THE ROLE OF THE LAWYER IN A FRANCHISEE’S DUE DILIGENCE

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THE ROLE OF THE LAWYER IN A FRANCHISEE’S DUE DILIGENCE

Due diligence is an essential element of any franchise purchase. This paper identifies key components of the lawyer’s role in the due diligence process, explores questions that may arise, and offers general guidance on advising clients who are acquiring franchises. Our discussion is broken into four categories: (1) defining the scope of the representation; (2) assessing your client and his, her or its particular situation; (3) reviewing the franchise disclosure document (FDD) and; (4) reviewing the franchise agreement and negotiating its terms.

Representing prospective franchisees necessarily requires addressing legal issues. But it is important to always consider that the legal issues are situated in broader business contexts that also need to be explained. So in each section, we discuss the technical and legal issues on which you should give guidance, the general business issues you should consider addressing, and those business issues that are probably beyond the competence of most lawyers who are not trained in accounting or finance. Of course, since all prospective franchisees and deals differ, the general guidelines discussed here must be applied to the specific facts of each prospective purchase.

I. DEFINING THE SCOPE OF THE REPRESENTATION

Prospective franchisees come to their lawyer with different expectations. Most have a budget. Some ask only for a limited task – for example, pointing out the riskiest clauses in the franchise agreement – but may not realize they could benefit from other information. You need to advise your clients about the variety of services that you can perform, so they can make informed determinations as to the scope of your services.

A. The Fee Agreement

Many states require attorneys to provide written fee agreements that, to varying degrees, require the attorney to define the scope of representation.\(^1\) You should familiarize yourself with the rules in your jurisdiction and be sure you are in compliance. Aside from ethical obligations, it is also good practice to define the scope of the attorney-client relationship up front, and usually to be more specific than ethical obligations might require. Being specific in your fee agreement helps to avoid conflicts down the road. You want to be sure that your proposed services and fee structure align with your clients’ expectations.

The scope of your review will be dictated by the risk and size of the investment and your clients’ willingness or ability to pay. A dog-walking franchise typically will not require the same in-depth analysis you might provide to a client interested in buying multiple units in a restaurant chain. And while many lawyers offer a specific review package at a set price, it is important to remain flexible. Prospective franchisees and opportunities vary considerably. It is important to assess each potential purchase independently, and to adjust the scope of review to fit the particular circumstances.

\(^1\) See, e.g., 22 NYCRR 1215.1; CAL. BUS. & PROF. CODE § 6148.
If you encounter a frugal client who insists on only the bare minimum, it is important to remember that this may trigger ethical obligations. The ABA Model Rules of Professional Conduct state that you "may limit the scope of the representation," but only if the limitation "is reasonable under the circumstances, and the client gives informed consent."\(^2\) "Informed consent" means you need to advise your clients of significant problems that a limitation in scope might entail. In these situations, you should include a disclaimer in your fee agreement explaining that the review is limited and based only on the information you were instructed to review. Even with a disclaimer, though, you are still obligated to act competently and with reasonable diligence.\(^3\) Thus, you may be required to inform your clients if you are aware of information that may be material to their decision, even if doing so is beyond the scope of representation in your retention letter.

**B. What Are Your Clients’ Questions or Concerns About the Prospective Deal?**

As practitioners, we are attuned to the issues that we believe are pertinent to our clients’ understanding of a franchise investment, but our assumptions can cause us to overlook issues that are important to them. Therefore, as part of defining the scope of your services, consider asking your clients to provide you with a detailed list of questions they want answered. Obtaining questions can help you provide the advice and information your clients are seeking, and make the review process more economical. When clients are initially reluctant to pay for anything beyond a limited review of the franchise agreement, encouraging them to write out the questions they want answered alerts them to the information they will be responsible for obtaining on their own, and may prod them to reconsider the scope of service they want you to provide.

**C. When Does the Engagement End?**

Aside from ethical obligations, the engagement ends when you or your clients decide it ends. The initial engagement typically involves a review of the franchisor’s disclosure documents, an oral or written explanation of the parties’ respective rights and obligations, and negotiation with the franchisor where possible.

Reviewing a prospective franchise deal, however, is also a foot in the door. Assuming your client eventually buys the franchise, there is the potential for additional attorney work and a long-term relationship. Clients often need initial help with forming an entity, preparing the entity’s governing documents, reviewing and negotiating lease documents, and other general business assistance. As the business grows, there may be employment issues such as preparing employee handbooks or contracts, and there is always a potential for disputes, whether with the franchisor, employees, or in other aspects of the business. Indeed, many attorneys use the review process as a loss-leader, providing a detailed review at a discounted rate.

\(^2\) ABA Model Rules of Prof’l Conduct, R. 1.2(c). Although many states have adopted the Model Rules of Professional Conduct, many have not, and others have modified the version that they use. It is therefore important to familiarize yourself with the rules applicable in your jurisdiction.

\(^3\) See, e.g., Model Rules of Prof’l Conduct, R. 1.1 and 1.3; Cal. Model Rules of Prof’l Conduct, R. 3-110.
II. INFORMATION NEEDED TO ASSESS YOUR CLIENTS' SITUATION

Before you review the FDD and franchise agreement, it is helpful to discuss your clients’ knowledge, experience, interests, goals, and the due diligence they have already done. This helps define how much additional due diligence is needed, and the scope of the advice you should offer.

To adequately advise clients, you may need to ask whether they are capable of being a franchisee or whether owning a franchise is really what they want. Occasionally the answers are obvious. They may show up well-informed and with a firm grasp of their ability to acquire and run a franchised business. They may need or want advice on only the legal issues. At the other end of the spectrum, you may encounter the misguided person who thinks franchising is a shortcut to avoid the hard work of owning a business. It may be readily apparent that this would-be franchisee is neither suited for nor really looking for a franchise relationship. Most often, it is somewhere in between, and requires some digging. This means asking questions and often educating your clients about the nature of franchising. Determining these issues at the outset also helps to define the relationship between attorney and client, and informs decisions about who will be responsible for the various aspects of completing due diligence.

A. Assess the Prospective Franchisee

Prospective franchisees come in all shapes and sizes. Sometimes you might be advising an individual, but often times it is a husband-and-wife team. Other times your client could be partners, groups of investors, or even corporations. Regardless of who or what your client(s) may be, the first step is to probe whether they understand the key business characteristics of franchising, what their experience is, and how much due diligence they have done.

1. Understand What A Franchise Is From A Business Perspective– A Mark, A System, and A Management Team

Be sure your clients understand the key business elements of franchising – that in exchange for a fee and giving up some level of control, the franchisee licenses a system or format and the right to use the franchisor's marks for a term. If your clients do not understand the basics, it is likely they will not understand the particulars of the franchise, and how or why certain aspects of the relationship matter. Understanding the basics of franchising is essential to understanding the value of the system and whether the value received is worth the price paid.

a. Marks – How Well Known, and In What Areas?

Brand recognition is generally a major factor in driving customers to a business, and also a foundation of franchising. Whether the franchise is a well-known national brand, or a start-up just getting into the market, the goal is to maximize brand recognition, which may come in the form of a trade name, tag line, logo, or other identifying elements (Some of these may be registered marks, which we discuss below in section III.A.10, which reviews FDD Items 13 and 14). Your clients should understand the extent of the
franchisor’s market recognition, and the value of its brand.

Good questions to ask include: Do the franchisor’s marks already have recognition nationally or in the area where the prospective franchisee is looking to buy? Are franchises already operating in the area? How much advertising is done nationally or in the local area? How well-protected are the marks? Perhaps most telling – has brand recognition allowed other franchisees to reach profitability at a relatively fast pace? Obviously a strong national brand has more market recognition than a start-up. However, even a start-up's marks can be of value if the system is growing and poised for greater brand recognition in the future.

Although brand recognition is a key factor, it is only one of many factors. The ultimate question must be: Is the whole of what a client is paying for worth the cost?

b. System – Could You Do It Yourself?

Your clients should also understand the value of the system. The system is essentially the business model and organization that the franchisor provides, and under which the franchisee will operate. Systems, however, vary widely. Some provide little control or support while others offer near total control and extensive support. Understanding the system is key to understanding what your clients are buying.

A general question to ask is whether the client could create something similar on his or her own. If he or she could, it raises the obvious question: why not? There are many valid reasons for clients not doing it on their own. Licensing the system avoids recreating the wheel, which might reduce start-up costs. The brand may have substantial recognition, a benefit not enjoyed where clients go it on their own. On the other hand, if the system is nothing more than a generic business plan, and there is little support or training, it may not offer any value at all.

More specific questions to ask are: Is there ongoing customer support? How good is the training? Does the franchisor direct customers to the franchisees? Is there substantial national or local advertising? Are the operational processes the franchisor provides unique or somehow beyond ordinary business methods? The basic premise to consider is whether the system provides value. If there is no real value, it will likely lead to an unhappy client down the road.

c. Management – It Can Change, But You Need to Depend On the Leaders

Management is an important factor in any system. A solid management team that works well with franchisees can make all the difference in the world. On the other hand, if management has a reputation for being difficult or unreasonable, it should raise a red flag.

As a franchise attorney, you may already have some insight if you have dealt with the system and management. If not, it is good practice to determine management's character before the relationship starts. Urge your clients to talk directly with management where possible, and seek the opinions of current and former franchisees.

Managers come and go. It is therefore good practice to determine the strength of the
management structure. Does it rely too much on strong personalities currently leading the company? What is the culture of the system? Is it tied to management or is it a strong system that will survive changes at the top? If it has changed in the past, how has this affected the company and the franchisees?

It is not uncommon for management to make promises that they will not enforce all the provisions of the franchise agreement. Even if they abide by these promises, new management may not do the same. It is therefore important for your clients to understand that the only true constant in the relationship is the franchise agreement. It is risky to accept potentially harmful provisions in the franchise agreement on good faith assurances by current management as to how they will be enforced.

2. **Worth and Liquidity**

Franchisors often have minimum requirements for prospective franchisees’ financial worth and liquidity. Meeting the franchisor’s standards, however, does not address a client’s personal risk. While a franchisor may be satisfied that your clients’ financial situation does not pose an undue risk to the franchisor, your clients need to consider their own risk. Do they have sufficient capital to get through start-up, to weather downturns, or to handle the consequences should the business fail?

The need to look beyond the franchisor’s minimum requirements is particularly true in systems that rely heavily on initial franchise fees. In these cases, the franchisor’s required qualifications may focus more on whether the prospective franchisee can afford the initial fees than the ability to sustain the business over the term of the agreement.

As part of your clients’ calculation, careful consideration should be given to financing. Clients may have the needed liquidity or may be able to use equity in their home or borrow against their retirement funds. If they borrow from a bank, though, they will almost certainly need to sign personally for the loan. Be sure they understand the level of risk they face. Encourage your clients to speak to their accountant or financial advisor; while you can help them define the risk, you should not be the one running the numbers and advising them on what level of risk is acceptable unless you are specifically competent in those areas and such advice is within the scope of your retention.

3. **Business Experience**

Your clients know their business experience. Yet they may not understand how that experience will fit into the franchise relationship. Thus it can be helpful to review a client’s prior business experience and discuss how it may integrate into a franchise in general and with the particular franchise system.

