

What You Should Know Before You Buy a Franchise

By

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Tim Pickwell & Associates

Over the course of a 19-year legal career, Tim Pickwell has represented some of the biggest names in the franchise and restaurant industry—and also advised some of the smallest. He gained his initial franchise experience negotiating international license agreements as corporate counsel for 6,000 unit franchisor CENTURY 21® Real Estate (1988-1994). He then headed up the international franchise division of \$2.2 billion revenue, publicly-traded JACK IN THE BOX® Restaurants (1995-2000), and served as corporate counsel to its purchasing, IT and marketing departments. From 2000-02 Mr. Pickwell was general counsel of a Silicon Valley-based pre-IPO telecommunications start-up, and also represented several other start-up and telecommunication companies. More recently, Mr. Pickwell served as General Counsel (2002-05) to the Coco's® and Carrows® restaurant chains, where, among other things, he supervised franchise sales and operations.

Mr. Pickwell's unique in-house background enables him to provide practical, business-oriented solutions to franchisors and franchisees. His expertise includes intellectual property licensing and trademark matters, international franchising, retail lease drafting and negotiations, franchise registration and compliance, litigation advice, and general corporate and business matters. Clientele includes established franchisors, large restaurant companies, multi-unit franchisee organizations, as well as single-site retailers, and start-up franchisors. Mr. Pickwell is a member of the California Bar, and is admitted to the Federal District Courts for the Northern, Central and Southern Districts of California. Mr. Pickwell is an Honors Graduate of the University of California, San Diego, and obtained his J.D. from the University of California, Hastings College of the Law. He resides in North San Diego County with his wife and three children.

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I. The Franchise Buying Process

- A. You contemplate buying a franchise.
- B. Research: internet, books, network, talk with business owners.
- C. Attend a trade show (perhaps like this one).
- D. Contact a Franchisor.
- E. First face-to-face meeting
 - 1. You are provided with a Uniform Franchise Offering Circular (UFOC)

F. Due Diligence – *What this presentation is about*

- 1. Legal or accountant review of UFOC
- 2. Contact existing franchisees
- 3. Research rents, costs, etc.

POTENTIAL ATTORNEY INVOLVEMENT

The American Association of Franchisees & Dealers (AAFD) recommends budgeting 2% (approx. \$5,000 on a \$250,000 investment) on advisors, costs and expenses for a thorough Due Diligence.

- G. Research Financing
 - 1. Franchisor financing, SBS, Family, investors
- H. Consider Incorporation
- I. Execute Franchise Agreement, Personal Guarantee
- J. Attend Training
- K. Lease
- L. Build out site
- M. Hire crew
- N. Open & Operate

II. Regulations Affecting Franchising in California

A. California was the first state to adopt franchise regulations

Three aspects to State laws:

1. Registration
2. Disclosure
3. "Relationship"

B. Key aspect of Federal law:

1. Disclosure

C. The Uniform Franchise Offering Circular

States laws often conflicted with each other, or with Federal laws. What was prohibited in one state was required in another. The "Uniform" Franchise Offering Circular was an attempt to unify the various laws and make it easier for franchisors to do business in more states.

1. There are 22 "Items"

III. What a Franchise Attorney looks for in a Franchise Agreement

- A. Thoroughness and quality of the contract drafting (Being a good franchisor is not cheap).
- B. Has the Franchisor thought through business contingencies? (Ex. Internet sales; different channels of commerce).
- C. Is the Franchisor planning ahead for growth?
 - 1. For example, has a start-up franchisor planned ahead for local, regional and national advertising?
- D. “Oppressive” Contract Terms v. Merely “Firm” Contract Terms
 - 1. Oppressive (no class actions, no jury trials, penalties).
 - i. These are provisions that the lawyers stuck in there just because they could. Ultimately, they have no value to the franchise system, but merely curtail the rights of franchisees, and tip the balance unfairly against the franchisee.
 - 2. Firm (high, but uniform and fair operational standards).
 - i. A strong, well-run system is preferred
- E. The Franchise Attorney typically has not met the franchisor or the franchise salesperson. The Franchise Attorney will provide you with an objective analysis of what the contract—as opposed to the people—says, because:
 - 1. Franchise salespeople change frequently.
 - 2. Franchise founders grow old, die or pass the business to their children.
 - 3. Franchisors get sold. (MBE, now “The UPS Store”; Century 21, now owned by Cendant, which also owns Coldwell Banker and ERA).
 - 4. Things change.
 - 5. That’s why we have contracts
 - i. A court will enforce this agreement against you, and a franchisor will typically deny anything oral that was promised, so you have every right to understand the contract, question it, and ask for clarification or modification.

