Chapter 9

In Chapter nine, we will be discussing franchising, and as you start to consider franchising, the thing you have to remember as we go through this area, and that is you're going to have some good news, and you're going to have some bad news.

The first thing that you have to remember is if you decide to get involved in a franchise or if you're checking out a franchise or even if you're involved in franchising right now is realize the problems we have nationally, and I mean from the franchisor's standpoint which is the person selling the franchise to the franchisee standpoint which would be the person which is yourself which might be buying a franchise from one of these large companies or a small company.

The key thing to realize as you get involved in a franchise is to check it out. Check it, double check, and triple check because as you start to do this you're going to find there's always some good news and some bad news. Also, the thing you have to keep in mind if you're getting involved and you're going to become a franchisee is if you happen to be a very strong person, and you're a person that doesn't like people to report to other people you may find you don't like the area of franchising because the bad news in franchising is that you're going to have somebody over you. You're going to have somebody that are actually going to be telling you different things that you have to do in your business and things you can and can't do, and if you're a very strong person male or female, you're going to find that you don't like that.

The good news is on the average is the franchise business has a lot lower failure rate than businesses at large, and I'm talking about the start-ups and the existing. So, we have some bad news. We have some good news. Nothing's perfect.

One of the first thing's you're going to have to realize is you're going to have to go out and check this franchise, and if you look at section nine, page one, we start talking about the state corporation commission in your state. We find there's about 20-some states that actually have state franchise laws of different sorts. Some are called "Business Opportunity Laws". Others are called "Franchise Laws". And, they exert influence over the sale and resale of business opportunities and also franchises.

Now, the ones that have to do with franchising are basically full disclosure in that the state is asking you as a franchisor or owner of the franchise to disclose to the next party all the pertinent information. In other words, tell the truth, and even if the truth is something that may be of a felonious nature, you're going to find that as long as they disclose it, they're okay.

One of the things we do when we're checking out franchises is check with the State Corporation Commissioner and the reason is we're trying to find out what problems have been registered from a legal standpoint against this franchise.

The other thing we have on the first page, if you look at the International Franchise Association, we've given you the address and the phone number, and the reason we have – this is the lobbying arm of the franchisor. They're a great source for checking out franchises to find out what the status is, how many there are, and they'll give you a lot of valuable information. You can either write to them or give them a telephone call.

We also want to mention with gathering information, the Small Business Administration has put out a lot of books on franchising as had the Department of Commerce and Transportation, and you can find these at your government bookstores, but the thing you have to keep in mind in the last couple of years, there haven't been a lot of new updated versions put out. So, you may have to do a little digging at your library in addition.

Let's start talking about the laws themselves now, because if we talk about the main law we have the National Franchise Law. This is the National Franchise Law that was passed about three or four years ago, and in this law, it was passed at the national level and it is administered by the Federal Trade Commission and basically it is a full disclosure law in that the franchisor has to tell the franchisee all the pertinent information about how well they're doing, who the officers are, and what their track record's been and how many franchises they really have sold. It gives you a lot of good information.

The thing you have to realize is though, they do not have to give you a copy of this document if you're buying an existing franchise, but what I'd like you to do is go back to the franchise company even when you're buying an existing one and ask them for a copy of the disclosure statement at the national level.

In addition, we've already mentioned there's 20-some states who have other requirements, and you might find if your state or the state you're going into has this requirement, and if they do, you're going to find there's also another document that may be similar or the same as the national document depending on what the state law requirements are.

The key thing is it's going to give you information and also in most areas, they're going to have a thing called "audited statements" which means it will give you the financial information on the franchisor, and the thing that amazes me year after year is most of you end up going out checking the franchisee and you find the business you're buying from another franchise person is doing very well. It's making a lot of money. But, then when you read the franchise document, it goes right over your head as you read the fact that the franchise company is losing money every year. Don't you realize that you have a two-step program here? You have a franchisor and a franchisee, and even if you're going to become the franchisee, if the franchisor is in trouble or the franchisor is not doing well, there's a good chance that you may end up losing the whole thing. Why? Because the top part of the company will go down the tubes.

