. The specific statute of each affected state must be reviewed. The emphasis is added.

### **b. "Marketing Plan"**

While the existence of a "marketing plan" is somewhat the in the eye of the beholder, advertising claims that it has a successful marketing plan, uniformity of marketing, controls on the purchaser's sale of competitive and non-competitive goods, operations or training manuals, requirements that the buyer purchase goods from approved sources, etc., are all factors that will be considered in determining whether the particular relationship has the requisite "marketing plan". California Department of Corporations release 3-F

(rev)(1980); Business Franchise Guide (CCH) Part 7558. As a practical matter these factors will be considered by any court. Hoosier Penn Oil v. Ashland Oil, Bus. Franchise Guide (CCH) Part 9834 (7th Cir. 1991) (minimum purchase requirement and primary sales area not a prescribed marketing plan); Gross v. IBM, Bus. Franchise Guide (CCH) Part 9817 (D.Conn. 1990) (marketing assistance not prescribed marketing plan); Wright-Moore v. Ricoh, 908 F.2d 128, (7th Cir. 1990); Blankenship v. Dialist Int., Bus. Franchise Guide 9808 (Ill. App. Ct. 1991) ("sales representative" held a franchisee because seller suggested a marketing plan).

Giving marketing suggestions to a distributor or licensee may be a "marketing plan. . . prescribed" even if the agreement explicitly states that the distributor or licensee is not required to follow the suggestions. Illinois Franchise Disclosure Act, General Rules and Regulations, Title 14, Subtitle A, Chapter II, § 200.102(C) and Cal Comm Op No 71/61F (1971). Compare, In the Matter of The KIS Corporation, Bus. Franchise Guide (CCH) Part 8,731 (1986) (mere suggestions not a "prescribed" plan under Wisconsin Franchise Investment law [causing Wisconsin and some other states law to amend their laws to include "a suggested" marketing plan, Bus. Franchise Guide (CCH) Part 3490.02]), with, In re The KIS Corporation, Bus. Franchise Guide (CCH) Part 9,269 (KIS agrees its plan violates The Rule and to pay \$1,550,000 in damages).

This encompasses relationships not traditionally called franchises.

### c. "Trademark"

This element is satisfied if the distributor or licensee is permitted to identify the business primarily under the licensor's mark or otherwise uses the mark in a manner likely to convey to the public that it is selling goods or services on behalf of the manufacturer or trademark owner. This is so broadly interpreted that, in a first assessment of the situation and prior to analyzing it for exceptions, it should be

considered met if the distributor/licensee uses the licensor's mark to identify any substantial amount of commerce.

### d. "Franchise Fee"

#### (1) GENERALLY

The Rules' six month limitation on counting monies to be applied to this element is not present in most state statutes. Franchise fee is "any fee or charge that a franchise . . . is required to pay or agrees to pay *for the right to enter into a business under a franchise agreement . . .*" [emphasis added]. While this certainly applies to denominated franchise fees, other payments, such as for inventory, construction, etc., may also meet this definition. Wright-Moore v. Ricoh, Bus. Franchise Guide (CCH) Part 10,020 (N.D. Ind. 1991) (Contra, Wright - Moore Corp. v. Ricoh Corp., 980 F.2d 432 (7th Cir. 1992)); Boat and Motor Mart v. Sea Ray Boats, 825 F. 2d 1285 (9th Cir. 1987); "Payment for services are presumed to be in part for the right granted to the franchisee to engage in the franchise business." Illinois Franchise Disclosure Act Regulations § 200.106, Bus. Franchise Guide (CCH) Part 7899. "While a truly optional payment is not a franchise fee, a payment by a franchisee, though nominally optional, may in reality be a required one, if the article for which payment is made is essential . . . for the successful operation of the business." California Department of Corporations Guidelines for Determining Whether An Agreement Constitutes A Franchise, Release No. 3-F (Revised), February 21, 1974, at 11. Bus. Franchise Guide (CCH) Part 7559.

The cautious seller's attorney and creative buyer's attorney will examine all payments made by the buyer, distributor or licensee to find all monies paid to the franchisor or its affiliates which may, as a practical matter, have been necessary for the franchisee to enter into the business. This search will not be limited to checking the written agreement or clearly labeled requirements that a "franchise fee" be paid. Rent, lease payments, service or training

fees, etc. paid to the seller or its affiliate may or may not comprise a franchise fee. The typical trademark license requires the licensee to pay a license fee. Such payments usually satisfy this element.

"Inventory payments" comprised of *bona fide* wholesale prices for reasonable quantities of inventory are not a franchise fee. McLane v. Pizza King, Bus. Franchise Guide (CCH) Part 8963 (Ind. S. Ct. 1987) (. . . [s]uch payments were "bona fide" wholesale prices for . . . [wholesale pizza supplies] are not a franchise fee), American Parts System, Inc. v. T & T Automotive, Inc., 358 N.W. 2d 674, 676 (Minn. Ct. App. 1984).

If the distributor/licensee buys goods from a seller at a price higher than a "*bona fide* wholesale price," the purchase price will be deemed to be a franchise fee. Advisory Interpretations, Bus. Franchise Guide (CCH) Part 9911 and 9912 (Wis. Comm. of Securities 1991). The Rule and its Final Guidelines are persuasive on this point. Maryland and Wisconsin expressly consider the following in determining whether the purchase of goods is at a *bona fide* wholesale price:

"(1) Whether the consideration is purely for the purchase of goods, not reflecting payment for the right to continue such purchases;

(2) Whether the purchase is only allowed and not required by the parties agreement; and

(3) Whether the cost of goods to the manufacturer is reasonably related to the price paid by the distributor, taking into account representative circumstances in the market of both manufacturer and distributor." Code of Maryland Regulations, § 02.02.10.0(E); Wisconsin administrative Code § 31.01(9).

A negative answer to any of these questions indicates that the payment was not at a *bona fide* wholesale price and thus is a franchise fee. An excessive required minimum volume requirement may be a franchise fee even if the price for the goods is reasonable.

### 3. COMMUNITY OF INTEREST DEFINITION

Hawaii, Minnesota, South Dakota, and Washington define franchise as, "A contract or agreement, either express or implied, whether oral or written, between two or more persons:

(3) by which a franchisee is granted the right to engage in the business of offering or distributing goods and services using the franchiser's trade name, trademark, service mark, logo type, advertising, or other commercial symbol or related characteristic;

(4) in which the franchiser and franchisee have a community of interest in the marketing of goods or services at wholesale, retail, by lease, by agreement, or otherwise; and

(5) for which the franchisee pays, directly or indirectly, a franchise fee."

This definition is for discussion purposes only. The specific statute of each affected state must be reviewed. The emphasis is added.

The "community of interest" element is met if the parties have a "continuing financial interest and interdependence" in the operation of the distributor's business, such as where the manufacturer's profits will depend on the volume of the distributor's sales, the relationship is expected to be lengthy and encompass a substantial part of the dealer's time and resources, etc. Cassidy Podell Lynch, Inc. v. Snydergeneral Corporation, Bus. Franchise Guide (CCH) Part 9885 (3rd Cir. 1991); (four factors must be present to find a community of interest: (1) licensor must have control over the licensee; (2) licensee must be economically dependent on licensor; (3) there must be disparity in the bargaining power between the two; (4) there must be a franchise - specific investment by the licensee.). This can be met in a trademark license agreement if the licensee's payments to the licensor are dependent on his sales. Ziegler Co., Inc. v. Rexnord, Inc., Bus. Franchise Guide (CCH) Part 8882 (Wis. 1987), remanded, Bus. Franchise Guide Part 9317 (Wis. 1988); Lakefield Telephone Co. v. Northern Telecom, Inc., 656 F. Supp. 813, Bus. Franchise Guide (CCH) Part 8,831 (E.D. Wis. 1987)

(community found), Contra, Kayser Ford, Inc. v. Northern Rebuilders, Inc., Bus. Franchise Guide (CCH) Part 9815 (W.D. Wis. 1991) (no community found where plaintiff's purchase of defendant's products comprised less than two percent of plaintiff's receipts); Kusel Equipment Co. v. Eclipse Packaging Equipment, Ltd., 647 F. Supp. 80, Bus. Franchise Guide (CCH) Part 8,734 (E.D. Wis. 1986) (no community found).

#### **4. OTHER DEFINITIONS**

In Arkansas a license to use a trademark or distribute goods or services in an exclusive territory is a franchise even if a franchise fee is not required. Arkansas Laws of 1977, Art. 355, amended by Laws of 1979, Art. 424. Delaware franchise law applies to purchasers of trademarked goods who resell the goods to retail outlets. Del. Code Ann. Tit. 6, § 2551(1). A Florida franchise exists where the buyer is given the right to offer, sell or distribute goods which are manufactured, processed or distributed by the seller and the buyer's business is substantially reliant on the seller for supplies. Florida Statutes, Chapter 817, § 817.416(1)(b).

#### **5. EXEMPTIONS AND EXCLUSIONS**

##### **a. Federal vs. State Exemptions**

A franchisor exempted under a specific state's franchise law may not be exempt under federal law and vice versa. State exemptions are important, however, because of the lack of a federal private cause of action. Reliance on exemptions is difficult because state exemptions are not uniform and the seller will sell more than one jurisdiction.

##### **b. Large Franchisor/Experience**

A franchisor with a large net worth and/or significant franchise experience may be exempt. The franchisor typically must have a net worth of \$1 million and/or have conducted business of the type it is franchising for at least five years or meet other experience criteria.

##### **c. Sale to an Existing Franchisee**

Renewals of existing franchises or sales of additional units to existing franchisees may be exempt. This is often limited by a requirement that there be no material change in the relationship between the franchisee and franchisor.

##### **d. Franchisee's Sale of its Franchise**

The sale by a franchisee of its franchise may be exempt.

##### **e. The Sale of Registered Securities**

The sale of a registered security that transfers the franchise is exempt in some states.

##### **f. Other Exemptions**

Lines of commerce that are specifically regulated such as gasoline service stations and motor vehicle dealerships are sometimes preempted or expressly exempted. A few states exempt franchise sales when they are below or above a threshold. Some states permit the franchise administrator to exempt sales where regulation in a particular case is not necessary to protect the public. Other miscellaneous exemptions exist.

#### **D. Federal Definition Of Business Opportunity**

##### **1. IN GENERAL**

The distinction between a seller assisted purchase of a franchise and a seller assisted purchase of a business opportunity is primarily that the former encompasses the purchaser's substantial use of the seller's trademark and the latter encompasses the seller setting the purchaser up in a business which the seller will supply.

Business opportunities are often unintentionally created when a seller helps a buyer get into the business of distributing the seller's own or someone else's goods or services. A manufacturer who turns over a territory, including established accounts, to a new local distributor and charges for the privilege has probably created a business opportunity. The

business opportunity definition encompasses sellers who sell the buyer an opportunity to set himself up in business with an assured market. The franchise definition elements of a common trademark and significant control or assistance are not required. While The Rule treats franchises and business opportunities equally, most states regulate them under separate statutes.

## 2. DEFINITION

A federal business opportunity is defined in § 436.2(a)(1)(ii). Generally, a federal business opportunity exists if the following three part test is met:

(1) Seller Controlled Sale To Buyer. The Buyer sells goods or services supplied by the Seller, its affiliates, or suppliers specified by the Seller, § 436.2(a)(1)(ii)(A).

(2) Seller Assists Buyer To Sell. The Seller directly or indirectly secures for the Buyer, § 436.2(a)(1)(ii)(B); (a) retail outlets, or (b) accounts or locations for vending devices or racks to sell the goods or services or to distribute them; and

(3) Required Payment Of \$500. The Buyer must pay \$500 or more to the Seller or an affiliate to obtain the opportunity § 436(a)(3)(iii).

The franchise exemptions discussed above for The Rule apply to business opportunities under The Rule.

## 3. EXAMPLE

Seller and buyer enter into an agreement in which buyer will purchase automobile aftermarket products (oil filters, gas additives, etc.) or operate vending machines at various locations. Seller will use his good offices to help the buyer find locations to sell the goods or to distribute the goods. In exchange for this relationship, the buyer either (1) pays at least \$500.00 for the seller's assistance or (2) has to buy more than a reasonable inventory to begin operation or (3) must purchase goods priced

higher than the *bona fide* wholesale price for such goods elsewhere, Final Guidelines at 49968.

## E. State Definitions of Business Opportunity

### 1. IN GENERAL

Twenty-three states (Alabama, California, Connecticut, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia) have business opportunity laws. In California, Indiana, Maryland, Michigan, South Dakota, and Virginia, companies which are covered by the state's franchise statute are exempt from its business opportunity law. Minnesota and Washington include a business opportunity definition as an alternative definition of "franchise."

### 2. MAJORITY DEFINITION

#### a. Definition

Fourteen states (Florida, Georgia, Iowa, Louisiana, Maryland, Michigan, Minnesota, North Carolina, Oklahoma, South Carolina, South Dakota, Utah, Virginia, Washington) have substantially the same definition of business opportunity.

"The sale or lease of any products, equipment, supplies or services which are sold to the purchaser for the purpose of enabling the purchaser to start a business and in which the seller represents:

(1) that the seller will provide locations or assist the purchaser in finding locations for the use of vending machines, racks, display cases or other similar devices . . . ; or

(2) that the seller will purchase any or all products made, produced, fabricated, grown, bred or modified by the purchaser using in whole or in part the supplies, services or chattels sold to the purchaser; or

(3) that the seller guarantees that the purchaser will derive income from the business

opportunity which exceeds the price paid for that opportunity, or that the seller will refund all or part of the price paid for the business opportunity, or repurchase any of the products, equipment, supplies or chattels supplied by the seller, if the purchaser is dissatisfied with the business opportunity; or

(4) that upon payment by the purchaser of a fee (the threshold amount varies from \$50.00 in Florida to \$500.00 in Iowa, Michigan and Utah) the seller will provide a sales program or marketing program to the purchaser; provided, that this subparagraph will not apply to the sale of a marketing program made in conjunction with the licensing of a registered trademark or service mark." ([only in Connecticut, Georgia, South Carolina, Louisiana, Maine, North Carolina, Utah]).

This definition is for discussion purposes only. The specific statute of each affected state must be reviewed.

