

A Franchise Primer For First-Time Franchisees

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Making business work.



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WHAT IS FRANCHISING?

Franchising is a method of distributing goods or services which, at a minimum, involves the following three elements:

- The granting of a right or “license” to carry on business using the franchisor’s trade mark;
- The payment of royalties or other ongoing fees to the franchisor; and
- An element of control by the franchisor over the way in which the franchised business is conducted.

ADVANTAGES OF FRANCHISING

There are many advantages to franchising with a proven, successful and fair franchise system:

Start-up Assistance and Continuing Support

Franchisees can benefit from start-up support offered by the franchisor including site selection and analysis; design and construction; training; and grand-opening programs. Many systems also offer ongoing support such as advertising, operating assistance, ongoing supervision and management, preferred sources of supplies and, in some cases, financing assistance.

Reduced Start-up Risk

Although there are no guarantees in life, proven and successful franchise systems generally offer a greater chance of success as compared to independent businesses. These systems have removed most of the trial-and-error inherent in start-up operations.

This advantage only exists, however, where the system has a proven history of successful franchising. New franchise systems which claim to have opened (or, worse, “intend” to open) twenty outlets in their first year or two of operations are usually neither proven nor successful. They may only be successful at selling franchises. These systems are more likely to be the “penny stocks” of franchising. The people who promote them often share similar characteristics, and the people who buy them often share the same fate.

Be Your Own Boss

Franchising allows individuals to go into business **for** themselves, but not **by** themselves. With the support of the franchisor, individuals with little or no business experience can usually learn to operate a franchised business quickly and become, in some sense, their “own boss”.

Established Product and Services

Franchises can offer a selection of unique products and services. Also, established franchises have brand-name recognition which might otherwise take years to develop. Franchises in mature systems can also benefit from the franchisor's market research and development, resulting in innovative new products and continual refinements to the system.

Mass Buying and Marketing Power

Franchisees can benefit from the cost savings associated with bulk purchasing power that their franchisors have access to. They can also benefit from the pooling of resources into effective local, regional or national marketing programs.

DISADVANTAGES OF FRANCHISING

Strict Compliance with the System

The main disadvantage of franchising is that a franchisee is not completely independent. To ensure uniformity, most franchisors demand strict compliance with the restrictions, procedures and controls set forth in the franchise agreement. Franchisees may also become weary of their operational and procedural obligations under the franchise agreement such as, strict accountability and reporting requirements, audits and inspections.

Ongoing Fees

In addition to the initial franchise fee, franchisees are usually required to pay ongoing royalty and advertising fees. Royalty fees are often based upon a percentage of your weekly or monthly gross revenues and you often must pay these whether you are making a profit or not.

Rebates

Very few franchisors actually pass along supplier rebates to their franchisees. Consequently, franchisees that are required to purchase from within the franchise system may be at a competitive disadvantage because they cannot take advantage of these rebates or competitive pricing available through other suppliers.

Franchisor's Failures Are Your Own

If your franchisor employs poor business practices, judgment or management, your business may suffer. Also, if other franchisees in the system are performing poorly, the system-wide image of the franchise may also suffer.

Franchisor's Conflicting Interests

A franchisor may pursue an over-aggressive expansion policy, opening new locations to enhance its own profits at the expense of existing franchisees.

IS A FRANCHISE THE RIGHT DECISION FOR YOU?

You should carefully consider a number of factors before deciding whether owning a franchise is the right decision for you.

How much money do you have to invest?

Your choice of franchise system will be determined partly by how much money you have to invest. You should ask yourself:

- How much money can you afford to lose?
- Will you need financing and where can you get it?
- Do you have additional income to live on while starting your franchise?
- How long will it take for the franchise to turn a profit? You will need enough money to not only to open a franchise, but run it until it is profitable.
- Is your family supportive of the sacrifices often required, including long and irregular hours, as well as possibly mortgaging your home or other assets?

Your Interests and Abilities

Many franchisees base their choice of franchise system on superficial factors such as how much they enjoy the retail product or the décor and ambience of the stores. Before deciding on which franchise system to invest in, consider your interests and the type of business you will enjoy working in.

People often buy a franchise in the hopes of making huge profits, only to find out later that they don't enjoy the business. The majority of franchises require full-time, hands-on attention by the franchisee. Be skeptical of any franchisor who tells you that their franchise is a passive investment.