Also, it makes me very suspicious. I mean, how good is a company going to be in the long run if the people running the main company can't even run it for a profit? There has to be something wrong there. So, I'm very suspicious in areas like that.

As we turn the page and start to consider other areas, one of the things I want you to start thinking about now is what we call a franchise profile because if you right to your different state organizations like the Department of Corporation, you're going to find that they will send you a book, and you can check with them, a booklet. It gives you information that you as a new person buying a franchise should think about, and again, if you order these from ten different states, you would find that each state has the same type booklet with the same information.

Let's go through some of the general information that they bring up, and also it's the same as the information we bring up because it's important to analyze the franchise you're getting involved in.

First of all, the general analysis – how many existing franchisees are there? And, again we're on 9-3. How many are in operation? What's the geographical spread? And, if you happen to be in Northern Maine, what good does it do you to be involved in an organization that has 50 other units, but they're in Southern Florida. Or, you're in Northern Washington and all the businesses are in Northern Mexico.

What I'm trying to tell you is you better make sure you're in their area. You also should check to find out if they've had success in the area you're going to, and the reason I mention that is time and time again you're going to read these great stories about people that have gone in for the first one in the market, the first one in the area, and they succeed. Those stories are Mickey Mouse, and what you're going to find is although that may happen occasionally, it doesn't happen very often. In fact, the rule is the first persons into a market usually fail. What I'd like you to do is adopt a philosophy of you are going to go into a market after somebody else has made it and done it successfully, and even though you're going to say you want to be in there first, what I'd rather have you say is you want to be in there successfully. The first people that go into a market are usually not successful. Why? Because it takes time to break that ground, and usually they run out of money before they do it. Why don't you wait until after the market's established and there's a success pattern.

I keep telling you if you want to do something exciting, don't do it in business. Get a plan, go skydiving. Buy a racing car. But, in business try to keep it as simple and as safe as possible.

Franchises have failed, how many have failed, why do they fail. These are things that you should be interested in because you may be buying something – a franchise – that has a basic flaw, and you will especially find this when franchises are new. So, go out and find out. Check it out. Find out why they did fail, and again you may have to go back to former franchisees, and if you don't know how to do this what I suggest you do is when you're reading the franchise document, you're going to find a number of lawsuits that may have been filed against this company. What you might do is you or your attorney might go back to those people and ask them what the problem is, and in this area you may find out that they've had a few failures and it may be for reasons that will keep you from buying it.

The local market area – has a franchise been awarded in this area? And, the thing that comes up continually is you better check to find out what the market area is because what you usually do when you're reading your document, you assume that you are the franchisee for the whole area. And, as you start to read the document, you're going to find you have a storefront store and you have the franchise 30 feet down Main Street and about 60 feet down the side, and then as we read the fine, fine print, we find that you really only have the territory eight feet above, and there's another unit up above you and you only have it down to ground level, and you also have the basement. Yes, I've exaggerated, but you read the document and find out what your market area really is.

New products next year, the next two to five years – one of the things that gives you a lot of benefit in this franchise business especially if you're a typical business owner that is just starting out is the companies, the better ones, are going to force you to go out in the next year or the next couple of years to actually add new products, to change what you're doing. Although, you may be the person that fights it, you're going to find the American public's tastes are fickle, and again, I'm not just talking about the food business. I'm talking about what they're after, what they want to buy, what their ideas and thoughts are. So, maybe you're going to find that if you're a person that only thinks one track and doesn't think too far ahead, a franchise may be very beneficial.

Competition – what competition is there? When they're selling you on these franchises, every one of them is going to have a tendency to say there's really not any competition, but you better go out there and find out because if you're going in with a very weak new hamburger operation and they're going to put you right next to McDonald's and they're going to tell you there's no competition, I just want to tell you, I and other people working with me in the past, have heard those stories. You're going to find McDonald's, as an example, is going to take their share of the market their in, and you're going to be left whatever's left after McDonald's taken theirs. So, be careful of the competition. Check it out.

