How to Lead Your Clients to the Purchase of a Franchise

By Barry Kurtz

FRANCHISING IS A FLEXIBLE, tried and true method of distributing products and services, offering business owners an alternative avenue to expand their already successful businesses. In a typical franchise arrangement, franchisees sell or distribute their franchisor's trademarked products or services in exclusive, protected territories in which the franchisor will not permit other franchisees to operate or to offer the same products or services. In addition, franchisees rely on their franchisors for advice, training, advertising and marketing assistance.

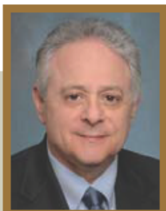
Franchisors also usually provide their franchisees with manuals outlining their corporate operations and standards, and closely monitor their franchisees for compliance to protect the integrity of their brand and systems.

Pros and Cons of Buying a Franchise

When clients consider the purchase of a franchise, McDonald's, Subway, and Burger King may immediately come to mind, but there are hundreds of other franchisors in a wide variety of food, retail, and service operations that are energetically competing with each other to sell their franchises.

The benefits to owning a franchise can include access to a proven business system, a wider customer base, greater brand name recognition, and a stronger market presence; group purchasing discounts, administrative assistance, professional marketing, and the benefits of corporate research and development; mentorship and continuing education and training; and support from the franchisor and other franchisees with similar goals, needs, and challenges.

While rewarding, acquiring and operating a franchise shouldn't be seen as a bed of roses, but a serious business with disadvantages that could



Barry Kurtz, a Certified Specialist in Franchise and Distribution Law by the State Bar of California Board of Specialization, is the Chair of the Franchise & Distribution Law Practice Group at Lewitt Hackman in Encino. Kurtz may be reached at bkurtz@lewitthackman.com.

well include investing in a franchise while entertaining the fantasy of independent ownership. Franchisors, in general, want followers, not innovators, and can impose strict limitations on any deviation from their corporate operating procedures and business model.

Buying a brand name franchise can be very expensive, with initial costs exceeding the costs required to start-up a wholly-owned, independent business. Generally, franchisees must pay their franchisors non-refundable advance payments, as well as non-refundable continuing royalty payments calculated as a percentage of gross revenue for the franchisor's operations and advertising services. At the same time, some franchisors may not provide the necessary training, guidance and support services that are critical for the success of a franchise.

What Is a Franchise?

If the elements of a franchise are present in an agreement, the business relationship governed by the agreement is a franchise regardless of the name given to it by the parties and is highly regulated by federal and state laws in favor of, and to protect, franchise buyers.

Under California law,[1] a business relationship is a franchise if the business will be substantially associated with the franchisor's trademark; the franchisee will directly or indirectly pay a fee to the franchisor for the right to engage in the business and use the franchisor's trademark; and the franchisee will operate the business under a marketing plan or system prescribed in substantial part by the franchisor.

By way of contrast, true licensing, distributorship and dealership arrangements are not franchises because they lack at least one of the three elements mentioned above. For example, under a typical licensing arrangement, a company, the licensor, permits another, the licensee, to sell its products or services in exchange for a percentage of the proceeds from the sale without any other involvement on the part of the licensor. The licensee operates under its own trade name and usually buys products or services from the licensor at wholesale prices that are, in turn, resold to the public with neither party substantially involved in the day-to-day business affairs of the other.

Regulation of Franchises

Federal law[2] and the laws of many states require franchisors to provide prospective franchisees with a Franchise Disclosure Document (FDD) before the franchisor may sell a franchise. An FDD is an offering prospectus written in plain English that provides prospective franchisees with answers to 23 specific questions about the franchisor and the franchise. Franchise candidates must have the FDD for at least fourteen full days before they can execute a Franchise Agreement or pay the franchisor any money.

Currently, thirteen states—California,[3] Hawaii,[4] Illinois,[5] Indiana,[6] Maryland,[7] Minnesota,[8] New York,[9] North Dakota,[10] Rhode Island,[11] South Dakota,[12] Virginia,[13] Washington[14] and Wisconsin[15]—require franchisors to provide similar information in their FDD and to submit their FDD for review and registration by a governmental agency before any franchises are sold. The FDD must include, among other things:

- Background information and business experience of the franchisor and its executives
- Litigation and bankruptcy history for the franchisor, its affiliates, and their executives
- Descriptions of the fees payable from the franchisee to the franchisor

- Initial investment required to open a franchised business
- Summary of the primary responsibilities of the franchisor and franchisee
- An explanation of the franchisor's training requirements and a schedule for classroom and on-the-job training
- Table of contents of the franchisor's operations manuals
- Information regarding institutional and local maintenance of any franchisor managed marketing funds and disbursements from the marketing fund in the preceding year
- An explanation of the territorial rights that may be granted to franchisees
- Information regarding the ownership and use of the franchisor's trademarks and patents

Purchase Guidelines

Potential clients should look for a business in which the typical daily activity aligns with their own interests and avoid those that will require a routine they may dislike. They will greatly enhance their chance of success by selling products or services they understand and by not jumping into businesses that are completely new and different to them.

Clients should consider their own strengths, weaknesses, and comfort levels. If they are happiest when following orders, buying a franchise could be a wise choice, with the understanding that they might, at some time in the future, chafe at the highly supervised nature of the franchisor/franchisee relationship.