4. **Franchise Experience**

Prior franchise experience is usually a plus. It often means your clients understand the process and knows what to expect in the new relationship. On the other hand, it may also mean they come in with preconceptions that may distort their analysis. While certain things may apply to all franchises in general, each has its own special facts and concerns. Expectations held from prior franchise experiences may not be relevant to a new franchise. This can be so even for franchisees buying a new franchise in the same system – they may not appreciate the effect of changes in a new franchise agreement, or may
even have mistaken beliefs about their current franchises. While prior franchise experience is by and large helpful, it is still a good idea to flesh out and discuss any expectations or preconceptions.

5. **Entrepreneur/Willingness to Follow System**

Beyond explaining your clients’ legal obligations under the system, it is also important to determine whether they are the type of person well-suited to fulfill them. Entrepreneurship is generally a plus, and will usually help them build a successful business. On the other hand, it can be a disadvantage if that same drive to succeed means they are likely to ignore the prescribed franchise system, thinking they can do it better.

It is therefore important not only to explain the obligations that go along with being a franchisee, but also to explain that failing to comply with the system can lead to default and termination. It is vital for clients to fully understand the control they are giving up by choosing the franchise model, and the possible consequences should they breach their agreements.

6. **Amount of Due Diligence**

It is critical to determine at the outset just how much due diligence your clients have already done, what investigation remains to be done, and who will do it. Where due diligence can and should be done by your clients, your role may simply be to explain and advise them of what research and investigation they should conduct.

a. **Review FDD**

Have your clients reviewed the FDD before meeting with you? At one end of the spectrum are clients who have not even opened the document for fear of its imposing size and perceived legalese. At the other are those who have read it thoroughly and actually understood what it says. Most are somewhere in the middle.

In most engagements, you will review the FDD, but it helps the process considerably if your clients have also reviewed the document. If they have not, it is good practice to advise them to read it thoroughly. This not only helps to educate them, but also helps to smooth the process when it is time to review the FDD with them. And of course, your clients’ review of the FDD will help them formulate the questions that will assist you in providing information that they can use in evaluating the investment.

b. **Check Out Competitors**

Have your clients checked out the competition? Do they understand what their competitive set is – the range of businesses that may compete with theirs? Can other franchisees or the franchisor compete locally, or is there an exclusive territory?

Even with brick and mortar franchises, the investigation cannot usually stop with the physical location. The ever-expanding Internet means competitors may now be halfway around the world. And with franchisors increasingly selling through big-box stores
or on-line, it may even be direct competition with others selling the exact same product or service. From wherever the competition may come, the point is to determine how it will affect your clients’ franchise.

Item 1 of the FDD provides information on competitors, but is often rather sparse. Asking the franchisor about the competition is a good way to follow this up. It will often have substantial information relating to its competitors. However, franchisors are also in the business of selling franchises. Advice about the competition coming from the franchisor should be scrutinized carefully, as there can be an incentive to downplay the competition to make the sale more attractive. Thus, it is good practice to rely on other sources as well. Typically, this means direct investigation, e.g., checking out the location, looking online for similar businesses, and talking with other franchisees.

c. **Talk Substantively with Other Franchisees**

It cannot be stressed enough how important it is for your clients to talk with other franchisees. This is often the most important aspect of franchisee due diligence and can provide some of the most critical information that a prospective franchisee needs to evaluate a franchise investment. If clients have not already started this process, point out the list in the FDD, and advise them to contact these people and start asking questions. It is best if the clients conduct some of these interviews in person at the franchise location. If possible, they should spend a day, or preferably multiple days, in a franchise location, to get a full understanding of how the business actually operates.

The questions your clients should ask include: Are the franchisees making money, and if not, why? Who is the competition, and how has it affected their franchise? What kind of benefits have they received from brand recognition? What do they think of management? Have they had any problems with the franchisor? How much work do they have to personally put into the business? Do they enjoy what they are doing and why? If they had to do it again, would they? The list could go on and on, but it really is open to any questions relevant to the particular franchise. In general, your clients should be looking for specific information on the particular business, and also an overall impression of whether the current franchisees are happy with their choice. If a significant number of franchisees have a negative impression of the franchise (or have left the system), advise your clients that this is a red flag, and push them to re-think their choices or at least give them added scrutiny.

A specific area to target is the franchisees’ financials. Some may be reluctant to provide this information, but many are not and will freely provide it. If they will not provide detailed financial data, your clients should, at a minimum, try to get general information regarding revenues, profits, and costs. This can prove to be invaluable when it comes to evaluating the franchise investment and in preparing a pro forma or business plan.

It is not unusual for franchisors to suggest that prospective franchisees should speak to specific franchisees. However, you should warn your clients that franchisors might offer up the more franchisor-friendly and successful franchisees. This is not necessarily a bad thing. Talking to successful franchisees can be very helpful and at times more useful than talking to the less successful franchisees. After all, these are the ones who are succeeding. Understanding this, though, your clients should still be sure to talk to others listed in the FDD so that they are getting a more rounded picture.
d.  **Talk to Terminated Franchisees or Those in Litigation**

Have your clients spoken with terminated franchisees or those in litigation with the franchisor? This is often a fast track to uncovering problems in the system. For instance, if the franchisor is frequently sued for breaching its obligations, or is frequently suing franchisees who have left the system, this raises concerns. Your clients should ask the former franchisees why they sued the franchisor or why they left the system.

Specifics are important. Lawsuits and terminations cannot be looked at in a vacuum and do not always indicate a problem. The answer is often more subjective than objective, and there is no set formula for deciding how many lawsuits or terminations it takes to indicate a problem. If it is one squeaky wheel, or even a substantial number of franchisees in a large system with different gripes, it may be the franchisees who are the real problem. On the other hand, if enough former franchisees have the same complaint, it suggests the complaints may be legitimate. If the franchisees won the lawsuits, it is usually a clear sign of a problem. And even a single lawsuit or single termination may indicate a serious problem. It is therefore critical to talk with the persons involved, assess their credibility, and understand the facts of each case.

e.  **Review Franchisor’s Financials**

It is important to determine how thoroughly your clients have reviewed the franchisor's financials. Understanding the strength and health of the franchisor helps to evaluate the system.⁴

f.  **Prepare Pro Forma**

Have your clients prepared a pro forma? If not, you should advise them to do so, as it can be an invaluable tool as to whether to proceed with the investment. Indeed, the primary questions clients want answered is typically whether the venture will make money and how much. This generally means reviewing financial information relevant to the franchise and projecting how the franchise will perform in the future – i.e., preparing a pro forma financial statement.

As the lawyer, you should not prepare a pro forma unless you are competent in accounting and financial projections, and your retention agreement extends to these services after full disclosure. And beyond ethical questions of competency, preparing pro formas comes with risk and responsibility. If the franchise fails or simply does not make the money you projected, at best you may have an unhappy client, and at worst you may be defending yourself in a lawsuit.

In most cases, your clients will enlist the help of an accountant or business advisor to assist with preparing the pro forma. It is good practice to collaborate with these outside advisors and create a team mentality. This helps not only with preparing the pro forma, but

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⁴ This issue is discussed in more detail below in section III.A.17 in the discussion of the FDD related to the franchisor's financials.
also with other business decisions such as deciding whether to form an entity, and if so, what type.

If you review the pro forma for your clients, be sure to explain the limits of your competency. At minimum, given your understanding of certain disclosures in the FDD, you can probably help crosscheck numbers to make sure your clients drew appropriate inferences from the FDD disclosures. Beyond that, you should be careful in the advice you give unless you have competency in accounting or financial projections.

One key consideration your clients should understand in preparing pro formas is to be sure the data used is as accurate as possible and the best available. As the saying goes, “garbage in, garbage out.” The most accurate information needed to prepare a pro forma financial statement typically comes from three sources: the FDD, other franchisees, and vendors/contractors.

The FDD provides considerable information on costs. Much of this can be taken directly from Items 5, 6, and 7 of the FDD and plugged into your projections. However, certain costs are estimated or stated as a range, so it is important to accurately estimate these. Other costs are not included. This often requires additional investigation by speaking directly to vendors/contractors or other franchisees. Other franchisees are an excellent resource to determine costs, particularly if they are in the same geographical area.

Item 19 can provide information relating to revenue or projecting earnings, but is not always a good source for reliable data. Other franchisees are often the best source for determining potential revenue. Many will provide their actual financials, which can greatly improve the accuracy of your clients’ estimates. This is an excellent resource and should be utilized where possible.

Your clients should also investigate how much money, if any, they will need to borrow, and what their monthly payments would be. Based on all this data, they should be able to put together a pro forma for their prospective investment.

B. What Are Your Clients’ Goals?

Along with assessing your clients’ understanding of the key business characteristics of franchising, their experience, and how much due diligence they have done, it is important to understand their ultimate goals. This will help guide you as to what is important and what is not, and instructs your clients as to whether the franchise they are contemplating buying is really a good fit. Typically, it is important to find out things such as whether your clients want to run the business, be active in management, or be absentee management. If they want to actively participate, what type of business would they enjoy operating? Are they interested in single or multiple units? Are they looking to be an area developer as well? Are they seeking a long or short-term investment, primary or supplemental income? Hopefully, they have already thought about these things, and the choice they bring to you will reflect these goals.

5 These items are discussed further in section III.A.5, below.

6 This item is discussed further in section III.A.15, below.
However, if they have not sufficiently considered their goals, advise them to do so. Similar to having them write out questions, have them write out their goals. This can solidify their thoughts and ensure that they truly understand what they really want. Particularly where they are looking to actively participate in the franchise, it is important to consider a franchise that will provide not only a sufficient return on investment, but one that they will ultimately enjoy operating.

With the thousands of franchise opportunities available, it is important that your clients have truly considered their options. Indeed, it is not unusual for clients to have considered only a handful of franchises before making their initial choice. This often occurs where the clients have dealt with a broker. Brokers can be useful resources, but often work from a limited pool of franchises. Their suggestions may also be influenced if they receive a commission instead of a salary. Therefore, you should advise your clients that although their broker promised to provide them with the best match, this may not be the case. Helping your clients identify their goals can go a long way to ensuring they have chosen a good fit.

C. **Gather Necessary Documents**

Every franchise evaluation includes a review of the related documents. This typically starts with the FDD and franchise agreement, as well as any marketing materials that your clients have received. It is good practice to obtain these documents as early in the process as possible. The FDD, which includes a copy of the franchise agreement as an exhibit, is generally given to the prospective franchisee in an electronic format. It is therefore usually a simple matter of asking your clients to email you a copy. If your clients do not have an electronic version, you can also request one from the franchisor.

If neither of those sources work, and the franchise is registered in California, you may be able to download a free copy from the California electronic access to securities and franchise information website (Cal-EASI). Cal-EASI has been behind in its postings for several years, but is expected to be completely revamped and up to date by summer 2014. It is also a good resource if for any reason you need to review older versions or amendments to the franchise agreement or FDD. This may come up if you are representing an existing franchisee who is buying a subsequent franchise in the same system.

D. **Gather Other Information Beyond A Review of Documents**

Aside from the key franchise documents, there are often other sources from which to collect information. As discussed above, the scope of the review and due diligence required is mostly defined by the risk and size of the investment, as well as a client’s budget for counsel. Thus, the time and effort required to go beyond a review of the franchise documents is also generally dictated by the particular situation. The following are helpful sources of information.