Choose something that you will enjoy doing for the next 10 to 15 years, and, more often than not, for long hours at a stretch. Also, choose something that matches your skills and abilities. Although the promise of franchising is that anyone can do it with the right training, successful franchising sometimes requires technical skills such as computer or bookkeeping skills which the franchisor does not include in its training.

INVESTIGATING THE BRAND

Before contacting the franchisor about buying a franchise, try to do some background research on your own. Here are some things to look out for:

Customer Demand

- Is there demand in your community for the franchisor's products and services?

- Is the market saturated?
- Is the demand seasonal?
- Is there likely to be continuing demand for the product or service in the future?

Competition

- What is the level of competition, nationally and in your community?
- Are the competing companies well established?
- Do the competing companies sell similar products at the same or lower prices?
- How does the target franchisor rank in the market?

Brand Name

- How well recognized is the franchise name?
- Does the franchise have a reputation of providing quality products or services?
- Have consumers filed complaints against the franchise with the Better Business Bureau, the Canadian Franchise Association or a local consumer protection agency?

INVESTIGATING THE FRANCHISOR

Once you decide which franchise you are interested in, you should contact the franchisor to request its franchise disclosure document. This is a legal document that the franchisor must provide to all prospective franchisees containing information about the franchisor, its franchisees and all material facts relating to the franchise. It also includes a copy of the franchise agreement and other documents which must be signed.

The following are some facts that should be included in the disclosure document and that you should know before buying into any system:

- How long has the franchisor been in business?
- How long has the franchisor been offering franchises?
- Does the franchisor own the rights to the system? **Tip:** Many franchisors do not own the rights to their system but are merely master licensees of an out-of-province or international franchise system. Therefore, you will want to know what happens if the local franchisor goes bankrupt or loses its licence. Will the ultimate owner of the rights to the brand and system recognize the Ontario franchise?
- What is the background of the franchisor's management?
- Do they understand the business or are they merely promoters?
- What is their experience in previous business ventures?
- Have they had any personal bankruptcies?
- Have they been involved in litigation?
- Does the franchisor secure and develop real estate? **Tip:** If the franchisor has its own trained people to identify potential sites and takes the lease in its own name and even develops the site at its own expense then, at minimum, the franchisor is willing to place its own credit at risk.

- Does the franchisor provide earnings claims and profit projections? If so, on what are they based?
- Are the projections based on franchisee-run units or corporate units?
- How long have the units used in the projections been in business? **Tip:** Making sense of financial projections and pro formas is never easy. Consultation with an experienced financial professional with industry experience is essential.
- Who sells the products to the franchisees? **Tip:** If the supplies are sold by the franchisor itself or through affiliated companies, the pricing is unlikely to be in the best interest of the franchisee unless the franchise agreement provides in clear language that the franchisee will always receive competitive prices.
- What innovations has the franchisor introduced since first starting the franchise?
- How selective is the franchisor when choosing its franchisees? **Tip:** It is a good sign if the franchisor thoroughly analyzes your financial strength and experience and invests the time and effort to evaluate you as an applicant.
- What is the failure rate of the franchisees?
- How many multi-unit franchisees are there? **Tip:** The more the better!
- How many long-term franchisees are there? How many have chosen to renew their agreements upon expiry? Successful systems enjoy a high percentage of long-term franchisees. **Tip:** As a general rule, **franchisees do not leave successful systems**. If franchisees have a tendency to leave the system in the first five years, the system is likely to be unprofitable and prospective franchisees may want to avoid it.
- Does the franchisor operate a large number of corporate stores in addition to franchise outlets? **Tip:** If so, the franchisor may ignore servicing the franchised outlets in preference to their own corporate stores.
- What is the franchisor's financial health? **Tip:** Check the credit history of the franchisor by obtaining a credit report.

THE FRANCHISE DOCUMENTS

Your relationship with your franchisor will be governed by the agreements which you sign. No matter what the franchisor tells you before you buy the franchise, unless these statements are in writing, the signed agreements are usually all that count in the event of a dispute. This is why it is important to read the agreements and to obtain experienced legal advice before signing them.

The following are some of the items that are addressed in most franchise agreements and related documents (for example, leases). You should have these questions in mind when reviewing the agreements. If the agreements do not answer these questions, you should ask the franchisor and be sure to confirm the discussion in writing afterwards.