#### **b. To Start A Business**

The seller must enable the purchaser to start a business. In determining whether a sale to an existing business is so substantially different than the existing business as to comprise starting a new business will be judged according to factors such as those discussed under the federal fractional franchise exemption. The sale of on-going businesses are also not covered by the State Business Opportunity Acts. Batlenento v. Dove Foundation, Bus. Franchise Guide (CCH) Part 9932 (Fla. Ct. App. 1991).

#### **c. Threshold Representations**

If any one of the four subsections is met, the agreement is a business opportunity.

#### **(1) VENDING MACHINES AND CHINCHILLA FARMS**

Subsections (1) and (2) are generally directed toward vending machines and chinchilla farms and similar activities. More fact situations collect in these two cracks than would logically seem possible. Fishermans Net, Inc. v. Weiner, 608 F. Supp. 1283 (D.C. Me. 1985)(refusing to

decide whether shopping center lease that included common area seating, decorations and promotional services falls within Maine BOA.

#### **(2) GUARANTEE OR REPURCHASE**

This section is rarely met on the face of the signed agreement. In the real world your client's salesman is on a commission and his hungry child is six months old. The salesman may "guarantee", "promise", or "represent" to the prospective buyer that he will make money, that the buyer can return unsold or unneeded goods, or that part of the purchase price will be refunded if the buyer changes his mind. Overpriced or required supplies, equipment, or market aids may be the price paid.

#### **(3) MARKETING PROGRAM**

The expanse implied by the subsection (4) phrase "a sales program or marketing program" can be inferred from the prior discussion with respect to franchise statutes. The required "fee" is minimal (from \$50 to \$500) and there is not a *bona fide* wholesale price exception. The avoidance provided by the "registered trademark or service mark" portion of this part varies considerably from state to state.

#### **d. The Trademark Difference**

Business opportunity statutes do not require the license of or association with a trademark. Thus, providing a sales or marketing program without an associated trademark can be a business opportunity and not a franchise. On the other hand, because pure trademark licensing agreements typically do not involve the "sale or lease of any products, equipment, supplies, or services" they are typically not business opportunity agreements. Final Guidelines at 49966.

Inclusion of a trademark in the relationship does not prevent its being both a franchisee and a business opportunity. Some states exempt "franchises" from their business opportunity statute.

### 3. OTHER STATES

California, Nebraska, Indiana, Ohio, New Hampshire, and Kentucky have business opportunity definitions which differ substantially from the majority definition.

#### F. Texas Definition Of Business Opportunity

##### 1. DEFINITION

Texas has a unique definition of "business opportunity" Tex. Rev. Civ. Stat. Ann. Art. 5069-§ 16.05(2)(B).

"Business opportunity means the sale or lease of any products, equipment, supplies or services:

A. which are sold to the purchaser upon payment of an initial required consideration exceeding \$500 which will be used by or on behalf of the purchaser to begin a business; and

B. in which the seller represents that the purchaser will earn or is likely to earn a profit in excess of the initial consideration paid by the purchaser; and

(i) that the seller will provide locations or assist the purchaser in finding locations for the use or operation of the products, equipment, supplies, or services on premises neither owned or leased by the purchaser or seller; or

(ii) that the seller will provide a sales, production, or marketing program; or

(iii) that the seller will buy back or is likely to buy back any products, supplies, or equipment purchased or any product made, produced, fabricated, grown or bred by the purchaser using in whole or in part the product, supplies, equipment, or services which were initially sold or leased or offered for sale or lease to the purchaser by the seller."

Understanding and applying this definition requires a familiarity with how the same or similar terms are used in The Rule and the laws of other states as discussed above. Price, Keffler and Braly, Franchising in Texas, 6 Franchise L.J., Fall 1986 at 1; Jane Ferguson, The Texas Business Opportunity Act: A Critical Analysis, 34 Baylor Law Rev. 348 (1982); Mark Miller, Franchising In Texas, 14 St. Mary's Law

J. 301 (1983); Joyce Mazero and John Holzgraefe, A Practical Guide To The 1985 Amendments Of The Texas Business Opportunity Act, 4 Franchise Legal Digest 3 (1985). This is particularly so as Texas has few reported decisions construing these terms while a large body of federal and out-of-state administrative and judicial interpretations exist concerning them.

##### 2. THREE PART TEST

The BOA in practice has a three part business opportunity definition. (The § 16.05(2)(B) requirement that "the seller represents that the purchaser . . . is likely to earn a profit in excess of the initial consideration paid by the purchaser" is met in most circumstances.)

a. The items or services purchased or leased by the purchaser must be used by or on his behalf to begin a business, § 16.05(a).

b. The purchaser is obligated to pay initial consideration exceeding \$500 to begin the business; § 16.05(2)(B)(10); and,

c. The seller must make any one of the three listed threshold representations. § 16.05(2)(B)(i) - (iii).

This covers a broader range of business arrangements than the previously discussed franchise or business opportunity statutes.

##### 3. TO BEGIN A BUSINESS

This requirement will normally be unquestionably met or not met. A purchaser of franchise rights to a new market area in a line of commerce he has no experience in is beginning a business. A purchaser of an enterprise that has operated at the same location for several months is not beginning a business but purchasing an ongoing one. This is further clarified in the ongoing business exemption § 16.06(1)(A) discussed below.

Sometimes a buyer will expand his current business by taking on a new line. As the statute gives no criteria for interpretation other than its preamble, and the burden of proving exclusion from a definition is on the party

claiming it. § 16.04 and § 16.06(2). these judgments must be made by relying on the persuasiveness of FTC interpretations of similar terms in The Rule. Final Guidelines at 49986. An automobile service station operator with over two years of experience who purchases a retail oil additive dealership anticipated to comprise less than 20% of the dollar volume of his projected gross sales for use at his service station is not beginning a business. A dry cleaning opportunity would seem to be a new business to him even if operated from the same location. Subject to the § 16.06(1)(B) fractional franchise exemption discussed below. There will certainly be close fact situations where the issue will be disputed before the jury and court. Eye Assoc. v. Incom RX Systems Bus. Fran. Guide (CCH) Part 9670 (2nd. Cir. 1990) (merely altering the nature of an existing business may be sufficient to "begin a business").

#### 4. INITIAL CONSIDERATION

The BOA defines initial consideration as "The total amount a purchaser is obligated to pay under the terms of a business opportunity contract prior to or at the time of delivery of the equipment, supplies, products, or services or within six months of the purchaser commencing operation of the business opportunity plan. If the contract sets forth a specific total sale price for purchase of the business opportunity plan which total price is to be paid partially as down payment and then in an additional payment of installments, then "initial consideration" means the entire sale price. Initial consideration shall not include the non-for-profit sale of sales demonstration materials, samples, and equipment not to exceed \$500." § 6.05(2)(B)(10).

"[W]hich will be used by or on behalf of the purchaser to begin a business. § 16.05(2)(B).

In contrast to The Rule this does not contain a *bona fide* wholesale goods exemption and is not limited to the first six months for accumulation of the \$500 if the payments are made "for purchase of the business opportunity."

Thus any contractual requirement to purchase or lease \$500 of goods or services during the first six months to be used to begin the business satisfies this part. Further, all payments required by the contract to be made for purchase of the business opportunity are summed to reach the threshold \$500. The fact that the six month period begins upon "the purchaser commencing operation of the business opportunity plan" makes it more difficult to draft documents to avoid this period.

The variances from The Rule described in the preceding paragraph which expand the universe of possible business opportunities are inapplicable to The Rule's § 436-2(a)(1)(i) "franchises" which fall within the scope of § 16.06(H). The above discussion of the BOA's variances from The Rule is, however, applicable to The Rule's § 436.2(a)(1)(ii) "business opportunities."

The "amount a purchaser is obligated to pay . . . within six months" in the first sentence quoted above from § 16.05(2)(B)(10) does not necessarily correspond to the "specific total sale price for purchase of the business opportunity" in the second sentence quoted above from § 16.05(2)(B). Further, the initial consideration must be used "to begin a business". BOA defendants will argue that payments for contractually required supplies which are not due until after the six months period are neither initial consideration nor used to begin a business. They will further argue that payments for supplies, etc., delivered within the six months but after the purchaser has commenced operations may be initial consideration but are not being used to begin a business.

BOA defendants will further argue that "obligated to pay under the terms o a business opportunity contract" means that only amounts specified in the purchase agreement itself may be summed to reach the required \$500. Thus monies required to be paid pursuant to other agreements between the seller and the purchaser and/or monies the purchaser will of necessity pay to the seller for goods or services

available only from the seller or which the seller, as a practical matter, required to be purchased from seller do not count toward the \$500 threshold.

The BOA was not, however, adopted in a vacuum. The Rule, the business opportunity laws of other states, and the legislature's express intent of protecting "against false, misleading and deceptive trade practices in the . . . sale . . . of business opportunities" will be used by Texas courts in interpreting the BOA. Thus the Final Guideline's discussion of "payments required by practical necessity" in interpreting "required payments" as used to define federal business opportunities "[r]equired payments are not limited to a simple franchise fee, but entail other payments which the franchisee is required to pay to the franchisor or an affiliate, either by contract or by practical necessity. Among the forms of required payments are initial franchise fees as well as those for rent, advertising assistance, required equipment and supplies -- including those from third parties where the franchisor or its affiliate receives payment as a result of such purchases -- training, security deposits, escrow deposits, non-refundable bookkeeping charges, promotional literature, payments for services of persons to be established in business, equipment rental and continuing royalties on sales.

The payments may be required either by contract or by practical necessity. Payments required by contract would include not only those required by the franchise agreement, but also those required in any companion contracts which the parties may execute, such as a real estate lease. Payments made by practical necessity include, among others, those for equipment which can only be obtained, in fact, from the franchisor or its affiliate." Final Guidelines at 49967. will be persuasive to the first Texas court to consider these defensive arguments, and absolute reliance on the above arguments is precarious.

Subject to the unique clauses in this definition, this article's above discussion and citations concerning "required payment" and "franchise fee" with respect to The Rule and the

laws of other states is applicable to this requirement.

## 5. THRESHOLD REPRESENTATIONS

### a. In General

The BOA threshold representations, in common with the DTPA laundry list representations, only have to be made to meet the statutory requirements. In contrast to a common law action for fraud, the purchaser does not have to have relied on or even believed the seller's representation. If the seller utters the magic words and all other requirements are met, he acquires BOA "seller" status.

### b. Locations

§ 16.05(2)(B)(i) dealing with providing locations or assisting the purchaser in finding locations is similar to the location representation common in other states' business opportunity laws. While primarily directed toward vending machines, chinchilla farms and similar activities, the caveat is that it applies to more fact situations than logic would appear to allow. Mirza v. T.V. Tempo, Inc., Cause No. 84-CI 0795, filed in the 288th District Court, Bexar County, Texas (Judgment entered for BOA Plaintiff on January 12, 1988 based partly on this subparagraph); Examples of circumstances which meet this requirement are where "[T]he franchisor may represent that he will secure ten gasoline stations to be retail outlets (e.g. oil filters, gas additives, etc.) or place vending machines in ten locations. The franchisee of a business opportunity venture is required to pay a fee or purchase goods or equipment (such as vending machines or display racks) in order to participate in the business opportunity offered by the franchisor." Final Guidelines at 49968.

### c. Marketing Program

The BOA extensively defines the § 16.05(2)(B)(ii) "marketing program" at § 16.05(2)(B)(12), "Advice or training provided to the purchaser by the seller or a person recommended by the seller, pertaining to the sale

of any products, equipment, supplies or services and the advice or training includes but is not limited to preparing or providing:

- (1) promotional literature, brochures, pamphlets or advertising materials;
- (2) training regarding the promotion, operation or management of the business opportunity; or
- (3) operation, managerial, technical, or financial guidelines or assistance".

This is related to The Rule's § 436.2(1)(i)(B)(2) requirement of "significant assistance" and the "marketing plan" of other states' franchise statutes. Licensors or manufacturers who assist their buyers make use of the items licensed or to sell the items purchased may meet this requirement. Contra, Practice Management Assoc., Inc. v. Cochran, Bus. Franchise Guide (CCH) 9684 (Fl. Dist. Ct. App.-1990) (management efficiency training not a marketing plan).

#### **d. Repurchase**

In contrast to other business opportunity statutes, § 16.05(2)(B)(iii) is triggered if the seller "is likely" to buy back. Other states require a guaranteed buy-back by the seller. Further, "buy-back" includes "any representation that implies in any manner the purchaser's investment is protected from loss." As discussed above, this requirement is met more often than is appreciated. Salesmen are paid to sell. Particularly where the sale involves the delivery of any reusable articles, the salesman may represent that the seller will "likely" repurchase unused items. If area development rights are sold, salesmen may imply that the seller will help the purchaser resell the area or otherwise help the purchaser out if he is dissatisfied. Once these representations are uttered a jury issue may exist concerning this item.

The BOA defendant's argument is that this requirement is directed primarily toward chinchilla and worm farm sellers (as contrasted to his line of commerce), that the major part of the business sold by him to the purchaser was clearly not returnable and that the transaction

should not be deemed a business opportunity simply because the salesman implied a possible buy back of a minor portion of what was transferred. DTPA and Business and Commerce Code cases characterizing transactions as being primarily transfers of intangibles or services respectively and thus not within those statutes may be persuasive on this point.

#### **6. THE FRANCHISOR EXEMPTION**

Most franchisors rely on § 16.06(1)(H) which exempts sales of franchises from the BOA conditioned on the franchisor complying with The Rule in all material respects in the State of Texas and filing a prescribed exemption statement with the Secretary of State together with a \$25.00 filing fee.

##### **a. Exemptions and Exclusions**

The Rule's exemptions and exclusions, § 436.2(a)(3) and (4) are important in working with § 16.06(H). Prior to the amendments effective September 1, 1989, there was an ambiguity concerning whether the seller of franchises which were exempt and excluded from The Rule, (for example, fractional franchises exempted from The Rule), "complied" with The Rule for the purposes of §16.06(1)(H) if the seller did not provide a franchise disclosure document to prospective purchasers.