7 CAL-EASI, [http://www.dbo.ca.gov/CalEASI/CalEASI.asp](http://www.dbo.ca.gov/CalEASI/CalEASI.asp) (last visited September 12, 2013); Minnesota has a similar database called Commerce Actions and Regulatory Documents Search or CARDS. CARDS, [https://www.cards.commerce.state.mn.us/CARDS](https://www.cards.commerce.state.mn.us/CARDS) (last visited September 12, 2013). A limitation of these sites is that they do not include documents from some of the larger more established franchises that are exempt from filing.
1. **Franchisor’s Website and General Internet Search**

The franchisor’s website and a general Internet search will often provide valuable information beyond the FDD. It also takes relatively little effort to check these sources. So it generally makes sense to do this in any case, and for both you and your clients to search these resources. Each looks at the information from a different perspective. Your clients may find information important to them from a personal or business perspective that you might overlook, and you might find information important from a legal perspective that they might not realize has any importance. For example, this can happen where a franchisor gives earnings claims or financial performance representations (FPRS) outside of the FDD.\(^8\) A client seeing this information likely would not understand the significance, whereas the attorney should.

There are also various websites where franchisees (and commentators) vent their complaints with certain franchise systems. These sites are not hard to find, but caution your clients that they may contain a lopsided and negative perspective. Nonetheless, your clients should ask about the points raised in these sites when conducting due diligence calls to current and past franchisees.

Finally, if the franchisor is publicly traded, you can use EDGAR\(^9\) to review the franchisor’s quarterly and annual filings, along with any interim filings required because of material changes. This can be very helpful, since the amount of information and other data available in the Securities and Exchange Commission's filings goes well beyond that which is required to be disclosed in the FDD.

2. **Generally and In Franchisee’s Desired Territory, is Franchisor a Start-up Or Mature, Growing Rapidly Or Stalled?**

The maturity, size, and growth of a system are also important factors. Start-ups come with inherent risk. There is little or no track record to predict how the system or individual franchises might perform over time. Thus, a start-up will generally call for a more thorough investigation. But despite the added risk, start-ups can still be a good investment. Some are just good ideas that have not yet developed, particularly where they fill a hole in an untapped market. Moreover, getting in on the ground floor can have its advantages. The initial fees are often less, and prime locations may be available. On the other hand, larger mature systems may offer better brand recognition and a built-in market, as well as stability and predictability, but they often have limited options as to prime locations and may have higher fees and royalties.

System growth is also informative, but usually does not tell the entire story. A growing system is generally a good sign. It is important, however, to understand why the system is growing. If growth is primarily due to a good sales team, it may instead expose a problem. Systems where revenue comes primarily from sales of franchises, instead of royalties, should typically be a concern. If the system also has a high failure rate along with the rapid growth, it is one to avoid.

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\(^8\) See additional discussion relating to FPR's infra at section III.A.15.

Also, if the system is growing too fast, it may present problems. This may raise issues as to whether the franchisor can provide adequate training and assistance to its franchisees, or whether supply lines are properly set up and stable.

If growth is stalled, it is important to consider the maturity of the system. When a new system is stalled and showing little or no growth, that generally indicates a problem. However, mature systems may be doing just fine even when not growing. Indeed, it is not unusual for a mature system with exclusive territories to remain relatively constant. The key is to look at these factors and make sure your clients understand what it means for the particular system.

3. **Is the Franchisor Pressuring the Franchisee Because Someone Else Is “Interested in the Proposed Territory”?**

High pressure sales tactics raise a red flag, and suggest that your clients should proceed with caution. It is not unusual for a sales person or broker to exaggerate interest from other buyers in order to close a sale. In these instances, ask for specific details. Try to determine if there really is an interested third party or a need to hurry. Indeed, in some jurisdictions the franchisor is required to provide this information.\(^\text{10}\) With all the various franchise options available, it usually makes no sense to bow to pressure and forego the necessary due diligence. Where clients feel compelled to rush the deal, make sure their interest or the rarity of the opportunity justifies the haste.

4. **If Your Clients are an Existing Franchisee, What Is Their Relationship With Franchisor?**

Where your clients already own a franchise or multiple franchises in the system, they will likely come to the table with a good understanding of what they are buying. If they want more of the same, it often means they have a good relationship with the franchisor.

On the other hand, it is not uncommon for an existing franchisee to want to expand even where the relationship with the franchisor is somewhat sour. They may be successful in their current franchises and confident they can recreate that success despite their franchisor. Non-compete provisions may also limit their choices for expanding.

In these cases, it is important to be sure that they have realistic expectations. They may face a tougher battle than if there were no existing relationship. It is not unusual for a franchisor to throw up roadblocks if it favors other franchisees who are interested in the particular franchise. Favoritism can be magnified, particularly where your clients have an already rocky relationship with the franchisor. Bottom line, clients should fully understand how their existing relationship with their franchisor may affect their ability to purchase additional franchises.

5. **If Your Clients Are an Existing Franchisee, Do They Have Any Claims That They Will Need to Release?**

Franchisors may require an existing franchisee to sign a release of all claims when

\(^{10}\) See, e.g., MINN. RULE 2860.4300, subp. 2.
purchasing an additional franchise. In these situations, it is critical to determine whether your clients have any claims. If they do, are they willing to release them or is the franchisor willing to carve out an exception in the release? This is an important discussion to have with your clients, since they may not even realize that there have been violations by the franchisor, or that they may be entitled to some type of redress.

6. Compliance With the FTC Rule or State Franchise Laws: Is the Franchisor Properly Registered (Where Applicable), and Did Your Clients Receive Proper Disclosures? If Not, What Does That Mean for Your Clients?

While most franchisors comply with the rules relating to franchising disclosure, it is not uncommon to find violations. There may be issues with proper registration (in states requiring registration), or with failure to meet disclosure requirements under the FTC rule.12 There may also be instances where the franchisor (or its agent) made prohibited disclosures or misrepresentations.

In states with a registration requirement, it is good practice to determine whether the franchisor is in compliance. Occasionally, the franchisor has not registered, and the violation is obvious. More common are instances where the franchisor has not completed registration or properly prepared or updated the FDD before offering the franchise for sale. The FDD will usually indicate the current year's date, and the date(s) of the FDD's registration with applicable states. If you have reason to believe that the FDD's registration may have lapsed, you should contact that registration state to inquire about the registration status of an updated FDD and/or follow up with the franchisor to determine if there is an updated, registered FDD, or if there is a problem with registration.

The classic prohibited disclosure is an earnings claim or financial performance representation (FPR) given outside of item 19 of the FDD.14 To find out if this happened, ask your clients if the franchisor or any of its agents provided any information relating to revenue, profits, or costs other than the written disclosure in item 19.15 It is also good

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11 Only certain states require franchisors to register their FDD with the state. These are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, New York, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

12 16 CFR § 436-437. While the FTC Rule does not provide for a private cause of action, see, e.g., Brill v. Catfish Shaks of America, Inc. 727 F.Supp. 1035, 1041 (E.D. La. 1989), franchisees may have a private cause of action under the common law and may have rights under state franchise statutes, business opportunity laws, and anti-fraud statutes applicable beyond consumer transactions. The FTC has administrative enforcement power regarding non-compliance with the FTC Rule, though it is not often exercised. Regardless of these enforcement issues, noncompliance with the FTC Rule on its own raises concerns worth considering and investigating.

13 Update requirements are that within 120 days after the fiscal year, a franchisor must update its disclosure document to ensure that the document is current. Further, within a reasonable time after each quarter of the fiscal year, a franchisor must update Item 22 to reflect material changes. Finally, when furnishing a disclosure document, a franchisor must notify a prospective franchisee of any material changes relating to a financial performance representation.

14 See also discussion infra, section III.A.15.

15 Although the new FTC Rule allows franchisors to provide cost information outside of Item 19. 16 C.F.R. § 436.1(e). it is important to remember that doing so may still constitute a disclosure violation. "[A] presentation
practice to review the franchisor's website and any marketing materials, as you may recognize an improper earnings claim where your clients may not.

Misrepresentations or omissions are usually more difficult to uncover. Reviewing the FDD may reveal disclosure violations, particularly where the franchisor simply fails to disclose information required in one of the numbered items. However, misrepresentations or omissions are not always instantly noticeable and can be uncovered only by first discovering particular information that should have been disclosed, or facts that indicate a statement is not true. So it is important to keep in mind the broader information acquired as part of the due diligence. Uncovering misrepresentations or omissions often requires connecting the dots from other information you may already have reviewed.

In any event, violations indicate problems. Determine how serious the problems are. Even if not so extreme as to be an instant deal-breaker, the problem can inform a client's decision as to whether to purchase the franchise.

a. **Tells Something About Franchisor**

Violations often provide insight into the franchisor. If the violation is purposeful, it should always be a concern, and trigger additional due diligence. If it was a result of negligence, that may say something as well. But it depends on the particular facts underlying the violation. There are really two dividing lines: the first is between negligent and unintentional violations, and the second is between material and nonmaterial violations. An understandable oversight is certainly not the same as an intentional misrepresentation, and a minor error does not merit the same concern as a material violation. Similarly, quantity may be informative. If the FDD contains numerous violations, it may indicate something about the franchisor’s culture, about its respect for the rule of law, or the resources it has, or does not have, to devote to compliance. Often what may provide the best insight is how the franchisor deals with the violation once the prospective franchisee raises it. Generally it is a matter of considering the seriousness of the violation, how it came to be, and how it is handled once uncovered.

b. **May Impact Franchisor’s Future Focus**

A serious violation may have ramifications beyond those directly affecting your clients. If the violation will likely affect other prospective or current franchisees, it may require the franchisor to devote significant resources to fix the issue. Multiple lawsuits or regulatory actions could have a devastating effect, should the franchisor be forced to divert resources that it might otherwise use to benefit its franchisees. If you or your clients or another franchisee uncover a violation, it is important to consider just how much of a distraction it might become to the franchisor and its ability to operate.

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of cost data, coupled with additional sales or earnings figures, from which prospective franchisees could readily calculate average net profits, is a financial performance representation, and does trigger the Item 19 disclosure obligation." FTC Franchise Rule Compliance Guide at p. 131, http://business.ftc.gov/sites/default/files/pdf/bus70-franchise-rule-compliance-guide.pdf
c. **May Impact Brand**

A serious violation may affect the brand itself. If it would allow current franchisees to rescind their agreements, it could cause a significant loss of market share and exposure. Multiple lawsuits or regulatory actions could similarly be devastating to the brand if the franchisor has to divert resources that it might otherwise put towards growth. If the misrepresentation reaches the level of fraud, and becomes well publicized, it might even affect the brand’s reputation with customers.

d. **Not Franchisee’s Violation**

The franchise sales and disclosure laws are designed to protect franchisees and do not include provisions by which the franchisee can be in violation when purchasing a franchise. However, as discussed in the next section, knowledge of the franchisor’s violation may affect the franchisee’s rights.

e. **Get-Out-of-Jail-Free Card**

Once a violation is discovered, the obvious question presents itself: What should a prospective franchisee do with this information? Generally there are three options: (1) decide not to purchase the franchise; (2) contact the franchisor and try to resolve the violation before purchasing the franchise; or (3) ignore the violation and purchase the franchise anyway. Opting for the first ends the discussion. If a client remains interested despite the violation(s), the second option is generally good practice. How the franchisor reacts to the problem will generally provide insight and guidance as to whether your clients want to move forward.