Training and Operating Assistance

- What is the nature of the initial training program?
- Where is it held, for how long and at what cost?
- Who conducts the training and what is their background?
- Are training materials provided by the franchisor?

- What ongoing operational assistance is provided (for example, does the franchisor provide general advertising and promotional materials, inspection and evaluation of the franchisee performance, administration of the advertising fund, establishment of bookkeeping, accounting, inventory controls and general operating procedures)?

Territory and Location

- Has the location of the franchised business been determined?
- Must the business be located within a specific territory?
- Does the franchisor have the right to approve the location?
- Is the franchisee given exclusive territorial protection (not only with respect to other franchisees but also with respect to franchisor-owned locations)?
- Can the franchisee open additional locations within the territory?
- Can the franchisee relocate within the territory?
- Is the franchisee granted the right of first refusal with respect to additional territories?
- Can the franchisor change the territory or split the territory under certain circumstances?

Term and Renewal

- What is the initial term of the franchise agreement?
- Is the franchisee given the right to renew the franchise agreement?
- Are there any conditions for renewal of the franchise agreement (for example, upgrading of the premises, execution of the current form of the franchise agreement, renewal fee, etc.)?
- What is the manner of exercising renewal rights by the franchisee (for example, requirement of notice to renew and time-frame for renewal)?

Premises

- Who is responsible for the selection and approval of the premises?
- Are the premises to be leased by the franchisor or the franchisee?
- If the franchisor leases the premises, what are the terms of the franchisor's form of sublease for the premises?
- Who will develop the premises?
- Who will pay for the cost of development?
- Is the franchisor developing the premises on a turn-key basis?
- Does the franchisor furnish standard layout plans, specifications and drawings for the development of the premises by the franchisee?
- Who is responsible for obtaining building permits and authorizations for the development of the premises and the operation of the franchised business?
- If the franchisor develops the premises, who is to pay for any excess over the estimated cost of development?
- What is the timeframe for developing the premises?

- Must fixtures, furnishings, equipment, signs etc. be purchased from the franchisor (or suppliers designated by the franchisor)?

Opening of the Franchised Business

- Does the franchisor give special assistance in connection with the opening of the franchised business (for example, advice, opening advertising, representatives at the opening, additional start-up assistance)?

Authorized Products and Services

- Is the franchisee required to purchase some or all equipment, products and related accessories and supplies from the franchisor?
- Are there any restrictions on the distribution and sale of the products or services?
- Is there a minimum amount of goods that must be purchased from authorized suppliers?
- Does the franchisor earn income on the purchase? (for example, by way of rebates and allowances)?
- How long does it take for orders to be filled?
- Is the franchisor required to approve all products sold by the franchisee?
- Are there new products and services under consideration for addition to the franchise? When are they going to be introduced? What is the estimated cost of these new products and services?

Costs and Ongoing Fees

- What are the costs of operating the business (for example, initial franchise fee, leasehold improvements, lease deposits, franchise training, travel expense, supplies, advertising and brochures, inventory, staff, other)?
- What is the basis for calculating the royalty fee? Is it a percentage of “gross sales”? If so, what is included in the definition of “gross sales”?
- Is there an advertising fee for regional or national advertising, or both? How often is it calculated and paid?

Advertising and Promotion

- Has the franchisor established a national or regional advertising program, or both?
- Is the franchisor required to account for the advertising fund?
- Can the franchisor charge an administrative fee for managing the advertising fund?
- Is there a minimum amount that the franchisee must spend on local advertising?
- Does the franchisee have the right to select local advertising providers?
- What are the arrangements for telephone listings?
- Is the franchisee required to advertise in the white or yellow pages?

Trade Marks

- Are the franchisor's trade marks registered? You can check this at <http://strategis.ic.gc.ca/cipo/trademarks/search/tmSearch.do>. Trade mark protection is essential to any franchise system. If the trade marks are not registered, do not buy the franchise under any circumstances!

Operating Manual

- Does the franchisor have an operating manual setting out specifications, standards and operating procedures for the franchised business?
- Are the provisions of the manual incorporated by reference into the franchise agreement? If so, you should insist on seeing it before signing the franchise agreement

Transfer of the Franchised Business

- Is the agreement transferable by the franchisor? The franchisee?
- Is the approval of the franchisor required prior to the transfer? If so, are the terms fair and reasonable?
- Must the proposed transferee be acceptable to the franchisor?
- Are certain transfers permitted without prior franchisor approval (for example, transfers to family members, transfers among partners or shareholders, transfers to wholly-owned or controlled corporations, and transfers upon the death or incapacitation of the franchisee)?