The 1989 amendment to § 16.06(H) added "including the relevant exemptions and exclusions in the regulations [The Rule] or an order or any other action of the Federal Trade Commission" to make clear § 16.06(H)'s intent to create a multifaceted exemption which defines coming within any of The Rule's eight exemptions and exclusions as complying with The Rule, and thus exempting the transaction from the BOA. The Rule's exemption of a transaction where the total of the purchaser's payments for "other than reasonable quantities of wholesale goods purchased for resale" within six months after commencing operations is less than \$500 would, for example, make such a transaction one that complies with The Rule for the purposes of being exempt from the BOA if

the transaction otherwise falls within § 436(a)(1)(i) Restated, a transaction must be a § 436(a)(1)(i) franchise sale to be exempted due to § 436.2(a)(3) and (4) exemptions and exclusions. The full discussion of bona fide wholesale prices and the franchise definitional elements of Part IV of this paper should be referred to in this respect. The Rule's other seven exemptions and exclusions are also applicable in this regard.

**b. Franchises vs. Business Opportunities**

The § 16.06(1)(H) exemption is limited to "franchises." Prior to September 1, 1989, § 16.06(H) defined the transactions exempted by the phrase "product or package franchise", terms which were known to franchise law practitioners but which were relatively inaccessible to the uninitiated as they were found only in The Rule's Final Guidelines. A package franchisee's method of operation in producing goods or services is controlled or assisted by the franchisor. Examples include fast food and transmission repair stores. Product franchisees distribute goods produced by the franchisor or those under its control and direction such as automobile dealerships and soft drink and beer distributorship. Final Guidelines at 49966. Further, the guidelines definition of these terms was not specific. The 1989 amendment replaced this descriptive phrase with "any arrangement defined as a "franchise" . . . in 16 C.F.R. Section 436.2(a)(1)(i)" Tex. Rev. Civ. Stat. Art. Ann. 5069-16.06(H). This definition is more useful because it can be looked up in the C.F.R. by the non-specialist and its precise meaning determined. The entire discussion of the definitional elements of a federal "franchise" in Part IV of this should be looked to in adjudging whether a particular transaction meets this definition and thus can be exempted from the BOA due to an exemption on exclusion within The Rule.

Transactions defined by The Rule as § 436.2(a)(1)(ii) "business opportunities" are specifically and intentionally not relieved of compliance with the BOA by § 16.06(1)(H).

While business opportunities are distinct from franchises, after taking some time with their different definitions, they are similar enough to initially cause confusion. It is logically proper to at least retain within the BOA's jurisdiction sales of business defined by The Rule as "business opportunities," as these encompass more of the worm farm and chinchilla ranches which more typically requires a bond for protection of the public. This requires, however, a familiarity with The Rule as a prerequisite to determining whether certain sales are exempt from the BOA under § 16.06(H).

**c. UFOC Format**

Since most franchisors use Uniform Franchise Offering Circular (UFOC) format disclosure documents, a question often arises concerning whether disclosures made in a UFOC format rather than the FTC format prescribed in The Rule satisfy §16.06(1)(H)'s requirement of complying "in all material respects . . . with the disclosure requirements and prohibitions concerning franchising in such Federal Trade Commission regulations." § 16.06(1)(H) states that "any alternative franchise disclosure statements permitted by the FTC may be used in lieu of its franchise disclosure requirements." The FTC approved the September 2, 1975 version of the UFOC effective through December 31, 1988, and approved the November, 1986 UFOC format effective beginning June 9, 1987 (only the November, 1986 UFOC format is approved for use after January 1, 1989). Bus. Franchise Guide (CCH) Part 8,862.

**d. "Complies In All Material Respects"**

Although a recent case stated, as an alternative ground for dismissal of a BOA claim, that "the Business Opportunity Act does not apply to the sale of a franchise as defined by 16 C.F.R. §436.2 Tex. Rev. Civ. Stat. Ann. Art. 5069-16.06(1)(H)" Meineke Discount Muffler Shops, Inc. v. Wesley Jaynes, et al, Bus. Franchise Guide (CCH) Part 9959 (S.D. Tex. 1991), there are so many exceptions to this

statement that they practically engulf the statement itself.

The seller's compliance in all material respects with all other "requirements and prohibitions . . . in such Federal Trade Commission regulations" is required to maintain § 16.06(1)(H)'s exemption. This particularly encompasses The Rule's five day, § 436.1(g), § 436.2(f), FTC Interpretive Guides (August 24, 1979), Bus. Franchise Guide (CCH) Part 6224; ten day, § 436.2(g); and first personal meeting, § 436.2(o) requirements for making The Rule's required disclosures to a prospective franchisee.

It is also necessary to provide notice of "material facts" § 436.2(n) and "material changes" § 436.1(a)(22) to the prospective purchaser as required by The Rule. Thus, an initially properly prepared franchise disclosure document will not exempt the seller from the BOA if The Rule's delivery time, updating and other requirements and prohibitions are not met.

(FTC Interpretative Guides (August 24, 1979), Part IE, CCH Bus. Franchise Guide, Para 6227.)

## 7. OTHER EXEMPTIONS

### a. Ongoing Business

"The sale or lease of an established and ongoing business or enterprise that has actively conducted business before the sale or lease, whether comprised of one or more than one component business or enterprise, where the sale or lease represents an isolated transaction or series of transactions involving a *bona fide* change of ownership or control of such business or enterprise or liquidation thereof" is exempt. § 16.06(1)(a). Meineke Discount Muffler Shops, Inc. v. Joynes, Bus. Franchise Guide (CCH) Part 9959 (S.D. Tex. 1991).

The typical sale of one or more on-going businesses by the owner is exempted by this section. The exemption is, however, full of litigable terms. The California definition of "on-going business" as "one that for at least six months previous to the sale: (1) has been operated from a given specific location; (2) has been opened for business to the general public;

and (3) has had all equipment, supplies or services necessary for operating the business at the given specific location" Cal. Civ. Code § 1812.201(b)(7) is persuasive authority.

### b. Leased Department

This limited exemption deals with independent retailers who sell their own goods or services from premises leased from a larger retailer in the larger retailer's store. § 16.06(1)(B). Department stores, for example, often lease some of their space to specialty shoe stores. The Rule's § 436.2(a)(3)(ii) definitions, guidelines and opinions discussed above should be persuasive concerning this exemption.

### c. Fractional Franchise

"A sale or lease to an existing or beginning business enterprise which also sells or leases equipment, products, and supplies or performs services: (1) which are not supplied by the seller and; (2) which the purchaser does not utilize with the equipment, products, supplies, or services of the seller" Id. and § 16.06(1)(E) is exempt. This is identical to a like business opportunity exemption of other states; Cal. Civ. Code § 1812.201(b)(6); Neb. Rev. Stat. § 59-1718 and is similar in intent to The Rule's 436(a)(3)(i) fractional franchise definition discussed above.

This exemption intends to cover business transactions that add a product or service to a preexisting large enterprise, such as a supply agreement between a tire manufacturer and a service station dealer. It is not intended to exempt the sale of a franchised restaurant to a person whose current "existing business" is a shoe shine stand.

The "beginning business" term is a lesser requirement than the 2 years of experience term found in The Rule § 436.(a)(3)(i) fractional franchise definition discussed above. Nevertheless, a seller who helps the purchaser incorporate on day one and then relies on this exemption on day two is likely to be disappointed.

The limiting "which are not" language seems to literally exclude from the exemption a purchaser who had any prior dealings with the seller. The Rule's 20% limitation, § 436.2(a)(5) on how much of the purchaser's new dollar volume the seller can supply and still retain The Rule's exemption, however, offers persuasive guidance. A sale of a new line of goods which will comprise over 50% of the purchaser's dollar volume would clearly seem to be more than an addition to the purchaser's line and be beyond the exemption's reach. In the absence of state interpretations, however, the breadth of this exemption could be determined by a fact issue submitted to the jury.

**d. Net Worth Exemption**

§ 16.06(G) exempts a seller with a net worth of \$25 million according to its audited balance sheet as of a date within 13 months of the date of the transaction and seller's who meet this financial criteria and guarantee seller's performance. Measurement of net worth as opposed to assets and the requirement of an audited balance which precede the transaction are used as screens on the rationale that such persons do not typically engage in the schemes against which the BOA is directed and that if they do they are typically available to satisfy judgments in the normal course.

**e. Gasoline Stations**

The cases are mixed as to whether the federal Petroleum Marketing Practices Act (15 U.S.C. Article 2801 et seq.) preempts similar state regulation. The BOA specifically exempts offers and sales of franchises covered by this § 16.06(1)(F).

**f. Miscellaneous Exemptions**

"Real estate syndications" § 16.06(1)(D) and "Transactions regulated by the Texas Motor Vehicle Commission, Texas Department of Labor and Standards, State Board of Insurance, or the Texas Real Estate Commission when engaged in by persons licensed by such agencies" are exempt.

**8. CONSTRUCTION**

"In construing this chapter a court to the extent possible shall follow the interpretations given by the Federal Trade Commission and the federal courts to Section 5(a)(1) of the Federal Trade Commission Act (15 U.S.C. Section 45(a)(1) and to 16 C.F.R. 436" § 16.15(d). This Section gives a court faced with an apparently novel point of BOA construction a large body of decided cases and FTC orders and guidelines to rely upon for direction. The most useful compilation of these sources is found in the Business Franchise Guide published by Commerce Clearing House.

Reliance on technical interpretations by a BOA defendant is precarious in close circumstances as "[t]he burden of proving an exemption, an exception from a definition or an exclusion from this Act . . . is upon the person claiming the exemption, exception or exclusion. § 16.06(2). Further, the statute's preamble directs that it "shall be liberally construed . . . to protect persons against false, misleading or deceptive practices in the . . . sale . . . of business opportunities . . ." § 16.04; *c.f.*, Eye Assoc. v. Incom RX Systems, Bus. Franchise Guide (CCH) Part 9670 (2nd Cir. 1990) ("When the Connecticut legislature passed the [Connecticut Business Opportunity Investment] Act . . . like drift net fishing, the Connecticut legislature intended its cast to be wide and deep so that it might cover all business opportunities . . ."). A similar preamble to the DTPA has been used by the Texas Supreme Court to expand the DTPA's reach far beyond what most attorneys would have predicted 10 years ago. Melody Home Manufacturing v. Barnes, 741 S.W. 2d 349 (Tex. 1987); ("The Court best serves the law which recognizes that the rules of law which grew up in a remote generation may, in the fullness of experience, be found to serve another generation badly, and which discards the old rule when it finds that another rule of law represents what should be . . ." at 354 [quoting Humber v. Morton, 426 S.W. 2d 554 Tex. (1968)]). BOA

plaintiffs will rely on the BOA preamble and this analogy.

BOA defendants will stress the "business opportunities" portion of the preamble's directive to argue that their license, distributorship and supply agreements were not the type of transaction the legislature intended to regulate.

## V. PROSPECTIVE FRANCHISORS

### A. The Lawyer's Role

The typical client knows more about his line of commerce than the attorney. He wants you to "paper over" the handshake deal. When the ink dries, the lawyers go back to their offices and the clients continue their commercial relationship. The novice franchisor client, however, is entering a new line of commerce, franchising, that the franchise lawyer knows better than the client. The franchise lawyer has structured other franchise systems, prepared franchise agreements and offering circulars, modified programs, dealt with disgruntled franchisees, worked with successful and unsuccessful franchisors, etc. The client has none of these experiences. Like anyone in a new situation, he initially has no common sense to rely on.

This puts the lawyer in an awkward role. Is the business franchiseable? Is the client prepared to begin franchising now? What is a reasonable franchise fee? How fast should he expand? The novice franchisor needs business advice concerning these critical decisions. If you do not offer sound business advice, he may not get it at all.

On the other hand, the franchise concept needs to be refined through test marketing and evaluation; press releases, booklets, sales materials, and an operations manual needs to be prepared; prospects must be identified, qualified and trained, quality standards established; etc. These business functions are generally inappropriate for the lawyer. Further, the lawyer cannot slide into de facto management without creating an indefensibly high bill for "legal

services" and losing his protected status as a "mere" attorney.

There is no pat answer to this dilemma. The best that can be done is to be continually aware that it is a problem. The Franchise Option: How to Expand Your Business Through Franchising, by Kathryn L. Boe, William Ginalski, and D. Henward, III (1987), is useful concerning this subject. Giving the client John Love's, McDonald's Behind the Arches, (1986), a book about the founding of the McDonald's restaurant chain, and its slow evolution through trial and error will increase his franchising common sense.

### B. Should The Client Franchise?Error! Bookmark not defined.

The typical prospective franchisor has the following story: "Business is so good I cannot serve everyone who wants to buy but my competitors see what I am doing and will preempt the market if I do not quickly go national. I do not have enough money and staff to do this myself, but people are calling who want to buy franchises from me. I have to accept their \$25,000 checks before someone else does and I lose my temporary advantage. I have done the hard part in getting to where I am now. Rapid expansion must begin now and be paid for with up front franchise fees without my using my own limited money."

The reality is that a substantial investment needs to be made in franchise law compliance; support staff has to be hired and trained for franchise sales, training and support; and operations manuals and procedures prepared, before franchises are sold. These costs will not decrease over time. Further, initial franchises and distant franchises will be unprofitable to service, and premature franchise sales may doom the entire enterprise.

Franchise legal expenses will increase as long as the system is expanding. Required items such as annual audited financial statements will cost thousands of dollars each year. Even simple items such as reviewing and approving each franchise's design plans, leases, sites, etc.,

require professional services at a cost to the franchisor. These franchising expenses will likely exceed income until enough franchises are on line and peacefully paying royalties each month to reach break even without being dependent on the sale of new franchises.

If the client needs your assistance in deciding whether to franchise, Advice to Prospective Franchisor (Appendix D) should be used to help him reach an informed decision.

### C. Full Disclosure

Once the decision to franchise is made, your most urgent duty is to make the franchisor and its personnel aware that they travel a narrow ridge in dealing with prospective franchisees. The franchisor must both (1) accurately disclose the information required to be disclosed by The Rule and all relevant state laws in accordance with the required forms, deadlines, procedures, etc., and (2) not fail to disclose material information as required by DTPA § 17.46(b)(23).