If a client chooses the third option, then the question arises whether the violation can be used as a “get-out-of-jail-free-card”. Common law fraud claims fail since the necessary element of reasonable or justifiable reliance cannot be met if the franchisee was aware of the violation. But in states with franchise acts, business opportunity laws, or anti-fraud statutes applicable outside of consumer transactions, it is not so clear whether a client can later rescind the agreement.

Many franchise systems try to avoid this situation by including integration and waiver provisions in the franchise agreement or requiring separate disclaimers or waivers to be signed by the franchisee. How effective this is remains unclear, as courts addressing these issues have come down on both sides. Essentially, some courts have held that reliance is not required for certain acts to allow the franchisee to recover, or it need not be reasonable or justified, and even that unclean hands will not bar statutory recovery for a violation. Others have held that reliance is a necessary element of a claim, and that

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16 Integration clauses and waivers apply only to information outside of the FDD. A violation on the face of the FDD is not affected. In addition to a standard integration clause, it is fairly common for franchisors to require prospective franchisees to sign a separate waiver form attesting, e.g., that they have not received any FPRs outside of Item 19 (or at all if the franchisor does not provide FPRs) or that they are not relying on any FPRs as a basis for their purchase. The waivers also generally instruct prospective franchisees to inform a specific senior management person if they have received any FPRs outside of Item 19.
unclean hands will bar recovery.\footnote{17}

Bottom line, if the violation is significant, it may make the most sense for your clients to just walk away. Keeping it secret and hoping it provides the right to rescind later is highly risky. With all the choices out there, it will almost always make more sense to find a better franchise that your clients are confident will succeed.

If the violation is minor or easily correctable, it usually makes sense to alert the franchisor to the violation and gain the insight from how the franchisor handles the situation. You should warn your clients, however, that this might scuttle or significantly delay the deal, as franchisors often refuse to sell the franchise once they become aware of a violation. So it is important to determine the significance of the violation. In some cases, just ignoring it may make sense. But it should never be relied on as a get-out-of-jail-free card if doing so means accepting a deal your clients would not otherwise accept.

\footnote{17 The leading case is \textit{Randall v. Lady of Am. Franchise Corp.}, 532 F. Supp. 2d 1071, 1087 (D. Minn. 2007), where the court took a hard line against the franchisor and held that the Minnesota Franchise Act does not require "justified" or "reasonable" reliance to support a misrepresentation claim, and that an integration clause or waiver argument was barred by the anti-waiver provision in the Franchise Act. The Randall court expressly stated: "franchisees who suffer harm after relying, even unreasonably, on misrepresentations by franchisors" may still recover damages." But see Ellering v. Sellstate Realty Sys. Network, Inc., 801 F. Supp. 2d 834, 845 (D. Minn. 2011); and \textit{Cook v. Little Caesar Enterprises, Inc.}, 210 F.3d 653, 659 (6th Cir. 2000) (finding "that reasonable or justifiable reliance was necessary for a Michigan Franchise Investment Law claim").

Michigan courts are split on whether franchisors may assert an unclean hands defense. In \textit{Martino v. Cottman Transmission Sys., Inc.}, 218 Mich. App. 54, 62, 554 N.W.2d 17, 21 (1996), the Michigan Court of Appeals held that the right to rescission under the Michigan Franchise Investment Law ("MFIL") was "unqualified" and refused to allow the franchisor to assert a defense of unclean hands against the franchisee. \textit{Accord, Cook v. Little Caesar Enterprises, Inc.}, 210 F.3d 653, 659 (6th Cir. 2000) (finding "that reasonable or justifiable reliance was necessary for a Michigan Franchise Investment Law claim"). But see \textit{Two Men & a Truck/Int'l Inc. v. Two Men & a Truck/Kalamazoo, Inc.}, 955 F. Supp. 784, 786 (W.D. Mich. 1997) (calling into question the \textit{Martino} ruling, and allowing an unclean hands defense to preclude a claim based on the franchisor's violation of the MFIL).

Courts have also held that reasonable reliance is a requirement for claims under the California Franchise Investment Law ("CFIL"). \textit{See People ex rel. Dept of Corporations v. SpeeDee Oil Change Sys., Inc.}, 95 Cal. App. 4th 709, 725, 116 Cal. Rptr. 2d 497, 509 (2002). In addition, the CFIL expressly provides an affirmative defense to damage and rescission claims for violations of two specific sections, \textit{CAL. CORP. CODE §§ 31200} and 31202, if:

the defendant proves that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he or she had exercised reasonable care, would not have known, of the untruth or omission.

\textit{CAL. CORP. CODE § 31300}. On the other hand, §31300 does not provide this affirmative defense for violations of several other sections. By expressly including only the two sections in the affirmative defense, arguably a franchisee's prior knowledge of a violation of the other sections would be irrelevant, and the right to rescind unqualified.
III. REVIEWING THE FDD

As important as it is to understand your clients’ goals and abilities, the main reason clients seek your advice is for your legal skills. Reading the franchise agreement and FDD disclosure sections, evaluating the information and comparing the two for consistency, and making realistic proposals in negotiations will often be your main focuses in a franchise review. It is here that your legal expertise really comes into play. The franchise agreement provides the legal basis for the relationship and the terms that govern the relationship. The FDD is designed in part to clarify or explain these terms, but also to provide additional, vital information about the franchisor and its system. Not only is it important that you thoroughly understand these documents so that you can explain the offering to your clients, it is also important to read these documents together and to compare them for consistency. The terms in the franchise agreement may vary from the language of the FDD and thereby create an ambiguity. If the ambiguity relates to an important term, you or your clients should identify and clarify it with the franchisor so that there is no misunderstanding when the franchise agreement is signed.

A. Reviewing the FDD

The FDD is broken down into 23 "Items", each of which requires disclosure or explanation of certain information. It essentially serves two purposes: to (1) disclose required information about the franchisor and its system; and (2) explain certain terms of the franchise agreement without the legalese. Along with the 23 Items, it also includes various exhibits including: copies of the franchise agreement and other agreements relating to the franchise (e.g., security agreements; promissory notes; personal guaranties; etc.); state-specific addenda; franchisor financial statements; a list of current and former franchisees; and if applicable, a table of contents of the operating manual.  

1. Item 1 – The Franchisor and Any Parents, Predecessors, and Affiliates

Item 1 provides a general overview of the franchisor, its history, and affiliated entities. This can often provide insight into the strength and viability of the franchise system.

The item also provides information about industry-specific laws and regulations applicable to the franchised business. This can be important as it informs the client of potential additional work and costs associated with the franchise. Franchisors expanding into states with more extensive regulatory schemes sometimes fail to disclose applicable regulations. In extreme instances, the franchise may not be able to legally operate in your state. In any event, it is important for your clients to be aware of, and understand, any

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18 The FTC Rule sets forth the various requirements of each Item in the FDD. See 16 C.F.R. § 436. Although the FTC Rule is controlling, the North American Securities Administrators Association (NASAA) issues guidelines that incorporate the FTC Rule, and are accepted in registration and disclosure states. NASAA 2008 Franchise Registration and Disclosure Guidelines, http://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf. (Last visited September 12, 2013).

19 California has some of the strictest environmental regulations in the nation that go beyond those of other states as well as those promulgated by the Environmental Protection Agency. Particularly where a franchise system uses certain chemicals that may be banned in California, but not elsewhere, this issue may be crucial.
applicable regulations, as this information may have a significant impact on the decision of whether to buy the franchise. While most franchise lawyers probably are not familiar with the regulations specific to each industry, it is good practice to alert your clients to this issue, particularly if the franchisor has recently expanded into your state.

The item also describes competition, but the descriptions are often sparse. The FTC Rule and NASAA Guidelines require only a general description. As discussed above, this information can generally be gleaned in much more detail from other sources.

2. **Item 2 – Identity and Business Experience of Key Persons**

Item 2 provides information about the principals, directors, officers, and other executives who have management responsibility. This is important information that may give insight into the strength of the leadership. Generally, you should look for executives who have substantial franchise experience. Executives who are either new or come from failed franchise systems may suggest a weak leadership team. Additionally, you may have information about the franchise systems at which the franchisor’s executives have worked that may give you insight into how they will operate. You should also look for stability; high turnover may indicate a troubled system or one in turn-around.

3. **Item 3 – Litigation History**

Item 3 provides an overview of the franchisor’s litigation history including pending litigation and concluded litigation for the past three years. Franchisors must now also disclose settlement terms of all settled litigation. Less litigation is generally a good sign. However, litigation by itself is not necessarily a bad sign. As discussed above, if there is a concern, it is good practice to follow up with the attorneys or parties involved in the lawsuits to try to get more information about the specific circumstances. Where possible, it can be a good idea to review court files in disclosed litigation to determine if the franchisor’s description of the litigation is complete and accurate. You can also crosscheck this information by using PACER or Westlaw to make sure that the franchisor is disclosing all litigation. In systems that sell franchises internationally, you may want to ask the franchisor about material litigation abroad as the franchisor may not be required to disclose these cases in Item 3.

4. **Item 4 – Bankruptcy**

This Item provides information on whether any persons or entities listed in Items 1 or 2 have been involved as a debtor in a bankruptcy proceeding. If the franchisor is or has been in bankruptcy, extensive due diligence is needed. If a parent, affiliate or executive is listed, it should raise concerns, but not at the same level as a franchisor bankruptcy. You can also PACER or Westlaw to make sure the franchisor is complying with its Item 4 disclosure obligations.

5. **Items 5, 6, 7 – Initial Franchise Fees / Other Fees / Initial Investment**

Items 5, 6 and 7 provide information relating to fees and costs of operating the franchise. Item 5 is an overview of the initial franchise fees. It may indicate a set fee, or a range depending on certain factors such as the number of territories purchased.
Item 6 is a chart that contains information concerning other fees that the franchisee may incur during the term of the franchise agreement. A careful explanation of these fees/costs, and the related contract provisions, should be given to your clients.

Item 7 is a chart that lists initial investment and expenses to operate the business during the first three months. Your clients should understand that these numbers include both fixed and estimated costs. The estimated costs are generally given as a range, so it is important for your clients to ascertain where their costs will fall. Checking with other franchisees, local vendors, and construction companies are good places to start. In reviewing this chart, you should pay close attention to the footnotes, where caveats and explanations relating to investment expense are made. Local costs and conditions should also be considered in this context.

The costs listed in Item 7 are not exhaustive. Other costs, such as ongoing costs associated with items like product or inventory, are not listed here. Additionally, subsequent upgrades may be mandated at the franchisor’s discretion. For example, the franchisee may be required to purchase a new POS system or new operating equipment (for example, kitchen equipment in a fast food franchise). Also, many franchise systems change over time, adding new product lines or services, implementing new systems, and undergoing other changes. Additional investments may be required in all these instances and the franchisee needs to understand that. Thus, your clients should determine any potential additional costs when they do a pro forma.

It is also important for your clients to understand that just meeting the numbers in these Items may not mean they are sufficiently capitalized. There could be additional costs that might cause your clients to be undercapitalized and unable to meet their commitments. Your clients should understand that they should have sufficient reserves in case the expected cash flow does not reach levels sufficient to sustain the initial start-up of the business.

6. **Item 8 – Restrictions on Sources of Products and Services**

Item 8 of the FDD provides information concerning restrictions on goods or services if the franchisee is required to purchase only from approved or specific suppliers. If the franchisee is free to buy from any supplier meeting certain specifications, this must also be disclosed in Item 8.