Termination

- Under what circumstances may the franchisor terminate the franchise agreement?
- Is there an opportunity for the franchisee to cure any defaults prior to termination?

SPEAKING TO CURRENT AND FORMER FRANCHISEES

Once you have completed your preliminary investigation of the franchise system, you should speak to as many current and former franchisees as possible. If the franchise is located in Ontario and Alberta, franchise law requires the franchisor to provide in the disclosure document a list of all existing franchisees within the province (including their business address, name and telephone number). You should also speak to franchisees that have left the system to find out why they left.

These are some questions that you should ask:

Support

- What kind of support did they get from the franchisor? Site Selection? Training? Grand Opening? Trouble-shooting?

- Did the franchisor assist them in selecting their location? If so, what did they do to research the feasibility of that location?
- What kind of on-going support do they get from head office?
- What forms of communication does the franchisor use (for example, emails, annual conventions, regional training)?

About the Franchisor

- Are you satisfied with the franchisor?
- Is the franchisor fair and easy to work with?
- Does the franchisor listen to the concerns of the franchisees?
- Have you had any disputes with the franchisor? Were you able to settle them?
- Are you aware of any disputes that the franchisor has had with other franchisees, competitors or the government?
- Has the franchisor kept its promises?

Training

- Do they think the training they received was adequate? Could it have been more thorough? Was anything missing in training in their opinion?
- Was the training effective?
- Did they need to go to a location far from home? If so, was travel and accommodation at their own expense?
- What did the training cost?

Costs

- Were there any unexpected or “hidden” costs in getting their business launched or in ongoing operations that were never explained by the franchisor?
- How long did it take them to “turn the corner” and show a profit?
- How long did it take for them to pay themselves a salary?
- Is their franchise profitable? What are their gross revenues? Their cash flow?
- Were the franchisor’s profit projections and earnings claims accurate?

Products and Services

- Are the products or services they sell of good quality?
- Does the franchisor have strong relationships with suppliers that allow for preferential pricing and optimal delivery of supplies?
- Do they ever have supplier problems? If so, what are they?
- What sells best? To whom? Who is the competition?

Advertising and Marketing

- How much money do they spend on advertising in a month?
- Is the regional or national advertising effective?

- Are they getting good value for their advertising dollars?
- Are they satisfied with the marketing and promotional assistance the franchisor has provided?

Operations

- How many hours a week do they work in the business?
- How effective are the franchisor's operational procedures and manuals?
- Are the manuals updated regularly?
- How much freedom does the franchisee have to make decisions?
- How many part-time and full-time employees does the franchisee employ?
- What is the employee turn-over?
- Is it hard to find qualified employees? How are the employees compensated?
- What challenges do they face on a regular basis in the business?
- How much support do they get from head office in meeting these challenges?
- How much support do they get from other franchisees in the system?
- Are they disappointed with any aspect of the business?
- What do they like least about the business?
- Why did they originally select this franchise? Are those reasons still important to them?
- If they had to do it all over again, would they?
- Would they recommend that you buy a franchise?

THE ROLE OF PROFESSIONAL ADVISORS IN FRANCHISING

Franchise agreements are complex documents. A lawyer will help you understand your obligations under the franchise agreement and related documents such as the purchase agreement, lease or sub-lease. An experienced franchise lawyer can also tell a lot just by looking at the franchise agreement and will have a good sense of what provisions can be amended in your favour.

A franchise lawyer who is active in the industry may also have prior experience with the target franchisor. This practical experience can be invaluable. A lawyer with the "inside track" can sometimes help you steer clear of a problem system.

Another professional advisor that you should not go into business without is an accountant. An accountant can assist in making sense of any financial projections provided by the franchisor and can tell you if they are realistic. A misstatement in the pro forma can make the difference between success and failure.

Before buying a franchise take the time to ask yourself if franchising is right for you. Then, investigate, investigate, and investigate some more.

Disclaimer

This document is intended to provide general information and should not be relied upon as legal advice. If you require legal advice we would be pleased to assist you.