Franchise specific consumer protection laws were enacted after too many voters were harmed by franchisor abuses. They are intended to assist consumers make intelligent decisions. While mature lines of commerce have players and rules that have been strong for generations, franchising does not yet have a strong institutional history or fund of common sense. Consequently, mistakes often occur in the franchise arena. Novice franchisors do not appreciate the consumer protection thrust of franchise law. Franchise laws are NOT FAIR. They ARE out to get you. Non-compliance can result in a BUSINESS DEATH PENALTY, PERSONAL LIABILITY and MALPRACTICE AWARDS. The parallel to securities law should be emphasized to prospective franchisors.

While clients universally want to avoid the cost of compliance, the penalty for noncompliance with franchise law can be destruction of the business and personal and criminal liability for officers and controlling persons. Wheeler v. Box, 671 S.W.2d 75 (Tex. App. - Dallas 1984) (officers personally liable);

Dollar Systems, Inc. v. Avcar Leasing Systems, Inc., Bus. Franchise Guide (CCH) (9th Cir. 1989); Avery v. Solargizer Intl., Inc. 427 N.W. 2d, 675 (Minn. Ct. App. 1988) (officers must have knowledge or reasonable grounds to know of facts to be liable); Courtney v. Waring, 237 Cal. Rptr. 233, (Cal. Ct. App. 1987; Sutherland, The Risks and Exposures Associated with Franchise Noncompliance, 42 The Bus. Lawyer; 369 (1987).

Violation of The Rule is a crime, U.S. v. Lawrence E. Jaspan, Bus. Franchise Guide (CCH) Part 9773 (1991) (Franchisor, on very bad facts, sentenced to three years, \$1,400,000 in redress to consumers and \$870,000 in civil penalties); People v. Mott, 189 Cal. Rptr. 589 (1983) (Defendant who failed to provide disclosure statement argued he was unaware the law required them. "Willful" criminal violation means willingness to commit the act and does not require intent to violate the law).

FTC enforcement actions typically make the franchisor's officers jointly and severally liable for consumer redress and civil penalties. FTC v. National Business Consultants, Bus. Franchise Guide (CCH) Part 9594 (E.D. La. 1991) (Franchisor and President liable for \$3,019,337 redress. [Later held in in the Matter of Robert Nomer, Debtor, Bus. Franchise Guide (CCH) Part 9992 (Bank's Ct. E.D. La. 1992) to be a non-dischargeable debt in bankruptcy]); United States v. Federal Energy Sy., Bus. Franchise Guide (CCH) Part 8433 (C.D. Cal 1985), (franchisor and its offices jointly and severally liable for \$3.0 million in customer redress and \$1.6 million in civil penalties).

Successful franchisees want to continue without payment and to be free of royalties. Unsuccessful franchisees want the franchise fee, their total investment and their lost opportunity costs all trebled plus attorney's fees.

Franchisors are vulnerable to "piling on" by franchisees after a lost franchise suit anywhere through the offensive use of collateral estoppel. Failure to comply with franchise law may give franchisees the right to rescind, Hicks v. United States Snack Group, Inc., Bus.

Franchise Guide (CCH) Part 10,131 (W.D. Wash. 1992), or obtain enhanced damages.

All franchisor personnel should understand that it is better to lose any sale than incur the probability of future litigation. Letters from the franchisor's president and memos on the bulletin board to this effect will help avoid future litigation by reducing questionable conduct. They may also be admissible at trial on the issue of punitive damages.

The first best place to bring this home is in your preparation of the franchise offering circular. Each UFOC Item should be used as an opportunity to interrogate the franchisor about any facts that could possibly be used in future litigation to put him in a bad light. If relevant, these facts should be disclosed in the offering circular unless the state administrator orders it out (also safe harbor).

Disclosure of embarrassing details in the offering circular almost never prevents a sale. People buy a franchise because they like its look and feel and believe they can make money with it. Disclosure does, however, help bullet-proof the franchisor against nondisclosure causes of action. Explaining the offering circular as a weapon against future rebellious franchisees encourages the franchisor to make full disclosure. If disclosure does prevent a sale, that is the best evidence that the sale should not have occurred.

The acts you should take to bulletproof yourself from failure of due diligence and malpractice claims will vary from memos to the file, to letters to the franchisor and its controlling persons, to hiring independent investigators. These also impress the client with the need to make full disclosure.

#### **D. The Franchisor's Trademark**

An essential premise of franchising is that the franchise system has a protectable, safe, marketable trademark that brings more of the right kind of customers to each franchisee's business than the franchisee could attract on his own. The customer's perception that he will get

what he wants if he goes to a business identified by the franchisor's trademark is a large part of the franchisor sells to the franchisee and what the franchisee sells to the public. A prospective franchisor's first priority should be to put his trademark matters in order.

The first item to consider in deciding whether a proposed mark should be adopted is whether it is protectable, i.e., whether the franchisor can exclude competitors from using the term in connection with similar goods and services. This needs to be decided in consultation with an experienced trademark lawyer. Once management decides to adopt and use a trademark, an application for federal registration should be promptly filed. Not promptly registering trademarks risks limiting the franchisor's right to prevent competitors from using the term, and may result in the franchisor's own right to use the mark being destroyed or limited.

State registrations are relatively useless except in a few states like Texas. A subsequent federal registration by another may deprive the state registrant of all rights except common law rights.

### **E. Structuring A Successful System**

#### **1. THE FRANCHISE AGREEMENT**

The franchise agreement you prepare provides the formal structure for the entire franchise system. The more you understand about the client's business, the more intelligently you can structure his franchise system. Merely copying a competitor's or form book's franchise agreement will cause long-term problems. You must take into account the special circumstances and expectations of your new franchisor. The first place to begin is probably an unstructured visit to the client's business, review of his forms, talks with his managers, etc.

As most franchise programs depend on royalties, a detailed franchisee reporting system is paramount. This requires frequent payments and reports by franchisees, random audits, secret shoppers, etc. While operational details can be

implemented in the Operations Manual "as the same may be revised from time to time," franchisee duties and payments which are likely to be disputed later should be detailed in the agreement itself. On the other hand, over-controlling the franchisee in the agreement harms salability, induces uneconomic over-control, and may make the contract unlawful.

If at all possible, get the client to actually read the entire final agreement in your presence and at a time and place when his attention can be focused on it. This final reading will often reveal inconsistencies between his expectations and your document. Further, because the client will generally conduct business without you at his elbow, he needs to be familiar with the document.

## **2. THE OPERATIONS MANUAL**

Attachment D emphasizes the many audiences the Operations Manual must address. The franchisor should prepare an Operations Manual he can be proud of in front of all these audiences. Copyright and trade secret notices will discourage unauthorized duplication, and are essential for later copyright and trade secret litigation and enforcement of post-termination non-competition covenants. Each franchisee should be assigned a number and that number stamped throughout confidential materials sent to him.

## **3. STAFFING UP**

Franchising will require the client to add management level employees. The prospective franchisor may already have located a franchise consultant or franchise development company that will take care of all these problems with the wave of a checkbook. While useful franchise consultants exist, they are unlicensed and several have an unsavory reputation. (To be fair, attorneys do not win popularity awards either.) Likewise, while it is useful to hire someone with franchise experience away from the competition, persons shopping for a new franchisor to work for may be doing so because their misconduct is coming to roost in their current position.

## **4. GOOD FRANCHISEES**

Nothing is more important than initial franchisee selection. Every franchise sale is the beginning of a long relationship. The up-front franchise fee will not cover future litigation expenses from an unhappy franchisee nor trouble stirred up or the loss of future franchise sales deterred by him.

- What is his business track record? While a prospective franchisee can be taught how to cook, replace transmissions, or launder clothes, he cannot be turned into a mature business person by a three-week training course. Most successful franchisees have a track record of long hard work and some, but not much, business background. These are typically people who know how to read P & L's, have supervised others, timely paid their bills, etc. Education is not as important as work experience. For example, has he been climbing the career ladder, or did he level out at a clerk's position?

- How Does He Manage His Own Money? Does he have ten credit cards, all of which are extended to the limit? Does he have a new sports car or a five-year-old sedan? Does he have bad credit and a defaulted student loan? Is he involved in his community? Some answers indicate a person who is likely to be a mature, hard worker who will create business goodwill. Some do not.

- Where Is His Initial Investment Coming From? Most franchisors require the franchisee to invest an unborrowed sum of money. Most small businesses are not initially profitable and need working capital. Real money obtains more commitment than borrowed money.

- Will He Personally Manage The Business? Most small businesses run best if the person physically running the store is the person who invested the money.

- Will He Work In The Business Before Committing To It? Some franchisors such as McDonald's Corporation require prospective franchisees to train on a part-time basis with current franchisees before either side makes a commitment. Both sides are better off if either discovers that the fit is not good before it is too late.

- Does He Understand The Long, Hard Hours Of Work Involved? Will the spouse tolerate the franchisee's total commitment to the business? Most small businesses require 14 hours a day, seven days a week for the first few months or years.

- Is He Suited To This Particular Line Of Business? The supervisory skills needed to operate a transmission shop are different than those needed to control herds of teenagers at a fast-food restaurant. Putting a round peg person in a square hole franchise is a bad decision.

The ultimate issue is whether the prospective franchisee will likely be a happy successful hamburger seller, transmission installer, dry cleaner, etc. for the full term of the franchise agreement.

## 5. PONZI FRANCHISING

Some franchise systems are intentionally or unintentionally a Ponzi or endless pyramid scheme. If it costs the franchisor \$10,000 out of a \$25,000 franchise fee to set a franchisee up in business the franchisor makes a \$15,000 profit. Some franchisors need this \$15,000 to pay their general operating expenses. Popular variations are to reap a large profit from building and equipping the location, selling a large initial inventory to the franchisee, etc. If the franchisee does poorly and his royalty payments are negligible the franchisor has to sell another franchise to cover his increased operating expenses. The franchisor now has two franchisees to support. If he still is not obtaining sufficient royalties to cover his operating expenses he must sell even more franchises.

This is an endless pyramid until it is cured or just ends.

To avoid this problem, a franchisor should be structured to be viable based on money it receives from existing franchisees, company stores, initial capital, etc. Not building a large profit into initial franchise payments is the best way to avoid the lure of selling franchises to losers for immediate cash. Further, if the franchisee fee is low the franchisor has its pick of better franchisees. Better franchisees are more likely to succeed and pay royalties every year, year after year and refer other prospective franchisees and less likely to sue the franchisor than unsuccessful franchisees.

## F. After The Agreement Is Signed

The franchisees are paying customers who the franchisor should bend over backwards to keep happy. Your masterful franchise agreement cannot make the franchisor money in the long run if too many of the franchisor/franchisee relationships sour. The best investment a franchisor can make is a continuous effort to, at a minimum, keep good relations with each franchisee and, at an optimum, create franchisee loyalty.

The franchisor will only succeed if what it provides the franchisees makes them more successful than they would be without the franchisor on their backs. The system is doomed if all that holds the franchisees is the cage of a harsh franchise agreement. The franchisor should provide such valuable start-up services for the money that good prospective franchisees will *want* to pay the reasonable franchisee fee. He should provide such valuable services to the franchisees thereafter that they *want* to pay their royalties, follow policy, and refer potential franchisees because they are happy, satisfied customers of the franchise system.

First month and first year franchisees should have frequent visits. All franchisees should be. Time spent hand-holding, being visibly concerned and delivering small favors and aid is one of your best investments.

The reason McDonald's succeeds is that it concentrates primarily on making its franchisees successful rather than trying to make a profit selling them equipment, goods and services. (A useful method of making this point is to give clients *McDonald's: Behind the Arches*, by John Love (1986), and reference them to pages 64-67. Because new franchisors look to McDonald's with reverence, the war story told on those pages will do more to get this point across than any amount of preaching).

Eventually, some franchisees will not comply with the franchise agreement and the franchisor will want to terminate them. Litigation should be avoided if possible as the cost of winning will likely be substantial and unrecoverable and a single franchisee victory a threat to the system's survival.

Mediation is usually preferable to litigation and arbitration often is. This is particularly true where the disputes concern an ongoing relationship rather than termination issues. If litigation cannot be avoided, be aware of termination laws and consider offering longer notice periods than required. Al Bishop Agency, Inc. v. Lithonia-Division of National Service Industries, Inc., 474 F. Supp. 828 (E.D. Wis. 1979). In contrast to franchise disclosure laws, franchise relationship laws actually change the terms of the franchise agreement. Thus, you must check applicable state laws before taking any action in this regard.

International franchising layers an additional set of laws on the franchisor's operations.

### G. Attorney Liability

A substantial barrier to entering franchise law is the potential for causes of action against franchisor's counsel. The clearest danger is being brought into a franchisee versus franchisor suit by the franchisor's claim that his failure to comply with the relevant franchise law, business opportunity law, antitrust law, baby FTC Act, etc., was due to his attorney's malpractice. Because franchisors operate in many states with differing and changing laws, franchisor counsel

spend unbillable time reading advance sheets, attending seminars, etc., to try to keep abreast of these developments as best they can.

Compliance with the substantive laws which affect a franchisor are beyond the scope of this article. The perfect franchise agreement and UFOC does not and never will exist and would quickly become outdated if they ever did. Practical problems and technical and arguable violations will invariably creep into the franchisor's operations due to its own dynamic character and the many dynamic complex laws of numerous jurisdictions as discussed above. (Bills are pending to enact Federal and Texas franchise relationship laws.) Whether franchisor counsel should have foreseen or prevented these matters can be argued by unhappy franchisors who previously instructed you to quit running up the bill.

In Meinershagen et al. v. Hughes & Luce et al., No. 89-13945-G (134th Jud. Dist. Dallas County, Texas 1992) the jury verdict found that the franchisor's attorney committed malpractice in his representation of the franchisor but that his malpractice did not damage the franchisor due to the franchisor's other problems. Avoiding the cost and lost stomach lining of even a successful defense to such an action requires more unrequested memos to the file, letters confirming advice and legal preventative maintenance than other attorney/client relationships. The situation is similar to a public offering of securities where a premium is paid and paperwork is generated due to the attorney's own possible legal exposure.