This Item also discloses a franchisor’s right to rebates or allowances and any amount that the franchisor may collect from the franchisees’ required purchases. This information should be carefully explained so your clients understand that on each required purchase, the franchisor receives some compensation. This amount should be factored in when evaluating what your clients are paying in exchange for the system and marks.

An issue arises where franchise documents provide that a rebate may be taken in the future, though it is not taken at present. Your clients should understand that the franchisor may, in the future, impose the requirement. The amount of those rebates or allowances will therefore not be known at the time the agreement is entered into, and that rebate or allowance may impact the price of the goods or services charged to the franchisee. Again, this should be calculated in your clients’ business plan.
7. **Item 9 and 11 – Obligations of the Franchisee and Franchisor**

Items 9 and 11 discuss the parties’ obligations. As most franchise agreements are rather one-sided, most obligations fall to the franchisee. This is crucial information that should be explained in detail to your clients. Understanding how the relationship will work and the various obligations of each party is often the most important factor when deciding whether to buy a franchise. The information in Items 9 and 11 is taken from the franchise agreement and cross-referenced to the various sections from which it comes. You should compare the language in the FDD to its counter-part in the franchise agreement for consistency. It is often here that ambiguity can arise. With respect to the franchisor's obligations, it is also important to watch for subtle qualifying words, such as "reasonable," "as needed," or "at our discretion," and to be sure to explain to your clients that the associated services may not be guaranteed.

8. **Item 10 – Financing**

Item 10 provides information as to whether the franchisor offers financing directly or through programs with lenders. The franchisor is also required to disclose whether it has any relationship with an outside lender. While franchisors may offer financing at more favorable rates, your clients should be aware that there may be drawbacks to financing through the franchisor. For example, if your client defaults on the loan, the franchisor can usually terminate the franchise, whereas that may not be the case if the default is with a private lender.

9. **Item 12 – Territory**

Item 12 describes the restrictions on territories, and whether the franchisee has any exclusive rights or restrictions in their territory. The franchisor must also disclose whether the franchise is for a specific location or a location to be approved by the franchisor, and any conditions for relocating the franchise. Under the new guidelines, if the franchise agreement does not grant an exclusive territory, the franchisor must include a specific admonition informing the prospective franchisee that they will not receive an exclusive territory and that they may face competition from other franchisees and the franchisor. This information comes directly from the franchise agreement and should be compared for consistency.

10. **Items 13 and 14 – Trademarks / Patents, Copyrights and Proprietary Information**

These Items provide information relating to the franchisor's intellectual property, including ownership rights and to whom the rights have been licensed or assigned. The franchisor is also required to disclose whether there has been any challenge to its trade or service marks.

As discussed above, brand recognition offers important insight when weighing the value of the franchise. But the value of the marks does not stop with brand recognition. It is also important to determine the level of protection afforded the marks.

A trade or service mark can be protected simply by use in commerce, but federal registration of the marks provides a greater level of protection. This is important because a mark may have little or no value if others may freely use it. Federal registration is a start, but even if federally registered, the inquiry should not end there. The next step is to determine
whether the registration is final or still pending and subject to objections, and if it is on the Principal Register or on the Supplemental Register. The Principal Register provides strong protection for marks, whereas the Supplemental Register provides little protection. Indeed, registration on the Supplemental Register often means that the mark is insufficiently distinctive to be on the Principal Register, and will gain protection only if not challenged during its time on the Supplemental Register. Item 13 provides extensive information about a franchisor's marks, including their status, any litigation, and claims or limitations relating to the marks. The status of the marks may be cross-checked on the Trademark Electronic Search System of the United States Patent and Trademark Office.\footnote{Trademark Electronic Search System, http://www.uspto.gov/trademarks/ (Last visited September 12, 2013). The USPTO website also provides several helpful guides and manuals relating to trademarks.} If such a search reveals that someone other than the franchisor owns the marks, make sure that the franchisor has the right to sublicense them to the franchisee.

11. **Item 15 - Obligation of the Franchisee to Participate in the Actual Operation of the Franchise Business**

   Item 15 explains whether franchisees must play an active role in managing the franchise or whether they can operate it passively. It is important to note that franchisors who allow for manager/operators often require the manager to have certain training or a specific ownership interest in the franchise. Where the manager does not have an interest in the franchisee, the franchisor may require that he or she is separately approved. It is therefore important to explain to your clients what the requirements are so that they understand what will be required of them and their managers.

12. **Item 16 – Restrictions on Goods and Services Offered by the Franchisee**

   Item 16 discloses any restrictions on what franchisees may sell. If there are restrictions, their effect will vary depending on the franchised business. It is therefore important for your clients to understand the nature of the franchised business and how these restrictions might affect them.

13. **Item 17 – Renewal, Termination, Repurchase, Modification and/or Transfer of the Franchise Agreement, and Dispute Resolution**

   These disclosures again come directly from the franchise agreement. Item 17 is an extensive chart identifying key provisions in the franchise agreement, citing the corresponding section, and providing a summary of the provision. Always compare the summary with the specific language in the franchise agreement, as they may differ. It is important to identify any ambiguities so that there is no confusion when entering into the agreement. If there is a material ambiguity or inconsistency between item 17 and the franchise agreement, it is best to address it with the franchisor before the contract is signed.

14. **Item 18 – Public Figures**

   Item 18 identifies any public figures associated with the franchise. This is typically not of much concern as only a very small portion of franchises utilize public figures.
15. **Item 19 – Financial Performance Representations**

Item 19 allows a franchisor to provide financial performance representations (FPRs, formerly called earnings claims) relating to its outlets. These can be in the form of either past performance or projections. The franchisor, however, is not required to provide FPRs. And even with the relaxed new rules intended to encourage franchisors to provide them under Item 19, many still elect not to do so. If the franchisor chooses not to, Item 19 must include an admonition indicating such, and directing the prospective franchisee to inform management, the Federal Trade Commission, and the appropriate state regulatory agencies if any financial performance information or projections are provided.

If the franchisor provides FPRs, it may do so only in Item 19 or appropriate supplemental documentation. It must have a reasonable basis for any FPRs and be able to substantiate its claims in writing. If the representation relates to past performance, it must indicate whether it relates to all existing outlets or only a subset, and if a subset, it must describe the subset by the characteristics that they share; for example, all company-owned stores or all franchises from a specific geographical location. If the representation is a forecast of future financial performance, it must state the material bases and assumptions on which the projection is based. The franchisor must also make specific statements and admonitions informing the prospective franchisee that their results may differ, and that the franchisor will provide written substantiation of the FPRs upon reasonable request, which should always be requested from the franchisor. As discussed above, FPRs outside of Item 19 are a classic violation, and care should be taken to uncover any inappropriate FPRs.

Where the franchisor offers an FPR, it can be an invaluable resource for your clients to use in their evaluation of the franchise investment. If this information is available, you should explain its meaning and import to your clients. It is important to remember that Item 19 does not necessarily reflect the best data available. Many franchisors do not provide operating costs because they may not have the information or conclude they cannot sufficiently unravel their franchisees’ accounting to make a meaningful disclosure. In other instances, the information may simply not be available to the franchisor. Gross revenues may offer little insight.

It is also vitally important for your clients to understand the source of the information provided in the FPR. For instance, if only the top performers or largest franchisees are included in the represented group, the information may be skewed and not particularly useful to a prospective franchisee looking to buy a single unit. If the FPR is derived from only corporate stores, those stores may not have the same cost structure (e.g. rents, royalties, labor, or product costs, etc.) as independent franchisees, so the information may again be misleading. Geographical location can result in misleading or useless information, too. If the sample includes only major urban areas, and a client is considering a franchise in a rural area, the information may not be useful at all. Thus it is vital to understand the segment from which the information is taken.

16. **Item 20 – List of Outlets**

Item 20 provides charts showing the number of franchised and company-owned outlets opened, transferred, terminated, or canceled and closed during the past three years. This provides invaluable insight into trends in the system. If the system is growing, it is generally a good sign. If, however, it is growing rapidly, it may indicate a system in which the
franchisor might outgrow its ability to adequately perform its obligations. In addition, if there is a significant overall reduction of outlets or a substantial failure rate in a growing system, it is usually a red flag. A high level of transfers may also warrant investigation to determine whether a significant number of the transfers relate to underperforming franchisees who needed to sell to stem their losses.

You should also review the Item 20 information to make sure that the charts are consistent with one another and whether the list of franchisees the franchisor provides is consistent with the numbers in the charts. Similarly, you can check this data against the information in the franchisor’s audited financial statements as well as the franchisor’s website.

There is also a more subtle inference to glean from Item 20. Franchisors are required to account for initial franchise fees as unearned income, and are not allowed to recognize them as income until the franchisor has substantially performed all the material services or conditions relating to the sale, which is generally no earlier than the start of operations. Thus, the number of granted but not opened franchises should roughly correspond to the unearned franchise fees line on the franchisor’s balance sheet. If it does not, that might indicate improper accounting or that the franchisor is discounting fees for some franchisees.

17. Item 21 – Franchisor’s Financial Statements

Item 21 requires franchisors to provide audited financial statements that conform to generally accepted accounting principles (GAAP) or in a form permitted by the Securities and Exchange Commission. Reviewing the franchisor’s financials is necessary to providing sound business advice, and can give significant insight into the franchisor’s strength and stability. Solid financials typically mean a stable franchisor. Unless you are an accountant or a financial analyst, though, your review of financial statements should be limited to your level of competency, and your clients should be referred to a competent professional for a comprehensive review of the financials.

The financial statements include a balance sheet, income statement, and cash flow statement. The statements must be in a tabular form and compare at least two fiscal years. Start-up franchises may provide unaudited balance sheets as long as they phase in audited statements as they continue to do business. This information provides insight into the strength of the franchisor.

The balance sheet provides information about the franchisor’s assets, liabilities and net worth for the past two years and must be presented in a tabular format for comparison. Basically, the formula and arrangement of the balance sheet will be: assets – liabilities = net worth.

There are a few key factors to look for. If there is excessive debt, or liabilities exceed assets, or the ratio of debt-to-earnings to is high, these are generally areas of concern. This information may indicate that the franchisor is unstable, and it may need to institute significant changes or obtain equity to remain viable. Conversely, if the company has or is trending toward significant assets and earnings with low liabilities, it can be a sign of a financially strong franchisor.

One important line item to look for is the valuation of intangible assets like trademarks, patents, and goodwill. These assets are difficult to value, and can be used as a means to unduly increase net worth. If the numbers here appear inflated or account for a substantial portion of the total assets, this could also be a sign of trouble.

The income statement shows how much revenue has been generated by the franchisor over the past three years. It also shows what the franchisor spent to make its products or costs to provide its services. Thus, this data tells you how much profit or loss the company generated for the period. You should note in your review of the income statement how the franchisor’s revenue is generated. Franchisors that primarily make money through royalties or product sales are generally strong and stable, whereas franchisors that primarily make their money through franchise sales are generally not. However, in a franchise context, while a healthy net income figure is important, it is typically more important to understand the franchisor's expenses and how they pertain to the franchisees. A franchisor that shows little profit because of extensive investment in the franchise system is obviously better than a franchisor that makes excessive profits at the expense of the franchisees.