Independent versus company owned – are all the outlets franchises? And, what's the date of the most recent company acquisition? And, the reason I ask these questions is a lot of the companies are going to lead you to believe that they're buying back franchises because they're trying to expand their bottom line profit, and as you start to read the franchise disclosure document, you're going to find the real reason they're buying these back is they're being sued by franchisees. How do they franchisors get rid of these bad statements that are on their disclosure documents? It's simple. They buy them out. They buy them back. When they do that, they remove a problem, and this is done quite a bit today, and because of this you're going to find there's also a lot of nuisance lawsuits being filed? Why? Because the franchisors in many cases have to buy them back just to get the lawsuits of their disclosure document.

The next category on page 9-5 actually has to do with a franchise contract, and as you go through this tape program, you're probably wondering what documents are you going to need when you list, you buy, you sell? In this section of this program, it has to do with finding a business, we have given you a check list and if you haven't gotten to that area yet, you might go back and look at that area that has to do with finding a business because that has a checklist in putting the need for a franchise contract.

Now, as we start to get a copy of the franchise contract, and again this could be on buying an existing franchise or buying a new one, what you should do is have your attorney and CPA review it. Again, if you're going to be looking at ten or 15 of them, you don't have to bring them in at each one, but you should bring them in on the one that you're about to buy because number one you're going to find great legal problems or ramifications, and also you're going to find that there are tax problems involved. So, why not get them resolved right in the beginning by going to your professionals?

The first thing you're going to run into is a thing called a termination clause. A termination clause basically was set up a long time ago, a number of years ago, and the reason for that is back in the early 1960s we really didn't have termination clauses in our franchise agreements, and we had people like Internal Revenue come back and tell us if we didn't have a termination clause, we'd have a problem from the tax standpoint. So, what we ended up doing at that time because I was involved in franchising back in the early 1960s – what we did was we put in termination clauses for five, ten, 20 years on. The thing that happened then was we started getting into the early 70s and mid 70s in the United States, we found we started having a lot of lawsuits because certain franchise companies that were having troubles with franchisees did not want to renew the franchise agreement, and also we had franchisors that had franchisees that were making a lot of money, and they would have a franchisee making X number of hundred thousand. Why renew it? Why not just build a similar unit across the street and cancel their franchise contract? And, we ended up with a lot of lawsuits, and from what we've been able to determine, most of them were ruled in favor of the franchisee as long as they were in good stead contract-wise.

Today, in the United States, we have a number of states that have put in franchise laws that regard the termination area, and just to generalize in this area as you or your attorney do check these out, you're going to find the termination laws basically say that wherever the basic period is of the franchise agreement, say for five years, the law basically is saying that they then have to renew for longer periods of time.

In the old days, back in the early 1960s, many of the companies that I was working with went 15-20 year on their contracts. Many of these companies don't go that long today because what happens is they don't know where they're going to be 20 years from now. So, what they do is they set up a five year contract with a renewal, and then if at the end of the five year period maybe they're in some area maybe in southern Alaska and they don't want to renew in that area, a lot of these state franchise laws do give them the opportunity then to back out at that time and not have to support that area and let the franchisee go. So, it's basically to protect the franchisor as far as going short-term on the contract.

Selling and renewal – when you start to talk to the average business seller, they're going to tell you yes they can sell their franchise. You're also going to find they can renew it, and again, it's probably a defense mechanism. Their mind or their memory process has failed them, and as you read the franchise agreement, you're going to find that you can't sell and renew, or the franchisor has first right of refusal. If they have first right of refusal, you're going to find if it happens to be a very good franchise operation, that means the franchisor is going to want to buy it back. Since they're in first place, you're going to find that you're going to have to wait whether you're listing it or buying it. You're going to have to wait in order to get in position to buy it or list it. So, you better check this out and see what it has to say.

Next thing – advertising and promotion Everybody thinks that every franchise document is the same. If you want to think about it did you ever notice things for gas station saying, "At participating stations" or the advertising for a fast food operation saying, "At participating stores". Now, what they're basically saying is they're not advertising together, and what you have is you have some of the people that have an old franchise agreement. Other ones will have the new franchise agreement. The ones with the old franchise agreement are not required to advertise or put in so much advertising. The new ones have to according to what contract they have or what franchise agreement.

This does cause a lot of problems in a lot of areas because the people that aren't paying the franchising companies a fee for advertising tend to irritate the ones that do. Why? Because it lowers the amount of profit the new people make, and at the same time the people that have been in it a long time and have the old contracts still benefit by the advertising done by the other people. So, it does cause a lot of problems.