Another danger is causes of action against the franchisor's counsel from adversely affected franchisees Courtney v. Waring, 237 Cal. Rptr. 233, reh. denied, 191 Ca. 3d 1434 (1982), (Cal Ct. App. 1987) "Plaintiffs allege that defendants negligently prepared a franchise prospectus which failed to disclose material information . . . It is the attorney's knowledge regarding the purpose of his work [that prospective franchisees would rely on the disclosure document] which . . . establishes a duty to those whose conduct has been

influenced" Id. Cal. Rptr. at 239, Bus. Franchise Guide (CCH) at 17,812-3. This effectively applies the "due diligence" standard required of counsel in the preparation of securities disclosure documents to franchise counsel; See, Wulff, Is Franchisor Counsel Subject To Due Diligence Obligations? An Analytical Response, 4 Fran. L.J. Spring 1985 at 3. or state regulators.

"This obligation [of disclosure] is the independent obligation of all persons contributing to the disclosure including the franchisor and its counsel and accountant, to the extent of their professional involvement." Minn. S. Div. 1704 (M.S. 80C.04)(a)(1); "Every person who directly or indirectly controls a person liable under . . . [the subject act], every person in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable who materially aides in the act or transgression constituting the violation, are also liable jointly and severally with and to the same extent of such person, unless the other person who is so liable had not knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist." California Corporations Code § 31302. Similar language is found in the franchise statutes of Illinois, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, South Dakota and Wisconsin.

Franchise and business opportunities laws' prohibition against a "material misrepresentation or omission" is similar to the language of § 10(b)(5) that has been used to subject attorneys involved in the preparation of false or misleading securities offering materials to joint and several liability. SEC v. Frank, 388 F. 2d 486 (2nd Cir. 1968); Reece, Attorneys Beware: Increased Liability for Providing Advice to Corporate Clients Issuing Securities, 20:3 Akron L. Rev. 519 (Winter 1987); Feit v. Lease Co. Data Processing Equip. Corp., 332 F. Supp. 544 (E.D. N.Y. 1971) ("a lawyer for the issuer plays a unique and pivotal role in the effective implementation of the securities laws.

As a result, special duties are imposed on the lawyer . . . the duty of the lawyer includes the obligation to exercise due diligence, including a reasonable inquiry, in connection with responsibilities he has voluntarily undertaken.")

Privity of contract is not always necessary to establish such a cause of action. Some states use a "balancing test" in considering "[t]he extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him the degree of certainty that he suffered injury, the closeness of the connection between the conduct and the injury suffered, and the policy of preventing future harm." Lucas v. Hamm, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 364 P. 2d 685 (Cal., September 5, 1961); Fickett v. Superior Court of Pima County, 27 Ariz. App. 793, 558 P. 2d 988 (Ariz. App., December 23, 1976). Further, intended third party beneficiaries may not require privity of contract.

Finally, the attorney malpractice standard is whether the attorney "exercised the skill, prudence and diligence that attorneys of ordinary skill and capacity in the community commonly possess and exercise in performing the tasks which they undertake." Rules have been proposed for certification of franchise practitioners. Fine, Model Standards for Recognition as a Specialist in Franchise Law, 4 Fran. L.J. Summer 1984 at 5. While they have not been adopted, they will be urged by the malpractice plaintiff's attorney as the standard against which your work for the franchisor should be judged.

## VI. CONCLUSION

This paper's focus on franchising's problems should not obscure the fact that there is good, honest money to be made as a franchisor or franchisee. If franchising is approached intelligently, it can be a money-maker for all concerned.



**ATTACHMENT A**  
**DISTRIBUTION STATUTES (January 1993)**

STATE	FRANCHISE SALE DISCLOSURE		BUSINESS OPPORTUNITY		RELATIONSHIP
	REGISTRATION	NO. REG.	REGISTRATION	NO. REG.	
FEDERAL		X		X	
ALABAMA				X	
ALASKA					X
CALIFORNIA	X		X		X
CONNECTICUT			X		X
DELAWARE					X
FLORIDA	X		X		X
GEORGIA				X	
HAWAII	X				X
ILLINOIS	X				X
INDIANA	X		X		X
IOWA			X		X
KENTUCKY			X		X
LOUISIANA				X	
MAINE			X		
MARYLAND	X		X		
MICHIGAN	X		X		
MINNESOTA	X		X		
MISSISSIPPI		X			X
MISSOURI					X
NEBRASKA					X
NEW HAMPSHIRE			X		
NEW JERSEY					X
NEW YORK	X				
NO. CAROLINA			X		
NO. DAKOTA	X				
OHIO				X	
OKLAHOMA			X		
OREGON	X	X			
RHODE ISLAND	X				
SO. CAROLINA			X		
SO. DAKOTA	X		X		
TEXAS			X		
UTAH			X		
VIRGINIA	X			X	X
WASHINGTON	X		X		X
WISCONSIN	X				X

## ATTACHMENT B

HOW TO REVIEW A FRANCHISE OFFERINGTABLE OF CONTENTS

	<u>PAGE</u>		
<b>I. In General.....</b>	<b>K-34</b>	<b>XIV. The Franchise Contracts.....</b>	<b>K-42</b>
<b>II. Who Is The Franchisor?.....</b>	<b>K-34</b>	<b>XV. Anything Strange.....</b>	<b>K-42</b>
<b>III. Management Personnel.....</b>	<b>K-35</b>	<b>I. IN GENERAL</b>	
<b>IV. Franchisor's Litigation .....</b>	<b>K-35</b>	Every legitimate franchisor has a franchise offering circular. The prospective franchisee should not purchase a franchise if the franchisor has not timely provided an offering circular, not complied with applicable registration and disclosure laws or suggests tricks to evoke compliance. Such a franchisor may be destroyed in subsequent litigation with regulators or other franchisees.	
<b>V. How Does The Franchisor Make Its Money .....</b>	<b>K-36</b>	The offering circular will either be in a FTC format having the 21 categories of disclosures set forth in 16 C.F.R. § 436 or in the Uniform Franchise Offering Circular (UFOC) format having 22 "Items." New franchisors may use the FTC format to avoid the expense of an audited financial statement during the first year, to avoid the more stringent UFOC disclosures or because franchisor's counsel does not yet realize that a successful franchisor must ultimately use a UFOC format. An FTC format is a negative indication.	
<b>VI. Cost Of Opening The Business .....</b>	<b>K-36</b>	The following questions can generally be discussed with the prospective franchisee while skimming the offering circular and attached agreements. Your only chance to convince him how serious this business transaction is may be to quickly locate and explain the more dreadful aspects of the purchase in your first office conference.	
<b>VII. What Will The Franchisor Do For The Franchisee?.....</b>	<b>K-36</b>	Most of the review concerns business rather than legal aspects. Most prospective franchisees need some guidance in this area. Further, if you do not give business as well as legal advice and the franchisee fails he may feel	
<b>VIII. Is There A Protected Area? .....</b>	<b>K-37</b>		
<b>IX. Is The Franchisor's Trademark Useful?.....</b>	<b>K-38</b>		
<b>X. What Is The Franchise's Term? .....</b>	<b>K-38</b>		
<b>XI. Will The Franchise Make Money? .....</b>	<b>K-39</b>		
<b>XII. What Is The Franchisor's Track Record? .....</b>	<b>K-40</b>		
<b>XIII. How Are The Franchisor's Finances? .....</b>	<b>K-40</b>		

you failed to point out the warning signs indicating that failure was likely.

## II. WHO IS THE FRANCHISOR?

UFOC Item 1, The Franchisor and Predecessors, in combination with Items 2-5 describe how stable and credible the franchisor is. Discuss the effect of the franchisor's inability to perform as a reason for needing a credible franchisor. The personal histories of the franchisor's personnel in Item 2 and the litigation in Item 3 will help you make this judgment.

### A. Duration

The longer the franchisor has been in existence as a substantial franchisor, the greater the likelihood it will survive throughout your franchisee's need for assistance. Twenty-five outlets for 10 years is better than one outlet for 100 years or 100 outlets for one year.

### B. Structural Continuity

Frequent changes of ownership or restructuring are negatives. They may indicate that the former owner who made the concept successful and helped nurse franchisees to success has moved on and been replaced by greedy money men or that the franchisor is restructuring to stay afloat.

### C. Competitive Line Of Commerce

If the franchisor claims in Item 1 that he has no competition, which is surprisingly common, this is a negative factor possibly indicating either hubris or deceit. Item 1 will more likely state that this is a competitive line of commerce. This is a good place to advise your client to talk to other franchisors who sell similar franchises. Your client will otherwise not be an intelligent purchaser.

Publications available for locating competitive franchisors are:

- *Franchise Opportunities Handbook*, published by the United States Department of Commerce. Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

- *The Franchise Annual*, published by Franchise News, Inc. 7828 Center St., P.O. Box 550, Lewiston, N.Y. 14092.

- *The Franchise Handbook*, published by Enterprises Magazines, Inc. 1020 N. Broadway, Suite 111, Milwaukee, WI 53202

- *Franchise Opportunities Guide*, published by the International Franchise Association. 1350 New York Avenue N.W., Suite 900, Washington, D.C. 20005.

- *Wall Street Journal*, Each Thursday edition contains a full page of business opportunity advertising.

### D. Other Lines

Franchisor distribution through other channels, such as Haagen Daz selling its ice cream in grocery stores in competition with its franchisees, is a negative.

## III. MANAGEMENT PERSONNEL

UFOC Item 2, Identity and Business Experience of Persons Affiliated With The Franchisor; Franchise Brokers, provides information about Franchisor's top management.

### A. Industry Experience

Is top management comprised of persons knowledgeable in the basic aspects of the franchise (i.e., "hands on" people who know how many pickles to put on a quarter-pounder, such as Ray Kroc), or are they promoters, here today, gone tomorrow? Look at these individuals' backgrounds. It is a negative if they have not spent most of their careers in the subject line of commerce.

### B. Track Record

The franchisor's personnel may have come from failed franchise chains.

"Obviously, what prospective franchisees should do is to consider past performance. Take [former] Command Performance's Chairman Richard J. Wall, a gravelly voiced, yarn-spinning 59-year-old who has been in franchising, he says, for 27 years. But Wall's lack of ongoing commitment to any one franchise - he bails out after building up a network - seems to jeopardize

franchisees' long-term investment. What happened to his former franchises? Esther Williams Swimming Pools has vanished. Bonanza Sirloin Pits made him a millionaire, he says when he sold out. Bonanza then went public. Since 1973 its return on equity has exceeded 7% once; the company has had management and franchisee problems." *Forbes*

Twenty months after this *Forbes* article, Command Performance filed for Chapter 11 reorganization (but survived under new leadership and is once again a viable chain).

### C. Management Firms

Many failed franchisors have had affiliated firms provide management services to the franchisor. Why must the principal officers of the franchisor set up a separate company to provide management services? A legitimate reason may be to save taxes. Other reasons may be to avoid some financial disclosures, (the Offering Circular must contain the financial statements of the franchisor, but sometimes not the affiliated company), or protect assets from franchisees if the franchisor fails. On balance, affiliated management companies are a negative.

### D. Franchisee Input

Current franchisees should describe the franchisor's management team as aggressive, willing to work with franchisees, and motivated to make the franchise system expand and succeed.

### E. Management Depth

Franchisor's management should have several individuals with complimentary skills who have many years of experience in the subject line of commerce. A one man show, with a spouse and children as the other principal actors is a negative.

## IV. FRANCHISOR'S LITIGATION

UFOC, Item 3, Litigation, can provide substantial information.

### A. Number of Suits

A number of significant franchise lawsuits relative to the total number of franchises indicates that some franchisees believe the franchisor lied, did not succeed financially, believe they were mistreated or otherwise want out. The fact that the franchisor won the suits may only show that the franchise investment so impoverished the franchisees that they could not afford to fight.

### B. Call Attorneys

Often the best "dirt" on a franchisor can be obtained by calling the franchisee litigant's attorneys (although generally the franchisor will have provided as little identifying information as possible). A less expensive option is to have your prospective franchisee call the listed franchisee litigants although they are often harder to locate.

### C. Type of Suits

Even the sanitized description of the parties' claims may help paint a picture of the franchisor. The Franchisor's description of litigation may be more accurate than truthful. For example, after losing the jury verdict a franchisor may settle by paying the verdict amount in exchange for a favorable judgment. Only the judgment is disclosed. Further, some franchisors fail to list all material litigation.

## V. HOW DOES THE FRANCHISOR MAKE ITS MONEY?

UFOC Items 5, 6, 8 and 9 disclose the franchise fee, royalty rate, and other required payments to the franchisor. These disclosures, may help reveal the purpose of the franchisor. Was the franchisor set up primarily as a conduit for the sale of products by companies owned by the management or relatives of the management of the franchisor? Was the franchisor started primarily as a lessee of property owned by management or relatives of franchisor's management? These are negatives. If the franchisor profits at the expense of its franchisees rather than due to their prosperity, independents and the franchisees of other franchise systems will have a price edge.

### **A. Required Purchases**

Goods or services that can only be purchased from the franchisor or specified sources may be undisclosed sources of profit to the franchisor and an unnecessary expense to the franchisee. Many franchisors make most of their money selling marked-up equipment. The client should investigate other possible sources as few goods are truly unique.

If franchisees must buy material amounts of inventory and supplies from the franchisor or designated suppliers, the client should quiz other franchisees about the distribution source's reliability and quality control standards and about the suppliers' pricing policies and credit terms. If franchisees complain about irregular deliveries, bad merchandise or price gouging, the client should be wary.

### **B. Use of Advertising Contributions**

Try to determine whether the franchisee's required advertising contributions are used to promote the sale of new franchises (which puts initial franchise fees in the franchisor's pocket, or for advertising the system's goods and services in ways that will help your franchisee's sales. Some franchisors assesses charges for advertising and/or administrative services as a hidden source of profit. You are much better off if advertising fees go into trust fund which reports income and expenditures.

### **C. "Other" Fees**

Item VI should list reoccurring or isolated fees or charges. The franchisee should determine if the services he is required to purchase from the franchisor can be obtained for a lesser cost or at a better quality elsewhere.

### **D. Unnecessary Controls**

The franchisor may require the franchisee to purchase goods or services from the franchisor, limit the goods or services the franchisee can sell, limit the franchisee's market area, require that goods or services be purchased from the franchisor or franchisor selected sources, require certain expenditures on advertising, permit the franchisor to terminate

the agreement if a minimum sales volume is not maintained, etc. The negatives must be outweighed by benefits provided.