The cash-flow statement shows how changes in the balance sheet and income statement affect the franchisor’s cash and cash equivalent assets. A franchisor that uses the accrual method of accounting recognizes income when a contract is signed, not when payments on that contract are actually received. That recognition increases the net income figure without actually increasing the franchisor’s cash on hand. By adjusting the franchisor’s net income figure by increases or decreases in accounts receivables, accounts payable, non-cash expenses such as depreciation or amortization and other non-operating activities, the cash flow statement paints a clearer picture of the franchisor’s inflow and outflow of cash and cash equivalents, which is useful in analyzing a franchisor’s ability to manage its cash and pay its bills. When evaluating a business, normally the higher the cash-flow the better.

You should carefully review the “Independent Auditor's Report” including any notes to the financial statements. The Independent Auditor’s Report provides an independent review of the franchisor’s financial statements and an opinion as to whether those statements have been prepared in accordance with generally accepted accounting principles and whether they are free from material misstatements. The notes will discuss in detail the franchisor’s accounting policies including recognizing revenue and expenses, writing off bad debts, and related entity transactions. It is also a good idea to review the "Management's Discussion and Analysis of Financial Condition," including any footnotes. While this section does not provide any hard numbers, it explains certain line items and gives you the opportunity to see the company through the eyes of its managers.

18. **Item 22 and 23 – Contracts / Receipt**

Item 22 lists the contracts your clients will be required to sign. These are generally attached as exhibits towards the end of the FDD. The franchise agreement is obviously one of the documents required to be attached as part of Item 22. There are additional documents that are required as well. These may include a personal guaranty, a confidentiality and non-competition agreement, a territory attachment, and a collateral assignment of lease. Your clients should understand that these agreements contain additional obligations, and may significantly affect the relationship. You should review all of these documents as well.
Item 23 is a receipt (or refers to an exhibit that is the receipt), providing certain notices, identifying exhibits contained in the FDD and acknowledging when the clients received the FDD.

19. State-Specific Addenda

Several states require that a state-specific addendum be attached to the FDD that modify the terms of some of the disclosures in the FDD.\textsuperscript{22} Such addenda may be required by the laws and regulations of the franchisee’s state of residence and, if different, the state where the franchise will be located. If a state addendum applies, it is important to review it, as the addendum may provide significant protections to your clients.

B. Do You Give A "Yes" or "No" Answer?

Most attorneys prefer not to give a yes or no answer to the question: "Should I do the deal?" Rather, they prefer to carefully explain the various risks, opportunities, rights, and obligations facing their clients so their clients can make an informed decision for themselves. All clients are unique with respect to the level of risk that they are willing to take, the opportunities and rights that they seek, and the obligations that they are willing to incur. The assumption you make may not accurately reflect theirs. For this reason, a simple yes or no may be beyond your role. In most cases, the better practice is to provide your clients with sufficient information so that they can tell you whether they would like to proceed with the transaction (after negotiations have concluded).

Aside from the general ethical requirements of advising your clients only within your areas of competence, however, there is no rule preventing you from giving a yes or no answer. And some clients may insist on an answer. In considering whether and how to respond, remember that telling a client yes may expose you to liability. Should the franchise fail, the client may focus the blame on you. It could even expose you or your firm to a malpractice suit.

Saying no does not carry the same level of risk. Clients are less likely to regret a no decision or to later blame their attorney. Additionally, there are circumstances where a no answer may be appropriate or even fall within your ethical duty to competently advise your clients. For example, where the review turns up too many red flags, and it is clear that buying the franchise would be a mistake, it may make sense to tell the clients no. In general, however, the better practice is to provide your clients with the necessary information and advice, and to allow them to make the final determination.

IV. REVIEWING AND NEGOTIATING THE FRANCHISE AGREEMENT

Occasionally, clients come to the transaction and assume that the franchise agreement can be negotiated. Usually, however, clients have been told by franchise sales personnel or others that the franchise agreement cannot be negotiated. It is important to explain to your clients that whether or not the franchise agreement can be changed, they must understand the details of the deal and their rights and obligations under the agreement.

\textsuperscript{22} The states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.
Moreover, even where the franchisor has told a client that the agreement cannot be changed, there may be some revisions to which the franchisor will ultimately agree and you will not know for sure unless you ask. Generally, whether provisions of the franchise agreement can be negotiated will depend on several factors, including the provision sought to be changed, the franchisee’s desirability, wealth, and experience, and the franchisor’s size, financial stability, and growth strategy.

As discussed in greater detail below, certain provisions of the franchise agreement are more easily changed. For example, if your clients are concerned about the time allotted to find a location because of the particular geographic area, the franchisor may be willing to extend the time frame contained in the agreement. Conversely, franchisors are less likely to negotiate the royalty fee, in part because maintaining consistency in the system is valuable to the franchisor. Since the economic downturn, however, even some of the larger, well-established franchisors have been willing to negotiate the franchise fee to close a sale.

The franchisee’s negotiating position will also depend on their investment capabilities and experience. From a negotiating point of view, the least advantageous position for a prospective franchisee is to be a small, single unit prospective franchisee of an established system. This client brings little significant benefit to the system (and is probably one of many prospects). Larger, multi-unit operators frequently have more sway in negotiations. Needless to say, they are bringing a substantial investment into the franchise system and paying substantial fees to the franchisor. These large-scale franchisees can jumpstart the growth of a new franchise system or simply increase significantly the size of an established system. This may increase their leverage in obtaining changes to the franchise agreement.

Also relevant is the status of the franchisor. Smaller, newer franchisors are more likely to negotiate just to get started in the establishment of their franchise system. Those franchisors needing an infusion of funds from franchise fees and royalties are also more likely to negotiate than more-established larger systems. The same is true of franchisors establishing franchises in a new geographical area. However, your clients should understand that while they may have more room to change a franchise agreement with a less-established weaker franchise system, they would also be entering into an agreement with a less-established, weaker franchise.

Although franchise agreements in most systems tend to contain similar provisions that address common issues, the specific terms of the provisions vary by franchise system. Moreover, it is not unusual for these terms to change from year to year in the same system. It is therefore important to thoroughly read the agreement that your clients may execute and that is attached as an exhibit to the FDD provided to your clients.

The following are among some of the more important issues to consider:

A. **Do Your Clients Have Any Deal Breakers?**

As discussed above, it is helpful to ask your clients if they have any particular concerns or questions about the offering before you commence a review of the documents. That way, you can pay particular attention to the provisions relating to those aspects of the deal. A related question is whether they have any deal breakers, such as rights that they must obtain or they will not proceed with the deal. Some clients need to obtain a certain protected territory, or will not do the deal. For others, a deal breaker may relate to the extent
of personal liability for the franchisee’s principals. Once you know your clients’ position on these types of issues, you can pay particular attention to those provisions in the franchise agreement and you can better prepare for negotiations.

B. Personal Guaranty

Most franchise agreements permit execution of the franchise agreement by an entity formed by one or more individual clients. However, almost all franchise agreements will also require a personal guaranty by the entity’s principal or principals. Some franchisors will further require a guaranty from the principal’s spouse, whether or not the spouse is an owner of the franchisee or actively involved in the operation of the franchisee. There are various reasons that a franchisor may request a guaranty from the franchisee principal's spouse. One of the most common reasons is that the assets of the franchisee principal and the spouse may be jointly held and thus not recoverable if only one of the spouses has executed a guaranty. The guaranty requires the individual to be bound by all the franchisee’s obligations under the franchise agreement, which include financial obligations as well as restrictive covenants and other non-financial aspects of the agreement. Discuss this guaranty in detail with your clients. They should understand that not only are they making an investment, but they (and perhaps their spouses) will be required to be personally responsible for the obligations owed to the franchisor. In this context, they should understand that personal liability will not be avoided by creating an entity to operate the franchise business, at least as to the franchisor.

When negotiating, a franchisee’s counsel often seeks to eliminate or at least limit the personal guaranty. While the franchisor will often refuse to eliminate this obligation entirely, it will sometimes agree to a “good-guy guaranty.” Such a guaranty would, for example, require the guarantor to pay the franchisor only those amounts incurred during the operation of the franchise and not monies that might be due for future royalties or liquidated damages. Typically, the “good-guy guaranty” would also require the franchisee's principal (and in some cases, the principal's spouse) to agree to the confidentiality provisions and in-term and post-term non-competition restrictions. The franchisor may accept this type of guaranty because it ensures that the franchisee and/or guarantors will pay all royalties owed while operating and that the franchisee’s principal would not benefit from the training and method of operation learned from the franchisor to compete with the franchise system under a different name.

C. Liquidated Damages

Where franchise agreements provide for liquidated damages, your clients should understand that upon termination, the franchisor may be entitled to demand payment of monies that your clients would have paid if they had continued to operate the franchise through the entire term of years. This type of clause is particularly common in the hotel industry. This is one factor that makes franchise ownership so different from ownership of an independent business, and one thing that some franchisees find difficult to understand. After all, your clients may believe that there is no reason for them to pay royalties (and possibly advertising or marketing fees) after they close their business since those fees are (typically) based on revenue.

Liquidated damage provisions usually identify the formula under which these obligations are calculated; for example, they can be calculated based on the average of past
royalties in the twelve months prior to termination. Once that amount is determined, it will then be multiplied by a fixed term or by the number of months remaining on the agreement. Franchisors may include the liquidated damages provision to better the chances of recovering lost royalties or future profits when the franchise agreement is terminated early.23

Negotiating a reduction of these damages is important, particularly if the franchisee’s principal is required to execute a personal guaranty. When possible, try to eliminate the liquidated damages clause completely, or limit it to instances where your clients continue to operate their business independently after termination. Where the franchisor will not agree to these changes, the negotiation should be aimed at trying to reduce either the amount of royalties to be paid or the term of months for which the royalties will be owed (or both). For example, a liquidated damages clause that requires payments equal to three years of royalty amounts (based on past performance) may be reduced to require payments equal to only six months.

D. Protected Territory

Clients frequently misunderstand the territorial scope of their agreements, believing that they have an exclusive territory when in fact they do not. The issue may arise from conversations with franchise sales personnel who may have given the franchisee the mistaken belief that they would have exclusive territorial rights where none exist. Indeed, the use of the term “territory” suggests that the franchisee will obtain rights for a particular geographic area. It is important for you to determine and advise your clients whether their territory is exclusive. Many agreements have no territorial protection at all and they should understand that the franchisor has the right to operate or to franchise another to operate a business in their immediate vicinity.

Even if it appears that an “exclusive” territory is granted to the franchisee, the franchise agreement most likely contains certain exceptions to that exclusivity. Most franchise agreements permit the franchisor to sell the products or services through alternative channels of distribution. For example, if the franchisee will operate a frozen yogurt shop in a particular shopping center, the franchisor may still be permitted to allow a food store within the same shopping center to sell the same product. A franchisor may also reserve the right to open a unit in what is referred to as a “non-traditional location” such as a university, sports venue, or hospital even if located with the clients’ “exclusive” territory.

