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## **Understanding Franchising**

by Alan Shaver

Buying or opening a franchised business is much like starting or purchasing any other business, except there are some legal hurdles to get past, and some advantages may exist. Franchising has grown into a very large business segment in the United States during the past 50 years, and in the process has made some franchisors and franchisees very wealthy. However, there have also been some notable failures. [If you are thinking about buying or opening a franchised business you may want to link to our article on “Questions to Ask Yourself Before You Start Your Own Business”.]

When considering whether to open a franchised business or purchase an existing franchised business it is important to follow all the procedures you would when examining any other business opportunity. You will want to know about location, competition, likely gross revenues, costs, suppliers, legal or practical difficulties, seasonality, and a number of other issues. However, one of the most important first steps is to request from the franchisor a copy of the Uniform Offering Circular (also called a “disclosure statement”).

The Federal Trade Commission and many states, including Maine, have established important safeguards for purchasers of a franchise. Key among these is the requirement to provide prospective franchisees with a uniform offering circular. This contains a great deal of important information about the franchisor, the business “system” encompassed within the franchise, obligations of the franchisee and the franchisor, royalty rates, initial and renewal fees, areas of exclusivity, suppliers, recent litigation by or against the franchisor, a copy of the franchise agreement itself, and a list of current franchisees.

What the uniform offering circular will NOT do is project earnings. It may provide some “pro forma” operating statements, but these will be couched with disclaimers and cautions intended to protect the franchisor from legal recourse by unsatisfied franchisees. This is where the old saw “Let the buyer beware” must be very much in your mind. If you really want to know the financial details of the business you need to talk to someone already operating such a franchise.

The list of current franchisees can be of great value to you in examining whether to get involved with the franchise. Contact some of the existing franchisees (preferably outside the competitive area you are considering) and visit with them. Ask them all the questions you can think of about the business, its advantages and difficulties, the relationship with the franchisor, supplier, advertising and marketing requirements, etc. Current franchisees will be the best source of information about the franchise and the business. “Mine” this information to the greatest possible extent. It will be enormously helpful to you.

With respect to advertising it is important to examine closely the franchisee’s obligations. Typically, a portion of the monthly royalty paid to the franchisor is devoted to the costs of

developing so-called “national advertising”. However, most franchise agreements impose requirements upon the franchisee to pay for local and regional advertising. Frequently, there will be a “cooperative association” of franchisees in a particular geographic area who will “pool” their money to pay for advertising in the local area. This becomes an added cost to operations. And, you need to understand how the “co-op” functions and which franchisee or franchisees tend to dominate it.

Next, have an attorney review the franchise agreement and the uniform offering circular so you can have the best possible understanding of this legal document. Typically, franchise agreements extend for a number of years, are written by the franchisor for its best interests, and there are few – if any – opportunities to negotiate changes in it. Once a signature is put on the franchise agreement the obligations are for the duration of the agreement.

There is, however, one subject about which you may be able to get some “concessions” from the franchisor, particularly if you are to be the first franchisee in your area. You may want to obtain from the franchisor a “right of first refusal” for any new or additional franchises to be granted in your geographic area. This will give you some say about the introduction of additional competition in your market.

It is important to bear in mind that the interests of franchisors and franchisees are “parallel”, but not identical and sometimes, can be in conflict. For example, how frequently and significantly has the franchisor requested major changes in the business system, altered suppliers, changed advertising or products, required “face lifts” of retail outlets, or tried to change the area of exclusivity? Some franchisors offer no area of exclusivity at all, which means an existing franchisee is always at risk for the introduction of another franchisee, or even a franchisor-owned competitor within its marketing area, making a right of first refusal in your franchise agreement even more important. Additionally, you should understand what kind of support can be expected from the franchisor and how essential this may, or may not, be to the success of the business.

Understand clearly what you may be required to purchase, in the way of supplies, equipment or product, from the franchisor and know whether its prices and terms are competitive with those available from other comparable suppliers. Sometimes, the obligation to purchase certain items from the franchisor can burden the business with excessive costs. Be sure you know and understand whether this situation will exist.

Finally, many franchised businesses involve real estate. It is vital to understand who must provide the funds to purchase and improve the real estate, and who will have real control over it. Even though the franchisee may own the land and building it is not unusual for the franchisor to have the right – should the franchise agreement be terminated – to take possession of the real estate in order to continue the business, either as a franchisor-operated unit, or by putting a new franchisee into that location. Such arrangements could impose significant cost burdens upon the original franchisee. Even if the franchisor does not have this right, it may have the right to prevent, for a period of time, use of the location by a competitive business.

You may want to visit the link to our page about various forms of organization you could consider for your business, such as a partnership, corporation, limited liability company, or the like.

A question you will want to get answered early is whether the franchisor will insist you have prior experience with its kind of business. For example, must you have prior experience working

in the restaurant industry if you are considering a food franchise, or in the auto services business if you are considering that kind of a franchise? Most franchisors will require a new franchisee to attend – at the franchisee’s expense – a school or training program operated by the franchisor. Even if you have prior experience in the industry, it is very likely you will be required to attend, perhaps for some weeks. This is not only an important commitment of your time and energy, but will involve not insignificant expenses and lost income.

If you “Google” the term “franchising” you will come up with a whole host of suggested links. A couple you may want to look at early on:

- [www.franchise.org](http://www.franchise.org) This is the website of the International Franchise Association, based in Washington, D.C. When visiting this site bear in mind the IFA is a trade association for franchisors, not franchisees. So, it is positioned to favor franchisors. However, it is an important site and will lead you to approximately 1,200 different franchise businesses.
- [www.worldfranchising.com](http://www.worldfranchising.com) This is the website for a magazine directed to people interested or involved in franchising. It will provide important links to many other sites at which you may obtain important information.

Franchised businesses offer an opportunity to enter an existing and established business, with presumably a history of success. It may reduce some of the risks associated with starting one’s own business. However, it also poses other potential risks. As in any business endeavor, having the greatest possible knowledge and understanding is the key to success.

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The national SCORE Association is a nonprofit organization dedicated to entrepreneur education and the formation, growth and success of small business nationwide. SCORE Portland is one of 389 chapters throughout the United States, with over 11,000 volunteers nationwide. SCORE is a resource partner of the U.S. Small Business Administration.

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