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Guide to Evaluating Franchises: Review Disclosure Documents

With the International Franchise Expo in town at the Javits Center, thousands and thousands of prospective franchisees (and, later on, their counsel) will be evaluating hundreds and hundreds of franchises being offered.

But what is the most critical, indispensable and helpful step in evaluating whether to acquire franchise rights from any given franchisor?

The answer is simple: a thorough review of the franchisor's Franchise Disclosure Document (FDD).

Under federal law and the franchise statutes of 15 states, no franchise may be offered or sold in this country unless the franchisor furnishes to its prospective franchisees a Franchise Disclosure Document at least 15 days before any franchise agreement (or related agreement) is signed or any money changes hands. The contents of a Franchise Disclosure Document are prescribed in detail by these federal and state laws, which also mandate that the FDD be written in "Plain English" so that it is readily understandable. The Franchise Disclosure Document, by law, must impart all material information that a reasonable prospective franchisee would desire in order to make an informed decision as to the acquisition of the subject franchise.

Reviewing Items

Where to start? At the beginning. The Franchise Disclosure Document is divided into 23 "Items," each of which addresses a discrete subject or group of subjects. A prospective franchisee should start by reviewing Item 1, which discloses the name and address of the franchisor; how long it has been in business; a description of the franchise being offered; what the nature of the franchisee's competition will

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be; and, whether any licenses, permits or other government approvals are required in order to operate the franchise. While it may seem intuitive to believe that older, more experienced franchise systems are safer, it remains that brand new franchise systems may offer more upside potential if they catch on (in this regard, stability and risk are on opposite sides of the coin).

After reviewing FDD Item 1, a prospective franchisee should immediately turn to FDD Item 20.

While it may seem intuitive to believe that older, more experienced franchise systems are safer, it remains that brand new franchise systems may offer more upside potential if they catch on.

This item sets forth a series of tables which depict how many company-owned and franchised units exist; how many have been established over the past three years; how many franchises have closed, been terminated or been reacquired by the franchisor over the past three years; and, how many company-owned and franchised units are scheduled to be opened in the coming year. These data hopefully provide a clear picture of franchise network expansion (hopefully in a moderate fashion, one which does not involve a franchisor granting franchises to whoever has a check that will clear and/or granting more franchises than the franchisor is able to support).

Again turning out of sequence, we suggest that a prospective franchisee next turn to Item 19 of the

franchisor's Franchise Disclosure Document. If a franchisor desires to impart any information to a prospective franchisee regarding the financial performance of its franchise network (gross sales or net profits of company-owned units, franchised units or both), it may only do so by first disclosing that information in Item 19 of its Franchise Disclosure Document. Put otherwise, if a franchisor does not feature such Item 19 financial performance representations but instead states that it makes none, then it is entirely illegal for the franchisor to otherwise impart such information to prospective franchisees, meaning it could accrue harsh civil (and possibly even criminal) liability by providing such information in any fashion whatsoever. These FDD Item 19 financial performance disclosures should be carefully reviewed with an accountant or other professional. And if the franchisor makes no Item 19 financial performance representations, the prospective franchisee will want to ask why (and if the franchisor replies that it is unable to do so by law, move on quickly).

Other Franchisees

Having digested who the franchisor is, how long it has been in business, the size of its network and whether that network has expanded or contracted, and how that network has fared economically, the prospective franchisee should then revert to FDD Item 20, in which the franchisor must set forth the names and contact information both of all current franchisees and those whose franchises were terminated, not renewed or who otherwise ceased doing business. Existing and prior franchisees possess a wealth of information and guidance which will prove useful to prospective franchisees. If they are happy, they quite typically will say so. If they are unhappy, they quite typically will say so even louder and explain why.

How is the franchisor doing economically? Does it have sufficient resources to fulfill the promises it is making to prospec-

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Franchising

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tive franchisees? For the answers to those questions, the prospective franchisee should turn to FDD Item 21, which sets forth the subject franchisor's balance sheet and income statements for the past three fiscal years (and, if those statements are older than four months or so, various franchise-regulating states may insist that more recent, unaudited "stub period" financial statements be set forth as well). Again, these financial statements should be closely analyzed with the help of an accountant or other professional.

Critically, a specimen copy of the franchise agreement which the prospective franchisee will operate under must be set forth in the franchisor's Franchise Disclosure Document. This is the contract that will exclusively govern the parties' relationship should a franchise be acquired. The franchise agreement must be very carefully examined, and here it really would be helpful to have a seasoned franchise attorney—one who specializes in representing franchisees (which this author does not)—review the contract. It can be lengthy and complex, but a thorough understanding of the franchise agreements terms is critical to determining whether or not to invest in a franchise.

Economics and Other Issues

Now we skip back to much earlier in the FDD. FDD Item 2 sets forth the names and business experience of all the subject franchisor's officers, directors and management personnel who will have involvement with franchisees. Item 3 will disclose the litigation histories (if any) not only of the franchisor itself but of its officers, directors and managers. Item 4 similarly discloses the bankruptcy histories (if any) of the franchisor and its officers, directors and managers.

The FDD then turns its attention to economics. FDD Item 5 sets forth the initial franchise fee which must be paid to acquire franchise rights. Item 6 discloses ongoing fees payable to the franchisor or any affiliate (or any third party for which money is collected by the franchisor), such as royalties, construction/remodeling assistance, advertising contribu-

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tions, purchasing cooperative fees, franchise transfer fees and franchise renewal fees.

FDD Item 7 is most important: It details the estimated initial investment required to construct, equip, open a franchised unit for business and operate it for three months. Again, it would be helpful to review these data with a professional (accountant, attorney or other) and, when inquiring of existing and prior franchisees as earlier advised, to ask them whether the figures set forth in FDD Item 7 proved to be accurate.

FDD Item 11 contains a wealth of information as to what the franchisor is obligated to do prior to a franchised unit opening and then thereafter. It also details the advertising programs of the franchisor; how they are administered; what computer systems (back office/POS/other) are required; and, what the franchisor's training program embraces.

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If a prospective franchisee will be in need of financing, then FDD Item 10 will prove of great interest since a franchisor must describe therein any and all financing programs (if any) it makes available to new franchisees.

FDD Item 17 addresses a number of significant issues in capsule, tabular form.

What is the length of the franchise term? What renewal rights will the franchisee possess following expiration of the initial franchise term? Under what circumstances may the franchisor terminate a franchise? Will the franchisor or the franchisee be free to transfer the franchise agreement to a third party—and, if so, under what circumstances?

Does the franchisor have a right of first refusal to acquire the franchisee's business? What happens upon the death or disability of an individual franchisee? What non-competition covenants bind the franchisee both during the term of the franchise and after it expires? And how and where will franchisor-franchisee disputes be resolved—by litigation? Arbitration? Mediation? Under what state's governing law? And in which court or other tribunal? All of these issues are summarily addressed in FDD Item 17.

Whether a franchisee is obligated to personally participate in the actual operation of its franchised business—or whether it may merely invest in that business and hire others to operate it—is disclosed in FDD Item 15.

Finally, FDD Items 13-14 set forth the franchisor's intellectual property rights—what trademarks, patents, copyrights and proprietary information it possesses and whether any of them have been granted protection by the U.S. Patent and Trademark Office.

Of course, there are a myriad number of other steps that a prospective franchisee may wish to undertake when evaluating a franchise. However, that prospective franchisee would be entirely remiss if it did not commence its investigative efforts by scrubbing the subject franchisor's Franchise Disclosure Document in the manner suggested herein.