Negotiations may improve these clauses for your clients, but probably only as to the degree of competition. You may be able to obtain a limited exclusivity either geographically or for a short timeframe. And, where the sales representative has told a client that the

23 In Postal Instant Press, Inc. v. Sealy, 43 Cal App 4th 1704 (Cal Ct App 1996), the court overturned an award of future lost profits holding: (1) that the franchisee’s failure to timely make past royalty payments was not proximate cause of franchisor’s failure to receive future royalty payments since the franchisor had terminated the franchise; and (2) even if the franchisee’s continued nonpayment was the proximate cause, an award of lost future profits to the franchisor would be unreasonable, unconscionable, and oppressive. See also Kissing, Inc. v. Singh, 304 F. Supp. 2d 944, 951 (W.D. Mich. 2003); and Burger King Corp. v. Hinton, Inc., 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002); but see Radisson Hotels Intl', Inc. v. Majestic Towers, Inc., 488 F. Supp. 2d 953, 962 (C.D. Cal. 2007) (distinguishing Sealy and enforcing an indemnity/liquidated damages clause.) See also Meineke Car Care Centers, Inc. v. RLB Holdings, LLC, 423 F. App’x 274, 282 (4th Cir. 2011) (franchisees closing before the end of the franchise term was the proximate cause of the franchisor’s future lost profits.)
franchisor will not expand into adjoining territory that is not owned by another franchisee or serviced by the franchisor but the agreement does not mention this, the first order of business should be to try to get that commitment in writing.

If your clients are concerned about the franchisor’s competition within the territory, you may want to consider seeking to obtain a right of first refusal for the franchisee. Under this arrangement, if the franchisor plans to establish a unit at the non-traditional location, the franchisee would have the right to open that additional unit. Of course, the franchisor would want to ensure that certain conditions were met before your clients could exercise this right of first refusal, such as making sure your clients are in strict compliance with the franchise agreement.

E. Term and Renewal

The term of the agreement is one of the most important issues that your clients should understand. Sometimes, clients believe that they are getting an “evergreen agreement” because they do not understand that a franchise is a non-exclusive license for a set term. Thus, it is important for you to advise them that the agreement has an initial term, and that it has to be renewed when that term expires. You should also advise them that in reality, a franchisee does not have the right to renew the identical franchise agreement per se; rather, they will have a right to renew the franchise only by executing the then-current form of franchise agreement, which is likely to be different (and could be more onerous) than the existing franchise agreement.

Some state laws may override franchise renewal restrictions.24 Thus, be sure to check applicable state law. You should also advise your clients as to whether the renewal is limited to a set number of terms. Often it is one or two terms, and frequently, the renewal term is shorter than the initial term of the agreement. For example, many franchise agreements have an initial term of ten years and two five-year renewal terms. In order to exercise a right of renewal, your clients will likely have to comply with certain conditions. These include providing the franchisor with timely notice, executing the then-current form of franchise agreement, paying a renewal fee, and executing a release. Further, your clients may be permitted to renew only if they are in compliance with their obligations under the franchise agreement. Be mindful of the fact that although most franchisors allow the franchisee to renew if all defaults are cured at the time of renewal, some agreements preclude renewal if the franchisee has ever been in default, even if the default was cured in a timely fashion.

One of the most important issues to negotiate is what terms the franchisor may change in its then-current form of agreement. Here, you should try to obtain an agreement that the franchisor will not increase royalties or reduce territory size. Similar to the discussion on sale/transfer restrictions below, increased royalties in the then-current franchise agreement reduces the franchisee’s expected rate of return and makes an investment in the franchise less attractive. Other negotiating issues might include the reduction or elimination of renewal fees, longer renewal terms, additional renewal periods, and a relaxation of the conditions for renewal. You may also want to ensure that the franchisees will not lose their right to renew if they fail to comply with a non-material obligation in the franchise agreement. Franchisees should not lose the right to renew simply because they may have failed to comply with a non-material obligation.

24 See, for example, N.J. STAT. ANN. § 56:10-5 (West 2013).
F. In-Term and Post-Term Non-Compete Provisions

Clients are often familiar with the concept of non-compete agreements. However, your clients may not understand the impact that these restrictions can have on their investment. You should explain the in-term covenant to your clients in great detail. For example, they should understand that, if they are entering into a restaurant franchise agreement, they may not be able to operate other restaurant businesses or, if they have an existing restaurant business, the operation of that business might violate the franchise agreement they are entering. In that event, you should try to exclude the clients’ existing business from the in-term non-compete provision.

More complex issues arise in connection with post-term covenants not to compete. These restrictions vary. Some affect only the franchisee or principal, but others are broader and may include spouses, other family members, or minority investors. The covenants are also enforced differently depending on which state law applies. For instance, while most states will enforce post-term covenants to varying degrees, post-term covenants are generally unenforceable in California. The ABA Forum on Franchising publishes a very helpful reference book that provides an in-depth analysis of how each state treats covenants against competition.

In states where a post-term covenant is enforceable, your clients should be informed that once the franchise agreement expires (or is terminated before the stated expiration date), they may not be able to continue to operate a similar business at the franchised business location, in their former franchised territory, or in a specified geographical area near their former franchise or near other existing franchises in the same system. The significant issue here is that the opportunities available to them once their franchise agreement expires or is terminated must be considered in determining their return on investment.

You may want to discuss with your clients their long-term goals to help them assess the significance of the risk posed by post-term non-compete provisions. A franchisor may be reluctant to negotiate the terms of these provisions. However, if there are special circumstances, such as a family member operating a business that could be deemed to be a competing business under the franchise agreement, you should negotiate specific exclusions prior to execution of the agreement. For more general exclusions, a non-compete provision can be modified in a number of ways. You can limit the geographical scope or duration of the provisions. You can also limit the application of the provision by more carefully defining the types of businesses that are “competitive” and thereby prohibited. For example, a more carefully crafted definition of a “competitive business” could permit a pizza restaurant franchisee to operate a hamburger restaurant with the pizza restaurant concurrently or after the termination or expiration of that agreement.

25 See CAL. BUS. & PROF. CODE § 16600.

26 COVENANTS AGAINST COMPETITION IN FRANCHISE AGREEMENTS 3, (Michael R. Gray & Natalma M. McKew, eds. 2012)
G. Sale/Transfer Restrictions

Your clients should understand that a franchised business cannot be sold in the same manner and with the same freedom as an independent business. Franchise agreements generally specify the method of transfer, require the franchisor’s approval for transfer, and often require the payment of transfer fees. Further, there is a question as to what the franchisee is actually selling. Most franchise agreements require the transferee to sign a new franchise agreement that may contain materially different terms and that may have a term equal only to the remainder of the franchisee’s term. Potential buyers will then not be in the same position as the sellers. They may have higher or additional fees, including a higher royalty rate, and will likely be required to remodel the franchise unit at substantial costs. Increased initial and ongoing expenses will reduce buyers’ expected rate of return, which will undoubtedly reduce the price buyers are willing to pay for that business. Accordingly, franchisees may not be able to get the full value of their business that would have been attainable if the buyers were allowed to operate the business on the same terms as the franchisees and without having to incur additional expenses.

You should attempt to negotiate the conditions on which a transfer will be permitted. At a minimum, your clients may want the option to transfer among family members without having to comply with the conditions for transfer such as payment of a fee, execution of a then-current form of franchise agreement, or remodel of the franchise. Moreover, the franchisor may reserves for itself a right of first refusal to be exercised after a potential buyer is located and due diligence has been conducted. This can be a problem where a buyer is not willing to invest the time and money in due diligence only to discover that the franchisor will exercise its rights to acquire the franchise. Moreover, if the franchisee’s principals intend to transfer ownership to an entity they form, or to their family members, they no doubt will not want the franchisor as a partner. You should therefore seek to exclude the option to transfer among owners and family members from the franchisor’s right of first refusal. If the franchisor will not remove this provision, you should ask to limit the amount of time within which it can exercise the right.

Although most agreements require that the transferee sign a new form of agreement, you should try to limit the franchisor’s ability to raise royalties or reduce territory, at least for the duration of the selling franchisee’s original term. You should also try to eliminate or limit transfer fees. Where the agreement contains a set fee (for example, 50 percent of the then current franchise fee) you should propose limiting the fee to the franchisor’s actual expense, with a cap, if possible. Where the transferee is required to renovate, counsel should try to eliminate this provision in instances where the transferring franchisee has built out a new unit or renovated it in, for example, the prior two years.

H. Costs for Future Upgrades and Modifications

Many franchise agreements require franchisees to comply with what is referred to as the “franchise system” or the dictates of the franchise manual. Such agreements are written with the understanding that the relationship is ongoing and that there are likely to be changes to the system or the manual that cannot be foreseen. As a result, the agreement often requires franchisees to incorporate any changes the franchisor mandates during the term. Although this flexibility can benefit the system and franchisees long-term, the impact of implementing changes can detrimentally affect individual franchisees. This is because they
will have no control over the timing for implementing the change or the costs that they will incur to implement the change. While it is unlikely you will be able to get the franchisor to agree to eliminate this requirement, you may be able to limit the amount that your clients have to expend in connection with modifications to the system. For instance, you may want to negotiate to set a limit on the costs your clients will incur to comply with required changes to the computer system, equipment, and other changes to the franchise. And where the franchisor reserves the right to require a wholesale renovation of the franchise unit, try to modify the agreement so that the renovation will not be required more than once in any ten-year period, or at least limit the cost to a reasonable percentage of the original build-out costs.

V. OTHER PROVISIONS TO NOTE EVEN THOUGH NEGOTIATIONS ARE UNLIKELY

A. Restrictions on the Use of Marks

There is one certainty in franchising: The franchisor controls the use of its trademarks. You should make clear to your clients that they cannot change the franchisor’s mark or use it any way that the franchisor has not approved. Additionally, they should be made aware that franchise agreements generally provide that any goodwill generated in connection with the use of the trademark belongs to the franchisor. This means that at the end of the franchise agreement, the franchisee will not get a return for the value of such goodwill.

Another key point is the strength of the franchisor’s trademarks. If marks are not strong, the risk exists that at some time during the course of the agreement the franchisor may require your clients to use a different trademark. Franchise agreements typically provide that franchisees must change the trademarks they use in business if the franchisor requires it, at their expense.

B. Royalty Structure or Other Revenue Stream

Most franchise agreements have a royalty structure, requiring a payment of a percentage of the franchisee’s revenue as income as a continuing royalty. You should inform your clients of the method by which the franchisor calculates the royalties and the manner in which fees are collected (sometimes directly from a franchisee’s bank account). Some agreements have minimum royalty payments, where the franchisee is required to pay a set dollar amount regardless of the franchisee’s actual sales. Others have performance requirements, where a franchisee is required to have a minimum dollar volume of sales, and royalties are calculated at the minimum or actual sales, whichever is higher. Some franchise agreements merely have flat fees. In all instances, you should inform your clients of the fee structure of the franchise agreement and they should utilize that information in preparing a business plan and analyzing the feasibility of success.

C. Supply Restrictions

Franchisors often require franchisees to purchase certain goods and services from only approved suppliers. These restrictions may force the franchisee to pay more than what
they might pay from other non-approved suppliers. This may be particularly true where the franchisor is receiving a rebate or kickback on the sales. It is important for the client to understand these restrictions so that they can accurately estimate the costs of operating the franchise.

D. **Franchisor’s Obligations**

A prospective franchisee’s expectations of the franchisor’s obligations often do not match the reality of the franchise agreement. In recent years, franchisors have significantly limited their obligations to the franchisee. It is not uncommon for the franchisor to have complete discretion over most of the services it provides, including when, how, and if those services are provided. This reality often clashes with franchisee’s expectations that the franchisor will assist them in all facets of operating the business, including in matters that the agreements themselves do not require. That fact should be carefully explained to your clients so that their expectations of the franchisor’s obligations are based on the contract.