IV. What to Look For in the UFOC

A. Financials (Item 21)

Read carefully and ask questions:

Does the franchisor derive most of its revenues from franchise sales or on-going royalties?

Ex: For an early-stage, high-growth franchise this wouldn't be unusual; but for an older concept, it means that the focus is on selling franchises, not necessarily servicing them and encouraging growth in the royalty stream.

Tip: Often franchisors form shells or unique subsidiaries to franchise in a new territory or country. The financials for the new company may be "thin", if not downright useless. Ask for the "real" financials.

B. Executive Backgrounds (Item 2)

Can be interesting. Recently looked a franchise agreement where all of the executives were from a competing franchisor in the same city. Why did they leave? Did the other franchise system work? Are they going to be sued?

C. Material Litigation (Item 3)

D. Trademarks (Item 13)

E. Advertising, Manuals & Training (Item 11)

F. Territory or Encroachment Provisions (Item 12)

Can the franchisor put a unit two blocks away? Can the franchisor sell the product in different channels of commerce (grocery stores, internet) and potentially undercut your sales?

V. Five Things You Should Know Before You Buy

A. Know What it Costs

1. Item 5 – Initial Franchise Fee
2. Item 7 – Initial Investment (Chart Form)
3. Item 8 – Restrictions on Sources of Products and Services (Approved suppliers may be more expensive)
4. Retail Site Costs and Build Outs

B. Know What You'll Make

1. Item 19
2. Ask Franchisees (Item 20)
 - i. Call terminated franchisees
3. Pro Formas
 - i. Recognize these are limited, but helpful.
 - ii. You are in a high-wage, high insurance cost state
 - iii. Your California real estate costs may be higher.
4. Adjust your prices and expectations according to YOUR market, not the Franchisor's best performing units in other markets.

C. Know What Is Required of You

1. Item 9 - Franchisee's Obligations
2. Item 15 – Obligation to Participate in the Business
3. Item 16 – Restrictions on What You Can Sell

D. Know What the Franchisor Will Do (Or Not Do)

1. Item 11 – Franchisor's Obligations (Training, Ad Fund, etc.)
2. Look for the word "may" instead of "will"
3. Marketing & Management

E. Know Your Exit Strategy

1. Post-Termination Covenants Not to Compete
2. Post-Sale Covenants Not to Compete
3. Onerous requirements upon assignment
 - i. Are they enforced?
 - ii. Will the company allow an early termination
4. Real Estate Lease Tip: Make sure that options are transferable.

Resources

A list of web-sites and articles to help you learn more about franchising

- A. WSJ.com, *Startup Journal*, Center for Entrepreneurs. www.startupjournal.com. Several excellent articles about franchising (including the good, the bad and the ugly).
- B. American Association of Franchisee & Dealer's (www.aafd.org) "Franchisee Bill of Rights". This franchisee focused organization will give you some insights into what you might look for in a "good" franchise.
- C. International Franchise Association (IFA) (www.franchise.org) "Code of Ethics". The worlds largest and oldest franchise organization.
- D. SBA Registry, hosted by FranData, a comprehensive list of franchisors with "streamlined" SBA Financing. www.franchiseregistry.com/Registry/
- E. Federal Trade Commission / Franchise & Business Opportunities. www.ftc.gov/bcp/menu-fran.htm

Your government's perspective on scams masquerading as franchises.