They will need to determine if the business model is profitable for the franchisor and its franchisees, and, if so, to what degree, and if the business is sustainable in the marketplace. Franchises built on fad products or services rarely survive. To be sustainable, the business concept should be unique enough to withstand competition and also be one that potential franchisees are willing to pay to learn.

Clients also need to be realistic about the costs of becoming a franchisee by looking for a franchise that matches their resources and obtaining a current FDD from the franchisor. A franchisor without an FDD is generally not one worthy of consideration.

Due diligence is vital with both you and your client learning everything possible about the franchisor and the franchise. Your clients should talk to every current and former franchisee that they can find. One of the most important signs of a healthy franchise system is a high level of satisfaction among current franchisees.

Potential clients should also investigate the franchisor's management team. A system with leaders who have substantial experience in the franchised business and industry is preferred over a system whose management team's experience is marginal or diluted by involvement in other activities.

Clients should also ask themselves whether the franchisor's staff, as well as other franchisees in the system, conduct themselves professionally. It's critical that the character of the people your clients will work with must match up with their own standards.

Franchise agreements tend to favor franchisors to maintain system uniformity. However, franchise agreements that are too one-sided place franchisees at the mercy of the franchisor's whims and judgments. Your clients should find a system where the franchise agreement is balanced, either during its inception or through its negotiation.

Legal Protection

Once a franchise is purchased, the parties must adhere to the terms of their franchise agreement and any applicable law. While reliance on applicable law is not a wise alternative to effective pre-purchase due diligence, California and seventeen other states[16] have franchise relationship laws that restrict a franchisor's right to terminate or refuse to renew or consent to a transfer of a franchise without good cause.

California recently expanded the termination, transfer and renewal rights for franchisees operating under franchise agreements entered into or renewed on or after January 1, 2016, and for franchise arrangements with an indefinite duration that permit either party to terminate a franchise agreement without cause.[17]

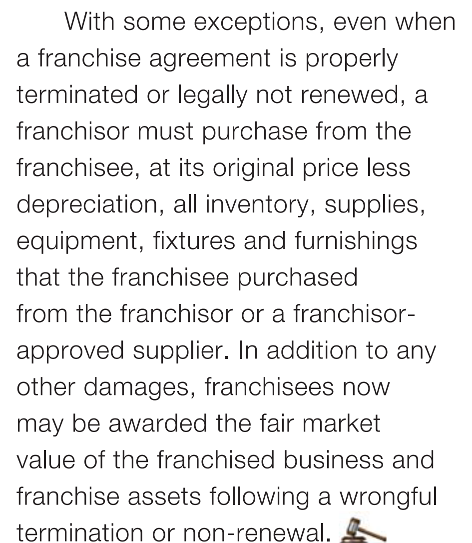
The new law increases the required cure period for franchisee defaults from 30 to at least 60, but no more than 75 days, unless the parties mutually agree on a longer cure period, and includes a new 60-day notice of default/termination requirement. In addition, the amendment imposes a new "substantial noncompliance" standard on actions and inaction that may constitute good cause for termination and non-renewals. Its goal is to eliminate terminations and non-renewals for non-material violations of the franchise agreement.

Despite these new notice and cure requirements, franchisors, if their agreements permit, may still terminate a franchisee with no opportunity to cure in the case of bankruptcy, abandonment, mutual agreement, material misrepresentation, illegal activity, repeated non-compliance with the franchise agreement, and imminent danger to the public.

The new law prohibits the sale, transfer, or assignment of a franchise, all or substantially all of the assets of a franchise business, or a controlling or non-controlling interest in the franchise business, without the franchisor's written consent.

Franchisors cannot prevent such a transfer to a purchaser who meets the franchisor's then-existing standards for new and renewing franchisees. The new law also creates a framework for the notice and information a selling franchisee must provide its franchisor on a proposed sale.

The new law mandates that a franchisor must, "as soon as practicable" after receiving a franchisee's notice, inform the franchisee of any additional information it requires and issue its approval or disapproval, with reasons, within 60 days or any shorter period provided in the franchise agreement. A franchisor that fails to do so will be deemed to have approved the transfer.



With some exceptions, even when a franchise agreement is properly terminated or legally not renewed, a franchisor must purchase from the franchisee, at its original price less depreciation, all inventory, supplies, equipment, fixtures and furnishings that the franchisee purchased from the franchisor or a franchisor-approved supplier. In addition to any other damages, franchisees now may be awarded the fair market value of the franchised business and franchise assets following a wrongful termination or non-renewal.

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[1] Cal. Corp. Code §31005(a).
[2] 16 C.F.R. §436.2.
[3] Cal. Corp. Code §31000.
[4] Haw. Rev. Stat. §482E-3.
[5] 815 ILCS 705.
[6] IC 23-2-2.5.
[7] Md. Code Ann., Bus. Reg.§14-214(a).
[8] Minn. Stat.§80C.
[9] N.Y. Gen. Bus. L.§683.
[10] N.D. Cent. Code §51-19.
[11] R.I. Gen. Laws §1928.15.
[12] S.D. §37-5B.
[13] Va. Code §13.1-557.
[14] Wash. Rev. Code §19.100.010.
[15] Wis. Stat.§553.
[16] 16 C.F.R. §436.2.
[17] Cal. Bus. & Prof. Code §20000 – 20043.