E. **Franchisee’s Obligations – Additional Obligations in Operations Manual**

Your clients should understand all of what is required of them. They should also be made to understand that the franchisor intends to enforce the provisions of the agreement for the purposes of developing a uniform franchise system where everyone operates under the same rules and regulations. FDDs and franchise agreements contain a substantial amount of information regarding the franchisee’s obligations. You should carefully explain and discuss these with your clients so that they understand what is required under the terms of their agreement.

You should also discuss that additional obligations may be imposed if the franchisor utilizes an operating manual, as most do. This is an area where counsel cannot provide a substantial amount of information to the clients because confidential operating manuals are generally not made available to a franchisee until after a franchise agreement is signed. If one is used, the franchisor must at least provide the table of contents for the operating manual with the FDD, but this still offers only a limited overview of the actual obligations. You should also explain to your clients that the confidential operating manual will likely change from time to time, and that additional obligations may be imposed by that ever-changing document. As discussed, these changes are typically within the discretion of the franchisor. And while the initial operating manual and any changes cannot conflict with the express terms of the franchise agreement or materially modify the relationship, they may still create additional unexpected obligations.

F. **What If the Franchise is Not Profitable?**

No franchisor guarantees the profitability of a franchisee, nor can it. Again, you should make clear the reality of the investment to your clients. Not all businesses are successful. Even if franchise businesses are more likely to be successful than independent businesses (a hotly debated topic),\(^\text{27}\) not all franchise businesses are successful. Having

your clients create a detailed business plan that outlines all the investment requirements and the prospective revenues and costs is a helpful exercise for them in understanding the financial circumstances of their investment. Needless to say, a business plan is merely a projection of performance and not a roadmap to the actual performance of that business. Your clients should be made to understand that even if the franchise is not profitable, the agreement obligates them to continue operating. As noted above, your clients cannot simply walk away from a franchise without concerning themselves with the potential for ongoing liability to the franchisor (as well as to third party vendors and landlords). These issues should be carefully vetted with them.

G. **Default and Termination**

Most franchise agreements do not allow the franchisee to unilaterally terminate the agreement, and do not allow the franchisor to terminate other than for causes specified in the agreement. State law may impose additional obligations not found under the franchise agreement. You should inform your clients of the numerous provisions in their franchise agreement that give a franchisor the right to declare a default and then to terminate the agreement. You should also explain their rights under those provisions, for example, to cure the default within a specified period of time. The result of termination in addition to the loss of the franchised business should also be explained to them, including any requirement for de-identifying the business, which is generally at the franchisee’s cost. Issues such as non-competition provisions that come into effect (as discussed above), should be discussed with them in this context.

H. **Dispute Resolution**

The last thing most clients have on their mind when starting the process of buying a franchise is how they will resolve disputes with the franchisor. But the methods required for resolving disputes should be of particular concern. Franchise agreements often contain dispute resolution clauses that are designed to benefit the franchisor at the franchisee’s expense. They may include a jury waiver or a one-sided fee-shifting provision. And whether they allow for trial or require arbitration, they often contain choice of venue and choice of law provisions specifying the franchisor’s home forum and state law. Such clauses frequently make the cost of seeking redress for franchisor wrongdoing prohibitive. In these instances, the lawsuit’s cost may simply outweigh the relief sought if your clients are forced to litigate in a distant venue.

If a state franchise act is applicable to a particular franchise system or franchisee, it is also important to determine the effect it has on choice of law and venue. Many of these acts contain anti-waiver provisions and provisions that that void choice-of-venue clauses requiring a franchisee to litigate out of their home state. While the anti-waiver provisions will usually insure that their state’s franchise laws will apply, the statutes voiding out-of-state venue provisions do not necessarily guarantee a home forum for the franchisee.

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In some cases, the state statutes voiding out-of-state venue provisions have been held to be preempted by the Federal Arbitration Act. As such, the American Arbitration Association routinely transfers arbitrations by administrative order to the location chosen in the contract regardless of whether a state statute states that the provision is void. In other words, the case manager decides where the arbitration will take place. The options, then, are to try to convince an arbitrator outside of your state to give up the case and his paycheck, or to file a separate action in Federal Court, but only if the arbitration provision lacks language giving the arbitrator authority to decide issues such as proper venue. Some courts, however, have found it unnecessary to reach a preemption analysis, holding that there was no meeting of the minds based on the particular statute and disclosures informing the franchisee that the venue provision may not apply due to the state’s franchise act.

Outside the arbitration context, courts have also read the statutes to be limited to voiding the specific clause, but not barring an out-of-state venue. In other words, they determine the contractual choice of venue provision to be void, but then apply the court’s general venue provisions. Other cases have ignored the statutes altogether and found the forum selection clauses enforceable.

Bottom line: it may be impossible to tell your clients where they may be forced to litigate if a dispute arises. But they should be aware that they might be forced to go to a distant forum, which could hinder or even preclude their ability to obtain any redress.

VI. STRATEGIES AND TACTICS IN NEGOTIATING THE FRANCHISE AGREEMENT

A. Be Prepared with a Strong Argument for Requested Changes

It is a good idea to come into any negotiation with a rationale for each of your requests, not simply a bullet point list. Thus, any particular requested change should be accompanied by some reason for that change. These include the following:

1. Fairness

Discuss with the franchisor or its counsel the notion that the requested changes are merely intended to give the franchisee a fair agreement. For example, you may suggest that being able to assign the agreement to family members without paying a fee is reasonable because the franchisor will not really incur any expenses in evaluating the prospective franchisee, particularly if the existing principal remains involved and if the family member acquiring the franchise has been previously involved in the operation of the business.

30 See Bradley v. Harris Research, Inc., 275 F.3d 884, 890 (9th Cir. 2001).


2. **Industry Standards**

Some franchise agreements are more restrictive than others in their industry. Where you can point to the provisions of an agreement of a competitive franchisor as being more reflective of the industry standard, you may be able to convince a franchisor to make the requested change.

3. **Economics**

In weak economic times, a franchisor may be more amenable to financial accommodations than otherwise. For example, a franchisor may agree to a reduced royalty rate for an initial period of time or if the franchisee is generating low sales volumes, both of which would help a struggling franchisee remain in operation.

4. **Win/Win**

It is important for counsel to understand the purpose of any particular clause in the franchise agreement. A franchisor is more likely to accept a requested change if the change also satisfies the franchisor's intended purpose.

5. **Clear Standards Help Both Sides**

A franchisor may be more likely to accept a requested change if you can show that the current language is ambiguous or open to interpretation. Clearer language helps both parties understand their respective obligations and rights.

6. **We Love You, but Management Changes**

Even though the franchisee may have a great relationship with the franchisor's current management team, the parties should not assume that the franchisor's management team will remain in place throughout the length of the franchise agreement. This may be a helpful point to bring up in response to a promise by the franchisor that it will not take a certain action but who does not want to change the terms of the franchise agreement to reflect that promise.

**B. Decide Whether to Approach the Franchisor with A Laundry List of Changes or Just the Few Most Important Issues**

Sometimes, counsel approaches negotiations by creating a long list of proposed changes, notwithstanding that their clients are willing to accept the deal if the franchisor limits its agreement to only a few of those changes. In such a case, you can ask for the moon and hope that the franchisor will at least agree to make the changes that your clients really want. Other times, counsel will approach negotiations by identifying only the major issues of concern. Choosing which way to proceed will often depend on the client as well as the franchisor. With large, established franchisors and small, single unit franchisees, the better approach may be to simply identify the real issues of concern and ask for necessary changes.
C. Have Limited Aims, and Be Prepared for Those to be Rejected

When your clients are in a weak negotiating position, they should understand that there is very little you can do to achieve the kind of changes they are requesting. Even when you are communicating with the franchisor about those proposed changes, your clients should understand that those proposals may, and likely will be, rejected.

VII. CONCLUSION

Representing prospective franchisees can be challenging and complex. This paper hopefully provides you some general guidance and helpful suggestions to make your representation easier and more effective.
MICHAEL EINBINDER

Michael Einbinder is a founding member of Einbinder & Dunn and has been practicing law since 1981. His experience encompasses commercial litigation with a broad range of legal and business skills. Throughout his 30 years of practice, he has handled complex commercial cases in state and federal courts representing businesses and industries throughout the country in cases involving, among other things, claims relating to breach of contract, fraud, misappropriation of trade secrets, interference with contractual relations, enforcement of non-competition agreements, real estate transactions, partnership and shareholder disputes as well as intellectual property matters. He has also appeared in various arbitration and mediation forums.

A substantial portion of his practice includes representation of start-up and established franchisors as well as multi-unit and single unit franchisees. Franchisors and franchisees are represented in a wide variety of industries, including restaurant, retail, hospitality, real estate, manufacturing, optical, recreation, business services, household and home improvement services, health care, education, child care and pet care. For franchisor clients, he has litigated and arbitrated all categories of disputes including trademark infringement claims, termination issues, enforcement of non-competition agreements, breaches of contracts and fraud claims. For franchisee clients, he has litigated an array of claims including those relating to franchise disclosure violations, franchise relationship laws, fraud, misuse of advertising funds, breaches of franchise agreements, non-competition issues and franchise terminations. His firm also handles litigation, arbitration, and mediation nationwide for both franchisors and franchisees (including associations).

Mr. Einbinder is an author in numerous publications, including contributing a chapter to the “Franchise Litigation Handbook” published by the ABA Forum on Franchising, co-authoring “A Franchisee’s Guide to Franchisor Bankruptcy” published in the Fall 2011 edition of the Franchise Law Journal and contributing a chapter in the ABA Forum Publication entitled “Covenants Against Competition in Franchise Agreements,” Third Edition, published in the Fall of 2012. Michael Einbinder has been listed among the top franchise lawyers by the Franchise Times for the past 10 years and is a frequent speaker on franchise issues at events hosted by the American Bar Association Forum on Franchising, the International Franchise Association Legal Symposium as well as the New York City Bar Association CLE program in which he has presented papers on franchise issues for other attorneys.
BRYAN W. DILLON

Bryan is a partner at Singler & Dillon, LLP, a boutique firm just north of San Francisco that exclusively represents franchisees in franchise matters. Since joining the firm 14 years ago, he has almost exclusively practiced franchise law. His clients range from some of the largest franchisee associations in the country, to large multi-unit franchisees, down to single unit franchisees. He is certified by The State Bar of California Board of Legal Specialization, as a Certified Specialist in Franchise and Distribution Law. For the past two years he has been a Vice-Chair of the California State Bar’s Standing Committee on Franchise Law, and is currently a Co-Chair of the Committee. He is primarily a business law litigator, but also represents clients in transactional matters. His transactional practice mostly involves advising prospective franchisees with respect to purchasing franchises and advising current franchisees with respect to disputes or exit strategies. Bryan has been a regular speaker at the West Coast Franchise Expo, offering seminars to prospective franchisees on such topics as "Choosing the Right Franchise" and "Understanding the Franchise Documents." His article "What Law Applies? The Importance of Understanding the Interplay Between Contractual Choice-of-Law Provisions and State Franchise Laws," was published in the Fall issue of the Franchise Lawyer. He was lead counsel for the franchisee plaintiff in the somewhat unusual case 1-800-Got Junk? LLC v. Superior Court, 189 Cal. App. 4th 500 (2010), in which the franchisor unsuccessfully argued against application of its own choice of law clause.