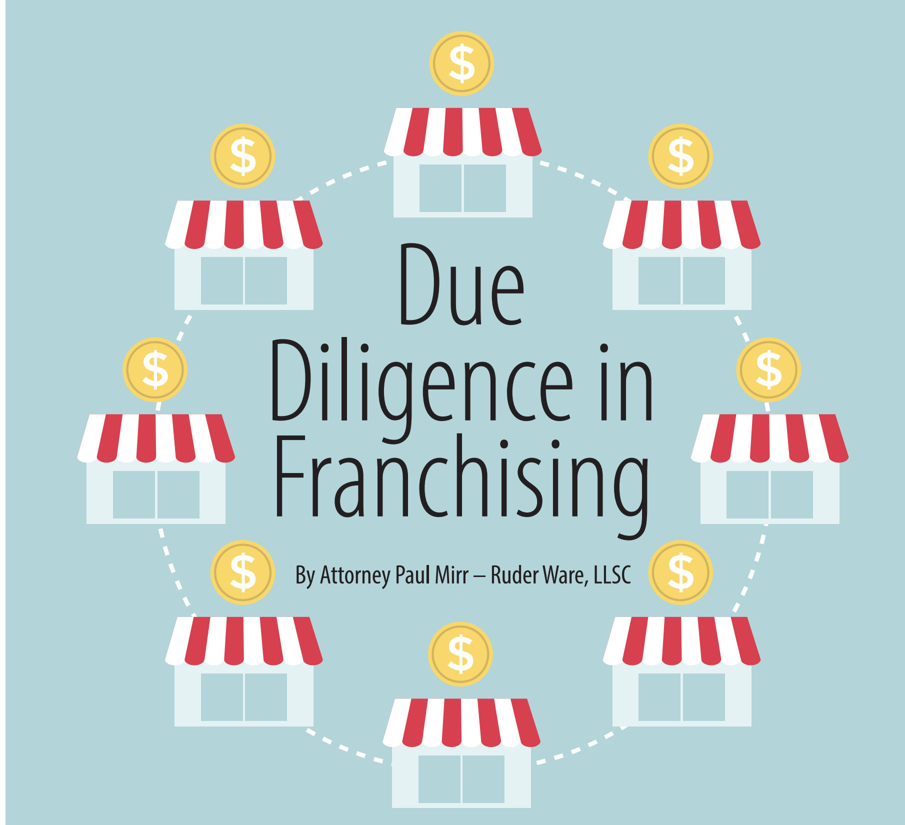


Due Diligence in Franchising

By Attorney Paul Mirr – Ruder Ware, LLSC

Purchasing a franchise can be an incredible way to own and operate a business with a proven business model and a track record of financial success. Furthermore, several of the decisions most start-up companies need to make will be predetermined, or at the very least suggested, by the franchisor's operating requirements. However, before a potential franchisee takes the leap and enters into a franchise agreement with a franchisor, certain items should be carefully reviewed (preferably with legal counsel).

First, the potential franchisee should request a copy of the franchise's Uniform Franchise Offering Circular ("UFOC"), which is a document required by the Federal Trade Commission to be provided by a franchisor to a potential franchisee before any money is paid or documents are signed. A copy of the franchise agreement itself is required to be provided with the UFOC.

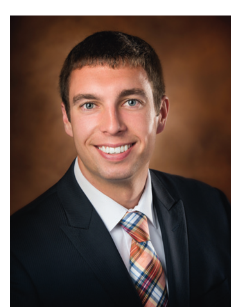
While the UFOC will admittedly not be a "page-turner" in the sense of a good novel, it should be read in its entirety so the potential franchisee will be making an informed decision of whether to enter into the franchise agreement. For example, the UFOC will give an overview and history of the franchise, along with information on the founder(s) and current officers or management team.

An important section of the UFOC will be the section on franchise fees and royalties. For example, most franchisors will require an initial or upfront fee (which can be substantial), and thereafter a continuing fee based on a fixed sum, percentage of sales, or a combination of the above. Additionally, look out for required advertising fees, technology fees (for using the franchise's computer system), mandatory training fees, etc. The UFOC will also include average start-up costs for things such as inventory, equipment, and leases. On the topic of equipment, several franchisors will require that certain (or all) items such as equipment or inventory be purchased from specific sellers, which effectively eliminates shopping for better pricing. Also, local franchises should pay particular attention to national advertising fund fees, as there is often no guarantee that such funds will actually be used for advertising in the local community.

The UFOC will also contain a list of any pending litigation or bankruptcy filings of the officers of the company, or the company itself. If there is a lot of complex civil litigation pending, that may be a sign to pass on that particular franchise and look for other opportunities. The UFOC will also list situations or circumstances in which the franchisor may be permitted to terminate the franchisee's franchise, such as poor financial performance. Long story short, franchises that have been around longer will have better and more detailed financial and operating information in the UFOC for franchisees to review, which will hopefully assist the franchisee in making an informed decision.

As stated above, a copy of the franchise agreement will be included with the UFOC. This is the most important document of all, as it states the actual terms that will be agreed upon between the franchisee and the franchisor. While the list is long, some specific provisions to look out for include (1) whether the franchisee will be given an exclusive territory, i.e., an area where the franchisor will not permit any other franchisees to operate (and if so, how big that exclusive area may be); (2) whether the franchisee will be given a right of first refusal if another potential franchisee desires to open in the current franchisee's general location; (3) as stated above, circumstances in which the franchisor may terminate the franchise (and vice versa, whether the franchisee may terminate the franchise); (4) the term or length of the franchise agreement, and whether renewal is allowable; (5) whether the franchisor can require the franchisee to purchase new equipment or re-brand the business upon demand; (6) whether the franchisor must have final say over the business's exact location, which can complicate or delay leases or purchases; (7) whether the franchise can be transferred or assigned (and if so, whether there is an associated fee); (8) the venue and location to settle any disputes (can often be out of state); (9) which state's law governs the franchise agreement; (10) whether certain items require personal guarantees; and (11) obligations of the franchisee upon expiration or termination of the franchise agreement, such as return of confidential information and removal of franchise marks, signs or other intellectual property.

The issues listed above are not meant to be an exclusive list of things to watch for, but instead examples of the many factors that go into purchasing a franchise and a reminder that the UFOC and franchise agreement must be carefully reviewed and understood prior to executing the franchise documents and making a substantial investment of your hard-earned money.



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