Not for long though. The major franchise companies because they will send somebody in there to get rid of that rotten apple or the person that's causing a problem. Especially, if they're rubbing the people that are paying the advertising fee, they're rubbing their noses in it.

So, advertising and promotion – incidentally at this time, we should've mentioned one thing I should've mentioned early, and that is the fact that you have to realize that since franchise agreements are different, and there's a number of different copies and examples of this company. It is possible to go back and renegotiate a franchise agreement, but you're going to find it's a lot easier to do this if you do it before you take over the business or you list the business because what happens is after the new owner's in place, you're going to find it's very difficult to go back and renegotiate these contracts. So, try to do it at the right time.

The next thing is patent and liability protection. When we talk about this area, what we're talking about is if the company is advertising that they have this specialty product and you're buying a franchise to sell, and what happens as you start to look at it, you're going to find that the patent protection and liability protection really isn't there. As you have your attorney check it out, it isn't there. So, what I'm saying is no matter what they're telling you in their literature, what they're telling you in their documentation, you better verify it and you better check it out.

Home office services – the things that keeps franchising going and the thing that keeps franchise consistent especially as you go to an operation – we talked about the McDonald's operation – the thing you have even if you didn't like the McDonald's hamburgers or the McDonald's French fries, the thing that McDonald's has and a lot of the other great fast food chains is they have consistency, and what you have to have is consistency because that's what the public is really looking for in the product. What you're going to find is the home office service is the ability of your home office to come around on a weekly or monthly basis or whatever and check it out and bring the different stores or the different businesses into line so that we do have a consistency. The thing you're going to find if you've never been in business before is you're suddenly going to be surprised to find that the manager of your business or even your employees want to change the product back to possibly the hamburgers that grandma used to make.

Now, grandma and the family loves grandma's hamburgers, but you're going to find the average public does not like that. They would rather have McDonald's hamburgers, and they want that type and let's not argue with success.

Commissions and royalties – there is no free lunch in business, so what you're going to find is that the companies that are doing very well are actually providing services to the franchisees, but the way they're able to do it is by charging royalties, commissions. They're charging three percent of the sales figure, five percent, ten percent – whatever the number happens to be, and with this money they're able to not only make a profit and stay in business, but that also enables them to come around on a weekly or monthly basis to check, verify, and give the franchisee support that they need, and that's one of the purposes.

The next thing is training – if there's a training provision, who provides the training and who pays for it? And, how long do you have this training? Does each owner get it? You better read the fine print.

Territory – what territory do you really have? Don't assume because the first sentence says a certain thing that the next few sentences are not going to water down what the first sentence says. So, read it, and again, on the last one, the one that you end up buying, you better make sure an attorney checks this before you sign-off and everything.

The last things we have here is territory, and again checking it to make sure that the territory is as what you think it is, and then exclusive or non-exclusive. Do you have exclusive rights to an area or are you in an area, a ten square block area, with 50 other people that have the same rights to the same area? So, read the agreement, have an attorney check it, and don't assume.

One last thing I want to mention in the franchise area is you're going to run into a number of things as you go out and get involved in business, and these companies are called "licensing arrangements". They're called "distributorships." They're called "dealerships". And, although there are a lot of legitimate ones out there, you're going to find there's also a number of these that are really franchise agreements or franchise documents, and what you're going to have to do is sit down with an attorney when you do have these, and find out if you have a dealership, a distributorship, a licensee arrangement or is it really a franchise agreement. Again, I'm not an attorney, but I do want to tell you if the company that you're buying a franchise from has set up some other type of legal form like a distributorship or a dealership to avoid the franchise laws, eventually they're going to get in trouble. We have seen this happen a number of times, and when it did happen, the parent company ends up going down the tubes as the government issues a cease and desist order, and then the franchisees start to go down the tubes after that. So, check it. Even though it may be an easier and a cheaper way to go by buying one of these, don't do it. If it's supposed to be a franchise and they don't call it a franchise, and they're trying to get around that law – side step down the street and buy another type business or list other type businesses. They're not worth working on. They're just a waste of time.