## **VI. COST OF OPENING THE BUSINESS**

UFOC Item 7, Franchisee's Initial Investment, describes the franchisee's initial cash outlays.

### **A. Accuracy**

Initial investment estimates can be very misleading. The client should prepare and verify his own list of likely expense items for his store in his trade area. This is one way of gauging the franchisor's honesty.

### **B. Debt Service**

Few initial investment estimates include the cost of debt service in spite of the fact that most new businesses, franchised or not, begin on borrowed money.

### **C. Total Obligation**

Explain to the franchisee that the "initial investment" disclosed by the franchisor is merely the up-front cash needed to turn the key in the door once. This is not what the franchisee will lose if the business fails. If the real estate lease is \$50,000 a year for five years, then the real estate lease obligation is \$250,000 not the \$4,166 per month disclosed in Item 7. Likewise, if the cost of leasing equipment is \$1,000 per month, for four years, the franchisee's equipment lease obligation is \$48,000. Identify a number of these continuing obligation type payments, multiply them out through their full terms and total for the prospective franchisee. The resulting sum, usually hundreds of thousands of dollars, may sober him.

## **VII. WHAT WILL THE FRANCHISOR DO FOR THE FRANCHISEE?**

UFOC Item 11, Obligations of the Franchisor; Other Supervision, Assistance, or Services, describes what the franchisor will do for the franchisee. Although most offering circulars are reasonably specific concerning

initial training because this is required by the UFOC, they typically provide no specific description of on-going support. If your client is relying on specific on-going support as a reason for buying, he should try to get these representations and agreements in writing.

### **A. Training**

Some training programs consist primarily of generic business advice such as small business management, public relations, accounting and bookkeeping, a little business law, etc. This can be obtained from the small business administration, any university or bookstore. Look for nitty gritty topics such as "When to change the cooking oil," "How to upgrade customers to higher priced items," etc. University professors are a negative because they do not have practical experience. The instructor should have twenty years of rebuilding automatic transmissions if the subject is rebuilding automatic transmissions.

Discuss this with the prospective franchisee before he visits the franchisor's headquarters. While the franchisor will not let your client take the instructional materials before closing (you can offer a confidentiality agreement but this may harm the client if he does not buy but stays in the industry), the franchisor will typically let the prospective franchisee look at the materials. If coached ahead of time, this may be enough to let the client determine if the training will really be of substantial value.

The cost of initial training is typically the initial franchisee fee. Some training costs, such as transportation to and from the training, room and board, being out of work and not bringing in any money for two or three weeks, etc. may not have been disclosed.

### **B. Work In A Similar Business**

Urge your client to work in a similar business (for free, if necessary, and for a franchisee of same franchisor, if possible) before deciding to purchase. The franchisor's promised training, trade secrets and operational assistance may be delivered by the equipment manufacturer to all purchasers or quickly obtainable through hands on experience.

### **C. Advertising Manual**

Most franchisors give their franchisees an advertising manual with useful advertising proofs. This can save the franchisee thousands of dollars. Prospective franchisees should see this manual as it gives an insight concerning the franchisor's concept of quality and assistance. The franchisor may only have a few poorly designed advertisements directed toward selling new franchisees.

### **D. Check Out Suppliers**

If the franchise's success depends on the franchisor's ability to deliver supplies, the client should contact the franchisor's suppliers to verify the relationship between the franchisor and the suppliers and to determine if the franchisee can buy direct.

### **E. Control Type Assistance**

"Assistance" such as inspection visits, training to use franchisor's paperwork and computer reporting systems, standardized controls, etc., may be directed more toward training the franchisee to turn himself in rather than helping the franchisee.

### **F. On-going Benefits**

After the franchise has been in operation and learned the ropes for six months, the only remaining franchise system benefit may be the right to use the franchisor's trademark and lower prices for supplies due to mass buying power. If the trademark and buying power do not produce significant advantages to the franchisee, he should consider why he is agreeing to pay a royalty on gross revenue for many years after he no longer receives a commensurate benefit.

### **G. Required Purchases**

A poisoned benefit to look out for is the franchisor's assistance in selecting suppliers and requiring the franchisee to purchase supplies and inventory from the franchisor or a company affiliated with the franchisor.

"My belief was that I had to help individual McDonald's operators succeed in every way I could. Their success would ensure

my success. But I couldn't do that and, at the same time, treat them as customers. There is a basic conflict in trying to treat a man as a partner on the one hand, while selling him something at a profit on the other hand." Ray Kroc, quoted in *Behind the Arches* (1986) page 67.

#### **H. Suppliers Affiliated With Franchisor**

If a supplier is a subsidiary or parent of the franchisor, the franchisor is unlikely to protect its franchisees from poor prices, quality, or service. If a franchisee is truly free to buy from any qualified source, the franchisor can give impartial advice to franchisees, who do not have the means to evaluate competing products.

### **VIII. IS THERE A PROTECTED AREA?**

UFOC Item 12, Exclusive Area or Territory, discloses whether the franchisee will have a protected area.

#### **A. Size of Area**

The advantage of a large protected area is that the franchisor cannot appropriate your client's success by putting other units there if the client's franchise prospers. The disadvantage is that no other franchisees will be in the area help your client develop critical mass there.

Sometimes prospective franchisees negotiate too much exclusive territory for themselves. If the business is one which requires several stores in an area to succeed and the prospective franchisee cannot itself set up those stores, biting off more territory than the franchisee can service may be counter-productive. For some businesses several franchises clustered in a market may create a market presence and have a better chance of survival than a single store lost in the clutter of competition. The first McDonald's restaurants in San Antonio, for example, did not do well until additional stores were added in the 1970s. Your client needs to be aware of this problem and decide whether it will affect him.

#### **B. Development Schedule**

The franchisor may condition the grant of a large area to the franchisee agreeing to a

multiple outlets development schedule multiple outlets. Often, the pressure of opening new stores on schedule causes the franchisee to expand on a schedule that is beyond his capabilities and which sucks time, energy and money away from the initial store. This can kill the franchisee.

#### **C. Site Selection**

Ask about the franchisor's expertise in this critical area. (The franchisor's representations in response will be useful in litigation if the site proves bad.) The client should also do market analysis, i.e. identifying his target market by area, age group and justifying why his selected location is best for serving that target income level, etc. market.

#### **D. Protection Against Franchisor Using Other Channels**

The franchise agreement should prohibit the franchisor from invading your client's trade area through direct mailing, sales through discounters, shopping centers, etc., after your client has established the franchisor's mark there. Some franchise agreements expressly reserve to the franchisor the right to certain accounts in the franchisee's area and the right to sell through other channels of trade.

### **IX. IS THE FRANCHISOR'S TRADEMARK USEFUL?**

UFOC Item 13, Trademarks, Service Marks, Trade Names, Logo Types, and Commercial Symbols, describes the franchisor's trademark position.

#### **A. Marketable**

The trademark should bring in more of the right kind of customers to the franchisee's business than he could attract on his own. The customer's perception that he will get what he wants if he goes to a business identified by the franchisor's trademark is a large part of the franchisor sells to the franchisee and what the franchisee sells to the public.

On the other hand, a well-known name will attract only a certain type of customer and

those customers will have a predetermined set of expectations your client must meet. Is the franchisor's trademark so little known that the franchisee will essentially introduce the trademark to his trade area. Do competitors have more valuable trademarks?

### **B. Federally Registered**

The franchisor should have a federal principal register trademark registration to exclude competitors from using its trademarks in connection with similar goods and services. Trademark registrations held by a management company may show a plan to insulate assets against franchisor's failure.

## **X. WHAT IS THE FRANCHISE'S TERM?**

UFOC Item 17, Renewal, Termination, Repurchase, Modification, and Assignment of the Franchise Agreement and Related Information, discloses the franchise's term and its renewal requirements.

### **A. Loss of the Franchise**

Successful small businesses produce two benefits to the owner, profits and accumulating equity. It should be emphasized to the franchisee that he is unlikely to die still owning and operating the franchised business. He is more likely to either (1) sell out or (2) be terminated or not renewed. A franchised business is not an asset that can be built up and then handed down from father to son. When the franchise agreement ends the franchisee will likely be completely dispossessed of his business without any compensation whatsoever. Often it must be essentially repurchased at auction after the initial term and renewals have expired. In this respect owning a franchise is more similar to leasing a business than to owning one.

### **B. Duration**

The typical prospective franchisee does not think of end game. Does the expected duration of the agreement justify the investment?

This duration should be sufficiently secure to protect against the franchisor from taking the business before the franchisee has an opportunity

to make a reasonable profit. Further, the franchisee should be able to sell the business he has built at a fair market price without unreasonable restrictions.

### **C. Renewal Terms**

Make sure the client understands that his business can be taken away at the end of its first term if not renewed and at the end of the renewal period and the conditions of renewal. If possible, the agreement should be renewable on its same terms and without an increase in royalty rate. The franchisor may otherwise raise the rate on renewal. Thompson v. Atlantic Richfield Co., 649 F. Sup. 969 (W.D. Wash. 1986). Try to obtain the franchisor's agreement that renewal will be under the original franchise agreement rather than the "then current agreement". Franchise agreements typically become more oppressive as the franchisor matures and becomes less dependant on selling new franchises.

### **D. Post-Termination Duties**

The importance of the numerous minute provisions justifying and implementing termination, winding up the business on termination and covenants not to compete need to be emphasized. Post-termination obligations, covenants not-to-compete, agreements to sell the business to the franchisor at a ridiculous price upon termination, etc. should be reviewed.

The effect of a post-termination covenant not-to-compete may be to bar the franchisee from the trade he spent 20 years learning, an effective forfeit of any equity in his business.

### **E. Forum Selection, Etc.**

The franchise agreement's forum selection, liquidated damages clauses and their likely consequences should be noted. Few franchisees can afford litigation in the city of the franchisor's headquarters.

### **F. Transfer**

While potential franchisees typically do not think far enough ahead to be concerned about transfer terms, it is as likely as not that the franchisee will want to sell the business

sometime during the franchise's term. While franchisors have a legitimate right to restrict franchise ownership to objectively satisfactory individuals, some franchise agreements impose byzantine and confiscatory terms in the sale approval section. This may include a franchisor right to purchase formula which purchases the business at book value, a low earnings multiple or with no credit to the business' good will.

### **G. Default**

A franchise agreement's default provisions run the gambit from substantive, failure to pay royalties; to trivial, failure to observe mandated business hours; to vague, "breach of any term herein." Most events of default appear reasonable in the abstract. Few franchisees, however, operate strictly within the franchisor's rules and technical defaults may be used to weed out troublesome franchisees.

### **H. Releases**

Many franchise agreements require the franchisee to give unilateral general releases as a condition of practically anything desired from the franchisor, renewal, approval of transfer, etc. You should attempt to negotiate for mutuality.

### **I. Arbitration**

Arbitration provisions can be fair. They are also sometimes drafted, in combination with waiver, liquidated damages, shortened statute of limitations, etc. to cripple franchisee in any claim against the franchisor.

## **XI. WILL THE FRANCHISE MAKE MONEY?**

### **A. Earnings Claims Not Made**

UFOC Item 19, Actual, Average, Projected, or Forecasted Franchise Sales, Profits, or Earnings will often contain a short statement to the effect that the franchisor makes no representations concerning expected profits.

Your prospective franchisee has some factual basis for the belief. He will make a profit if he purchases the franchise. When Item 19 states that the franchisor makes no

representations concerning the franchisee's projected earnings, the franchisor's sales representatives will likely either have made verbal representations or suggested that the franchise confer with the franchisor's existing franchisees. Your prospective franchisee should call existing franchisees to find out how they are doing, but with several warnings.

### **1. FAVORED FRANCHISEES**

Many franchisors encourage prospective franchisees to call favored franchisees who give glowing reports concerning profits. Favored franchisees may be subsidized in some way, be in a particularly lucrative market, be particularly aggressive franchisees, etc. These conditions may not equally apply to your prospective franchisee. It is unlikely the franchisor will direct your prospective franchisee to unhappy franchisees.

### **2. COMMISSION SALES AGENT FRANCHISEES**

Many franchisors reward franchisees who bring new franchisees into the system. This turns the franchisees into commission sales agents. Relying on such franchisees as the sole source of vital information is like relying on any other commission sales agents, such as used car salesmen.

### **3. CALL DISSIMILAR FRANCHISEES**

If an Item 19 disclosure is not made, the client's calls to the Item 20 franchisees (discussed below) concerning their sales, earnings, operating results, etc., are doubly important. If the franchisees are not willing to speak candidly, this is itself informative. Your client should call as many varied franchisees as practicable. Some should be of long standing; new; in rural areas; in urban areas, etc. Be aware that existing franchisees will not know for sure that your client is not a representative of the franchisor taping the conversation. You are unlikely to get many candid negative reports.

### **B. Earnings Claims Made**

If earnings claims are made in Item 19, carefully study its notes and compare them with the expense data of Items 5-7.

## 1. COMPARABILITY

It is particularly important to note differences in the franchisees used as the basis for the information disclosed in Item 19 as opposed to the circumstances your prospective franchisee is likely to face. The critical factors should be determined depending on the line of commerce and used in analyzing the data provided.

### a. Cluster Effects

Most of the franchisees upon whom the disclosed information is based may be clustered more centrally to the franchisor's headquarters and main clusters of franchisees than your franchisee will be. Thus, the existing franchisees on whom the Item 19 data was compiled are more likely to receive substantial central support than your franchisee.

### b. Geographic Relevance

Geographic and urban versus rural location of the existing franchisees is important. A high dollar volume for existing franchisees based on franchises in the southern United States is unlikely to be a good predictor for a snow-cone franchise in Alaska. The franchisor may be able to provide a regionally based earnings claim or data.

### c. Duration

The profitability of older franchises may not be indicative of a new one.

### d. Comparability

The units used to provide the data often include franchisor owned units which may have fewer expenses and other advantages. Prototypes and franchises with first-time customer patronage - brought on by heavy advertising and promotional expenditures may not be comparable. There are many ways to be accurate without being truthful.

### e. Non-Repeating Franchisees

The franchisor's cumulative data will necessarily not include non-reporting franchisees. This may be a problem where the reason they are not reporting is financial distress.

### f. "Average"

Averages may be mean, (divide total result by number of reporting stores), median (the middle value, 50% of reporting stores higher and 50% lower) a modal (result most often obtained). A small percentage advantageously situated stores with atypically high results can skew the average above what your franchisee should realistically expect.

## 2. HISTORICAL

With few exceptions, the data presented in Item 19 is historical only. Few franchisors project results. Many of the effects that caused those results will not be present for your franchisee's store.

## 3. COST AND PROFIT

If cost and profit is disclosed, the ownership and other factors separating the sample chosen from those not included in the sample should be looked into. For example, company owned units may not pay a royalty, may receive more franchisor support, etc.

## 4. SHOW TO CURRENT FRANCHISEES

The client should show the earnings claim to several local franchisees and ask if they did as well.

## 5. NO GUARANTEE

Stress that the franchisor salesman's representations and the franchisor's earnings claims to the contrary, the proposed franchised business' success is not guaranteed. It may fail. If it fails the franchisee will not only have lost his up front investment but will likely be on a long term real estate lease, owe monies to suppliers and employees, for taxes, etc.

## **XII. WHAT IS THE FRANCHISOR'S TRACK RECORD?**

UFOC Item 20, Information Regarding Franchises of the Franchisor, lists the names, addresses, and phone numbers of current and some past franchisees.

### **A. Best Predictor**

The best predictor of whether the purchase is a good deal are the comments of the franchisor's current and past franchisees. Insist that the prospective franchisee call a large number of randomly selected franchisees (in addition to the ones the franchisor suggests he call).

### **B. The More The Better**

Generally, the more franchises a franchisor has and the longer he has had them the more stable the system is and the more likely it is to survive to help your franchisee.

### **C. Interview Existing Franchisees**

Encourage the prospective franchisee to physically interview franchisees face to face who are located geographically distant from the franchisor's headquarters. Although the statements of the franchisees should not be taken at face value, they are an indication of how the franchisor will likely treat your specific prospective franchisee. The client should ask whether the franchisor's site selection, training programs, and assistance are useful, how competent and available its field support personnel are, how useful its advertising and marketing programs are, whether a franchisee association helps share and cure common problems, and whether they would sign up with the franchisor if they had it to do over again.

### **D. Interview Terminated Franchisees**

Item 20 requires the franchisor to identify franchisees who have been terminated in the last year in that state. Strongly encourage your perspective franchisee to call these terminated franchisees. If there are few or none provided for your state, ask the franchisor for the lists provided for other states.

## **XIII. HOW ARE THE FRANCHISOR'S FINANCES?**

UFOC Item 21, Financial Statements, requires that the franchisor's financial statements be attached. The financial statements are where bodies are buried and the accompanying notes the likely place to find them. The franchisee can engage an accountant to review this financial data. Typically, however, he will not make this investment in due diligence.

The franchisor should have enough capital and net income to provide the support, advertising, promotions and expansion your prospective franchisee expects for the duration of the franchise agreement.

### **A. Capital**

Is the franchisor sufficiently capitalized? A Franchisor with minimal net worth, usually designated as total stockholders' equity, or operating losses may not provide the 20 years of support your client wants. A franchisor with a net worth of \$1,000,000 presumably has \$1,000,000 to provide services to your client. The substance may, however, be less. Subtract as suspect from stated net worth assets such as:

1. Goodwill justified by monies spent on start-up advertising and other costs (rather than their current value);
2. Accounts receivable from affiliated companies and other related parties;
3. Loans to officers, owners, their relatives and other related parties;
4. Substantial accounts receivable from (possibly disgruntled) franchisees.
5. Goodwill acquired from entities in which the officers or principal owners had a controlling interest;
6. Mark-ups of assets purchased from affiliated companies, officers and principal owners; and

### **B. Operating Profits**

A franchisor with years of operating losses may not survive. Determination of what is substantial in the stated operating profit

requires looking at the sources of income and the payees of expenses.

### **C. Ponzi Franchising**

If the franchisor's revenues primarily come from new franchise sales rather than royalties, the franchise is less likely to be a good investment. It may cost the franchisor \$10,000 out of a \$25,000 franchise fee to set a franchisee up in business and the franchisor used the remaining \$15,000 to pay general operating expenses. If the franchisee does poorly and his royalty payments are negligible the franchisor has to sell another franchise to cover the franchisor's increased operating expenses. The franchisor now has two franchisees to support. If he still is not obtaining sufficient royalties to cover his operating expenses he must sell even more franchises. This functions as an endless pyramid until the bubble bursts. Popular variations are to reap a large profit from building and equipping the location, selling a large initial inventory to the franchisee, etc.

### **D. Accrued Accounting**

Accrued rather than cash accounting may be a legitimate accounting tool but may also be a smoke screen. Income accrued but not yet received from affiliated companies, officers and principal owners, disgruntled or failing franchisees should be analyzed and possibly deducted from net profit.

### **E. Expenses**

Expenses paid to affiliated companies and officers who are principal owners should be analyzed to see if they reflect market rate costs or are unreasonably low - such as rent on a building leased to the franchisor by the officers. Below market costs are unlikely to be sustained.

### **F. Assets**

A large accounts receivable comprised of past due royalties from franchisees may indicate that current franchisees are not profitable, not happy or otherwise not paying royalties. This may be reflected in the accompanying notes together with an "allowance for doubtful accounts." As noted above, accounts receivable

from affiliated companies and loans to officers or other related parties may never be received.

An item entitled something like "excess of cost over fair value of net assets acquired" may indicate a leveraged buy-out in which the acquiring company paid more for the assets of the acquired company than the assets were valued at on the acquired company's books. This difference or excess is the "premium" paid to the shareholders of the acquired company due to the acquiring company believing it can do better with the acquired company. It is doubtful that this "asset" will benefit a potential franchisee. On the contrary, it may indicate that the new management must quickly wring profits out of the franchisees. Similar "asset mark-ups" may occur when the franchisor acquires a property with a substantial goodwill value.

### **G. Liabilities**

Substantial short term liabilities may show that the franchisor will not be able to meet its obligations in the next twelve months. Substantial long-term debt will retard franchisor's ability to perform for years and increase its need to obtain cash from franchisee.

### **H. Accountant's Notes**

Because the franchisor's financial statements after the first year must be audited and because the trend has been to hold accountants liable for negligence to third parties who can reasonably be foreseen to rely on the audit, the accuracy of audited statements prepared by reputable accounting firms are usually reasonably reliable. A franchisor may, however, go to its local friendly neighborhood accountant to obtain an "appropriate" financial statement. The reputability of the accountant who prepared the financial statement is thus a consideration.

The accountant's notes should be scrupulously examined with a cynical eye. The more obtuse an explanation for items such as doubtful accounts, the more likely the note is to be hiding something of importance. As discussed above, the notes should be carefully read because they are where you will find the buried bodies, if anywhere.

For example, the contingent liability notes should be looked at to see what the contingencies are. Some franchisors, for example, guarantee their franchisees' real estate leases. If the franchisees fail, they may take the franchisor down with them. The franchisor may have \$10,000,000 of such contingent liabilities, but due to its estimate of a 1% probability of loss, only list the matter in the financial statement as a \$10,000 liability. The franchisor's liabilities are understated if you know the subleasing franchisees are failing.

### **I. Management Companies**

This is often not disclosed anywhere but in the financial statements. The mere existence of a management company is a slight negative. If it is receiving obscene profits it is a major negative.

### **J. Stale Report**

The UFOC required annual audited financial. If the financial are more than a few months old, the client can ask for unaudited interim period updates, particularly a recent balance sheet and a year-to-date income statement. If the interim statements show unusual swings, the client can ask the franchisor to explain and justify them.

## **XIV. THE FRANCHISE CONTRACTS**

### **A. Generally**

All agreements the prospective franchisee is required to sign as a condition of obtaining the franchise should be attached to the UFOC. In addition to the franchise agreement, this may include real estate leases or subleases, equipment leases, financing agreements, loan or credit agreements, and cooperative advertising agreements. These franchise agreements often contain cross-default clauses. Counsel should give the ancillary agreements the same care and attention the franchise agreement itself receives.

Because not all are always attached to the UFOC, counsel should inquire about them.

### **B. Advertising Contributions**

Prospective franchisees typically focus almost entirely on the 5% monthly royalties and not on the 2-4% advertising contributions. Since advertising contributions are also calculated on the franchisee's gross revenues, they can be a significant part of a franchisee's cost of doing business. Many franchisors lull franchisees into ignoring the advertising contribution issue by pointing out that the franchisor has never yet required any franchisees to pay advertising contributions. At a later date, however, the franchisor will likely rely on the contractual term which will substantially increase the franchisee's expenses.

Control over this money is important. The more actual control franchisee counsels and associations have over the money the better. The larger the proportion of the advertising contribution directed to your franchisee's local regional or state advertising the better advertising contributions are sometimes used to advertise in other areas of the country and for the sale of new franchises rather than ways that benefit the franchisee.

### **C. The Operations Manual**

Franchise agreements typically have a clause, buried in the middle of a paragraph on page 45, that the franchisor may supplement and amend the franchise agreement by changing its operations manual. While franchisors need to retain flexibility to manage and adapt the franchise system to meet future circumstances, the potential for abuse is apparent. Counsel should explain this problem to the prospective franchisee and, if possible, restrict the franchisor's ability to change the deal by changing the operations manual.

## **XV. ANYTHING STRANGE**

Strange things are incapable of being neatly listed. As in any other context, however, deviations from the norm often provide important clues. Franchising has standard operating procedures. For example, most franchisors use a UFOC rather than an FTC offering circular format. If the subject offering circular is in an FTC format, your suspicions

should be aroused concerning whether the franchisor is attempting to evade some UFOC disclosures.

A franchisor's failure to include the normal repertoire of oppressive venue fixing, covenant not-to-compete, liquidated damage provisions, etc. should catch your attention. While the absence of these provisions may be useful to your particular franchisee, the commercial marriage aspect of the franchise relationship requires that you want the franchisor to be intelligent and strong. A franchisor who omits standard oppressive covenants from your franchisee may be destroyed by its inability to keep other franchisees in line. This may harm your franchisee's prospects of obtaining long-term beneficial assistance from the franchisor.

Further, the absence of the standard oppressive clauses may indicate too much eagerness by the franchisor for new franchisees. Perhaps the franchisor needs numerous additional initial franchise fees to pay operating expenses. As discussed above, that would be a substantial negative factor.

**ATTACHMENT C****ADVICE TO THE PROSPECTIVE FRANCHISEE****A. RULE #1: COMPARE YOUR ALTERNATIVES**

1. What will the franchisor do for you that you could not do for yourself with the franchisee fee and royalty? Use "T" charts to compare buying the franchise with opening a similar business on your own, going with another franchisor, going into another line of commerce, staying where you are, etc. There are too many things to consider to do it in your head. If you have more than one alternative you can use more columns.

**[EXAMPLE "T" CHART]****SHOULD I BUY AN XYZ FRANCHISE?****YES****NO**

1. I need the franchisor's training because I don't know how to start and run a restaurant.

1. I could work in a similar restaurant for training, get training from equipment sellers, or pay someone to train me.

2. The franchisor's trademark will pull in 20% more sales volume than if I create and use my own trademark.

2. The 5% royalty I will pay on gross revenues will exceed the profit on the extra sales I will make because of the franchisor's trademark.

3. The franchisor is the only source of the necessary equipment.

3. Because I called equipment suppliers, I know I can get equivalent equipment directly for less.

4. I can combine my local advertising dollars with those of other franchisees to get national and local advertising that will increase my sales

4. Most of my sales will come from customers within a five minute driving radius who can be reached with direct mail, community newspaper, billboards, etc.

5. Etc.

5. Etc.

2. Show your charts to as many advisors, franchisees, and persons in that line of business as you can for their input.

you can work "undercover" for a franchise or a similar business. Go out of town if necessary.

3. Work in the line of business before you buy a franchise. There is no excuse or not spending a week or a month in a similar business to learn what everyone in that line of business knows. You can be up front by going to a similar business in another city and offer to work for free pressing clothes, flipping burgers, etc., or

a. The most important discovery may be that you hate the business.

b. You may learn that you do not need the franchisor's training: everyone in the business knows how to do it; the equipment and service providers give free training; you can get the training elsewhere.

c. Most customers may patronize this kind of business due to its location, quality, and individual reputation rather than the franchisor's trademark.

4. What do competing franchisors charge, what do they provide, and whose franchisees are more typically successful and happy?

**LESSON #1: USE "T" CHARTS TO HELP YOU DECIDE.**

**RULE #2: LEARN THE FRANCHISOR'S WIN/LOSS RECORD.**

1. The best single predictor of success for you is the success rate of franchisor's past and current franchisees. The franchisor's disclosure statement should list its current franchisees, its 3-year record of terminated franchisees, and 10-year record of franchise litigation. The franchisor will direct you to his pampered franchisees. Talk to them, but also seek out dissatisfied franchisees, terminated franchisees, and franchisees who have sued the franchisor.

2. Call at least a dozen randomly selected franchisees. You are making the biggest investment of your life.

a. How satisfied are they?

b. Do they make money? Ask to see their books.

c. What would they do differently if they could? Choose another franchisor, no franchisor, another line of business, etc.

d. Will one of them (probably not in your city) let you work in his unit without pay for a week?

**LESSON #2: CALL THE FRANCHISOR'S PAST AND CURRENT FRANCHISEES.**

**RULE #3: MAKE A FINANCIAL PLAN.**

1. "Franchise fee," "cash requirement," "total investment," and "total obligation" are not synonymous. The franchise fee is only a small part of your investment.

2. Do you have complete information on your expected initial and future costs of doing business? (e.g., leases, insurance, taxes, working capital)? Show your proposed two year budget to the franchisor and to several franchises and ask if it appears workable.

3. Assume that you would have a lower sales volume without the franchisor's help and trademark. Would you make more money at that lower volume less the franchise fee and royalties?

4. Do not believe the numbers you give the banker to help you get the loan. Plan to lose money at first.

**LESSON #3: IT WILL COST MORE THAN YOU THINK.**

**D. RULE #4: GET ALL PROMISES AND REPRESENTATIONS IN WRITING.**

1. The franchise agreement says "no other promises have been made." This will be pointed out to you next year after the salesman who made the oral promises has moved on.

2. Put all the verbal promises and representations you are relying on in a letter to franchisor and ask the franchisor to sign it.

**LESSON #4: GET ALL PROMISES AND REPRESENTATIONS IN WRITING.**

**E. RULE #5: INVESTIGATE YOURSELF.**

1. "Employee" is an honorable estate. "Independent businessman" is the only way for some people. "Franchise" may or may not be a fair trade-off for you.

2. A franchise must endure a mixture of independence and subjugation/ assistance. You

need the experience, personality, and drive to make the store successful. You will also have to sometimes do things with your business you disagree with because of the franchisor's instructions. Sometimes the franchisor is right and saves you from yourself; sometimes he is wrong.

3. A franchise is a business. You have to be able to manage money, employees, and customers. In spite of what anyone says you will spend 100-hour weeks at the business for the first few months and work down to 60-80 hours a week.

4. Is your spouse willing to share you with the business and perhaps spend long hours at it himself/herself?

LESSON #5: FORMALLY CONSIDER WHETHER YOU WOULD BE HAPPIER AS AN EMPLOYEE, A FRANCHISEE, OR AN INDEPENDENT BUSINESS PERSON.

F. RULE #6: CONSULT WITH EXPERTS.

1. Your accountant
2. An experienced business attorney
3. Persons with experience in the linen of business

LESSON #6: EVALUATING A FRANCHISE REQUIRES MORE AREAS OF EXPERTISE THAN YOU HAVE.

G. RULE #7: IS THE FRANCHISOR A LONG TERM WINNER?

1. One of the worst things that can happen is for the franchisor to bankrupt or become unable to support you. Show the franchisor's financial statement to your accountant.
2. Does the franchisor make money only if you do (main source of revenue is royalty) or is it really a pyramid scheme (main source of revenue is the sale of franchises or equipment) or a way

to lock in buyers for its products (major source of revenue is sale of required product to franchisees)?

3. How long has the franchisor been in business? Does it have an experienced management team and franchise support staff? Stability is a good sign that the system is viable and that you will not be a guinea pig.

4. Are there any lawsuits or government investigations pending against franchisor? Call the plaintiffs and have your attorney call the plaintiff's attorney.

5. Has the franchisor adequately investigated you to determine if you should be successful? Only deal with franchisors who are concerned about whether you will succeed.

LESSON #7: IF THE FRANCHISOR IS SHAKY, RUN.

H. RULE #8: READ THE FRANCHISE AGREEMENT.

1. A high-priced, educated, experienced franchise attorney wrote the franchise agreement so the franchisor will win all contract disputes. The business transaction may make economic sense but you will still need to read the agreement to know where you stand legally.

2. Keep reading, the worst terms are near the end.

3. Your franchise will eventually terminate. What happens to your business if the franchisor plays hardball?

4. Do you have an exclusive area or territory? If so, for how long and for what geographical area and subject to what limitations? Under what circumstances can the franchise agreement be renewed, sold, terminated, or modified?

5. Have a business attorney explain the agreement to you and try to negotiate smaller fees, larger protected territory, longer term,

renewal on the current contract's terms, the right to buy own equipment and supplies, etc.

LESSON #8: READ AND REREAD EVERY WORD OF THE FRANCHISE AGREEMENT.

I. RULE #9: WHAT ELSE IS HAPPENING?

1. Call the franchisor's competitors and talk to them. What will your franchisor do better than them? Which franchisors will dominate in 10 years?
2. Is the franchisor aware of the trends in his industry? Does it know what's going on with the competition? What is it doing to meet the competition? Ask these questions.
3. Will there be a sustained demand for the product or service over the next five-ten years or is this a fad?

LESSON #9: THINK ABOUT THE FUTURE.

J. RULE #10: LOCATION, LOCATION, LOCATION.

Excellent site selection is key to success. The problem is you have to make this decision when you are the most ignorant, before you start. Spend a lot of time on this decision. Talk to other local real estate agents and owners of businesses similar to yours.

LESSON #10: SITE SELECTION IS CRITICAL.

## COMPARISON OF FRANCHISED AND INDEPENDENT BUSINESSES

### 1. BEGINNING THE BUSINESS

<u>TOPIC</u>	<u>FRANCHISE</u>	<u>INDEPENDENT</u>
Initial cost	Initial franchise fee (which may cover training, and site location, and opening assistance) and all other typical initial costs; the cost of real estate lease, build out, furnishings, equipment, staffing and inventory may be increased due to franchisor's requirements or decreased because of franchisor's assistance and buying power.	No initial franchise fee. May have time and money costs for training and site location. May make costly mistakes which the franchisor's advice may have prevented. Other costs are the same.
Business structure	Franchisor has veto over business structure and partners. Will require personal liability to franchisor.	Can choose any business structure and select any partners or stockholders.
Trademark	Can and must use the franchisor's trademarks which may or may not be valuable.	Must select your own trademark and make it valuable through your own efforts.
Knowledge and experience	Often not needed if Franchisor helps with training, site selection, operating procedures, bookkeeping, etc.	Must have enough to make good decisions until you earn knowledge and experience.
Equipment, services and supplies	May have access to superior products and reduced prices. Some items must be purchased from franchisor or sources designated by him, they may or may not be desired, desirable or competitively priced.	Must shop for supplies and the best deals available to a single business, can determine your own needs.
Location	May have experienced expert franchisor help in selection. May be restricted, however, to a particular area. Need permission to move or for more locations.	Must select location with neither help nor hindrance

## 2. OPERATING THE BUSINESS

Goods and services offered	Restricted to goods or services you can sell and may be compelled to sell unwanted lines. This prevents both mistakes and opportunities.	Must determine own merchandising strategies without franchisor's help or hindrance.
Paperwork, compliance with laws	Franchisor's initial training course instructs concerning wages, taxes, insurance, etc.	Must locate your own information, join trade groups.
Profit/Loss	Profit per unit sold is reduced by royalty and other payments to franchisor but franchisor's volume purchasing, valuable trademark, assistance and pre-tested products and procedures may increase volume, reduce mistakes, and cut cost per unit sold.	Profit or loss depends on own efforts and decisions.

## 3. END OF THE BUSINESS

Risk of forfeiture	May forfeit the business if terminated or not renewed and be barred from the line of commerce by a covenant not-to-compete.	
No one can close you down except your creditors Selling out	Can only sell to persons approved by Franchisor. The business may either be more stable salable and valuable or more precarious and unmarketable due to the franchise relationship.	Can bring in partners, children or shareholders or sell the business as you please. There may or may not be a market for the sale for your business.

**ATTACHMENT D****ADVICE TO THE PROSPECTIVE FRANCHISOR****A. RULE #1: A FRANCHISE IS NOT JUST ANOTHER DEAL.**

1. Franchising is not necessarily a route to quick profits. The costs of travel, support staff, development, advertising, legal fees, etc., will exceed the franchise fees and royalties paid by the first franchisees. All logic to the contrary, monthly legal and support costs will not decrease while your system is expanding. The big money is made from happy successful franchisees who keep sending in royalties for many years after you helped set them up.

2. Franchising may not be your best option. Prepare multi-year pro forma cash flow and profit and loss statements which compare expansion funded internally, through outside investments, loans, or franchising. Talk to your officers, attorneys, accountants, and bankers concerning these alternatives.

3. Franchising is heavily regulated. Selling a franchise is like making a public offering of stock. The price of admission is months of preparation and high legal fees before you get a penny back. The penalty for not complying with franchise laws can be a business death penalty and personal liability.

4. Begin your preparations now. Some items such as obtaining federal service mark registrations are relatively inexpensive (\$750.00) but may take a year to complete. Your operations manual will take months to prepare. These are essential to successful franchising.

**LESSON #1: FRANCHISING IS LONGER TERM, MORE TIME-CONSUMING, MORE RISKY, AND MORE EXPENSIVE THAN YOU CURRENTLY BELIEVE.****B. RULE #2: FRANCHISE LAWS WILL CHANGE THE WAY YOU DO BUSINESS.**

1. Franchising is equally more dangerous than whatever you are doing now. A franchise system is affected by federal and each state's franchise, trademark, antitrust and consumer protection laws, etc. Your franchise attorney will either successfully navigate your system through these laws or it will wreck on their rocks. Get a lawyer who has already learned on prior franchisors.

2. The high legal cost estimate given by the franchise lawyer will be too low. Initial document preparation is expensive, and those documents will need to be updated whenever a material change occurs and at least annually. Every new state you expand into presents another set of legal problems.

3. You do not hire attorneys for their business advice but franchising is new to you. The experience a franchise attorney has had with other franchisors can be valuable.

4. Drag the attorney out to your business and make him walk through it, have him talk to your managers, buy your goods and services, etc. He knows the law, but cannot tailor the franchise system to your specific needs unless he knows your specific business.

5. Do not demand a short franchise agreement  
(a) Franchisees will sign anyway (believe me);  
(b) your attorney has more room in long agreement to put in terms favorable to you;  
(c) the agreement must last for years in many different states and through circumstances you have not yet thought about. It cannot be short and do the job.

6. Put all bad facts in your franchise disclosure document, including worst case problems and expenses. Franchisees buy because what they see, hear, smell, and touch convinced them they have a good chance to make money as your

franchisee. They almost never decide not to purchase because of negative disclosures in the disclosure documents. Every bad fact you disclose to the prospective franchisee now is a bullet that a dissatisfied franchisee's attorney cannot shoot at you later.

**LESSON #2: GET A LAWYER WITH EXPERIENCE REPRESENTING FRANCHISORS AND PREPARE FOR HIGH LEGAL FEES.**

**C. RULE #3: AN EXCELLENT PERSONALIZED OPERATIONS MANUAL IS ESSENTIAL.**

1. It is harder to tell someone how to cook than it is to cook. It is even harder to simultaneously tell 50 different people in 50 different locations how to cook so that the cooks are all happy and the cakes all taste the way you want them to.

2. The operations manual must be a first-class work you are proud of because it serves many functions before many audiences.

a. It identifies the relevant subjects to yourself and helps you organize to deal with them;

b. It is used in the sale to prospective franchisee;

c. It is used by your trainer in training;

d. It is used by the franchisee in training;

e. It is used by the franchisee for his life as a franchisee;

f. It is used as a policy change method by sending updates;

g. It is reviewed by the disgruntled franchisee's attorney who is looking to see if the manual and franchise you sold his client are sufficiently worthless to justify a lawsuit against you or whether it is so good that he will advise against suing you;

h. It is reviewed by the jury as evidence of what you provided;

i. It is reviewed by the judge as evidence of what you provided;

j. It is used by your own stores;

k. It affects the final product delivered by your system to the Great American Public;

3. Make it like an onion with removable sections: all sections go to the franchisee, most go to the franchisee's manager, only a few are available to the cook, etc.

4. It is painful and time-consuming to put a good operations manual together. Start now.

**LESSON #3: STRUCTURE THE SYSTEM AROUND AN OPERATIONS MANUAL.**

**D. RULE #4: START SLOWLY.**

1. Choosing the first franchisees is critical. You will learn a lot about how to franchise by providing franchise services to the first franchisees. Because you do not want to start with a bad track record, select persons for franchisees who you know will succeed because they have enough capital, experience and motivation. Make sure they are in the absolute best locations and go overboard in providing them with support.

2. There is only so much of you to go around. You cannot be in 12 places at once. Only sell as many new franchises as you can help open and help through their trying first few months.

3. Cluster your franchises in limited geographical areas to get the benefit of the critical mass effect and keep your overhead down. Only as your staff expands can you extend your franchise numbers and geography.

4. Sell only a few franchises while the viability of the concept is being proved, the rough edges are being smoothed out, and you and your staff are working through the learning curves.

5. Every new franchisee increases your overhead. Economy of scale will be elusive until you obtain critical mass.

**LESSON #4: BEGIN WITH A VERY FEW FRANCHISEES WHO WOULD BE SUCCESSFUL FRANCHISEES AND WORK TO KEEP THEM THAT WAY.**

**E. RULE #5: ONLY SELL TO PERSONS WHO YOU BELIEVE WILL BE HAPPY, SUCCESSFUL FRANCHISEES AND WORK TO KEEP THEM THAT WAY.**

1. Selling a franchise is like saying "I do" to the franchisee. You not only have to help him through thick and thin, you have to live with him and his effect on your other franchisees and prospective franchisees. Always try to sell to someone who will be successful anyway. To make an informed guess you must qualify the prospective franchisees. Never sell a franchise to a loser just to get the franchise fee.

2. Avoid Ponzi franchising. The franchise relationship should be structured so you and the franchisee sink or swim together. If they don't make money, you shouldn't make money. If they do, you do.

3. The competition on the front lines is intense. If the Great American Public does not patronize your franchisees more than mom-and-pop competitors who do not pay a royalty, your franchisees will fail and sue you. The competition on the front lines is intense. If you hinder your franchisees by requiring them to purchase anything but the best products and services for the lowest prices or if you fail to provide the best support possible, your franchisees will ultimately die. The competition

3220811v1

will kill them.

4. Make sacrifices to create franchise loyalty. They are your most important customers and assets. Do not rely on your oppressive franchise agreement unless a bad franchisee knifes you in the back. Stay out of court. You are a business person, not an attorney. Only attorneys make money in court.

5. Happy franchisees send money and referrals. Unhappy franchisees send lawsuits.

**LESSON #5: NOTHING (NOT EVEN IMMEDIATE CASH) IS MORE IMPORTANT THAN HAPPY, SUCCESSFUL FRANCHISEES.**

**F. RULE #6: THINK OF EVERYTHING.**

1. Qualify the franchisee.
2. Location, location, location.
3. Business plan.
4. Lease.
5. Furnishings, fixtures, signs, equipment, inventory (pencils, wastepaper baskets, clocks, etc.).
6. Obtaining, training, and keeping great employees and franchisees.
7. Advertising, initial sales.
8. Working capital.
9. Being a Dutch uncle.
10. Putting as much as possible in the operations manual.

**LESSON #6: YOU WILL PROVIDE MORE DIFFERENT KINDS OF SUPPORT THAN**

**YOU CURRENTLY EXPECT.**