

## WHAT YOU NEED TO KNOW ABOUT FRANCHISE YOUR BUSINESS

*Item by item description of the Uniform Franchise Offering Circular*

### **Item 1. FRANCHISOR, ITS PREDECESSORS AND AFFILIATES**

Some of the information that a franchisor is required to reveal in a UFOC, such as disclosure of bankruptcies and lawsuits in the franchisor's past, may be embarrassing and detrimental to the sale of franchises. If a franchisor were to transfer its franchise operations to a related company with a clean bill of health, it could evade these disclosure requirements. To make this impossible, numerous disclosures about "predecessors" and "affiliates" are required in Item 1.

### **Item 2. BUSINESS EXPERIENCE**

In some UFOC's, biographies of the franchisor's key people only cover the last five years and do not mention educational background. This is because some franchise examiners will not approve an offering circular unless the franchisor deletes all non-required information from its Item 2 biographies, not because all franchise executives have a maximum career span of five years and no education.

### **Item 3. LITIGATION**

Franchisors and their personnel must tell prospective franchisees about lawsuits and arbitration proceedings brought against them. But they do not have to tell prospective franchisees about actions they have brought to collect debts owed to them by franchisees who have lost money trying to follow their franchised systems.

### **Item 4. BANKRUPTCY**

Among other things, any franchise executive who has filed bankruptcy within the past ten years has to tell all in Item 4. Often, however, the requirement catches some poor man who is an employee of a franchisor and is just trying to quietly live down a personal bankruptcy.

**Item 5. INITIAL FRANCHISE FEE**

In Item 5 the franchisor has to disclose whether the initial franchise fee is uniform. Supposedly, this lets a prospective franchisee know that he is getting as good a deal as everyone else. In reality, the required disclosure is not effective. This is because it is only applicable to franchisees currently buying franchises. If the price was different in the past or changes in the future, these facts do not have to be revealed. The exception is California, which obliges franchisors fill out a form each time it sells a negotiated franchise and attaches these forms to the back of its offering circular. Virtually every UFOC says that the initial franchise fee is nonrefundable. This means that the franchisor does not have to give a franchisee's money back if he gets cold feet, fails to locate financing, or, as is often the case, cannot find a satisfactory site. It does not mean that franchisors never refund these "nonrefundable" fees (because they often do), but only that a franchisee should not rely on it. If the franchise agreement does not require the franchisee to pay the initial fee until the franchise is ready to open for business, or if the initial fee will be paid into escrow, this means that the state is worried about the franchisor's ability to survive. No franchisor sets its agreement up this way voluntarily. The state must have required it to defer or escrow the fee as a condition of registration. Just because the state is concerned, however, does not mean the State is correct.

**Item 6. OTHER FEES**

These fees are listed in this section.

**Item 7. INITIAL INVESTMENT**

This chart is supposed to give a franchisee a realistic notion of how much money he needs to get up and running with the franchisor's system. Although the chart is supposed to be based on actual data, many franchisors base it on their "experience" instead (in other words, they guess). Franchise litigation histories show that the figures in Item 7 are often highly optimistic. Prospective franchisees should test the reality of these figures by pricing key expenses, such as rental of office space.

**Item 8. RESTRICTION ON SOURCES OF PRODUCTS AND SERVICES**

The franchisor is supposed to disclose, in Item 8, whether it takes kickbacks from suppliers in return for requiring franchisees to buy from those suppliers. The franchisor is also supposed to disclose whether it makes money on the franchisee's purchases from vendors the franchisor designates or recommends. However, the UFOC guidelines on this subject are phrased so confusingly that many franchisors are not sure what is required and therefore the responses may be inaccurate.

**Item 9. FRANCHISEE'S OBLIGATIONS**

These obligations are listed here.

**Item 10. FINANCING**

In this Item, the franchisor is supposed to tell the franchisee all about the financing it provides or arranges for the franchisee to obtain from someone else. Franchisors hate to answer all the detailed questions in Item 10 because of the work required and require knowledge of esoteric matters such as how to calculate APR. So they answer Item 10 by saying they don't offer or arrange financing. The fact that the same financial source has funded 9 out of every ten franchised store build-outs in their systems is apparently just a coincidence. If a franchisee expects to need financing and no information about it appears in Item 10, he should get the information in writing, even if it is just a letter from the franchisor's bank.

**Item 11. FRANCHISOR'S OBLIGATIONS**

This is the part of the offering circular where the franchisor is supposed to describe in detail everything it is going to do for its franchisees. However, the disclosures are primarily directed toward revealing what the franchisee has to do, instead. This isn't the franchisors' fault. The Guidelines for preparing a UFOC are set up this way. Part of this section concerns computer equipment. The franchisor is required to disclose whether it can "independently" access a franchisee's computer data via modem and examine the franchisee's data without contractual restriction. In the section on advertising, the franchisor is required to reveal how much of the advertising money paid by franchisees it can use to reimburse itself for operating the advertising fund. Many franchisors take no compensation at all, contributing more to the advertising

fund than the franchisees do. Even though many franchisors promise franchisees to use their expertise to help the franchisees find good business locations, careful reading of Item 11 of most offering circulars reveals that the franchisor has no responsibility at all for site selection. Instead, the franchisee has to get the franchisor's permission to develop a given site, but cannot hold the franchisor responsible if the site turns out to be bad.

**Item 12. TERRITORY**

If the franchisor can build a competing outlet or grant a franchise right on top of another franchisee's location, it is supposed to be disclosed in Item 12. If a franchisor can compete with its own franchisee by selling its branded product in supermarkets or other outlets at a lower price than its nearby franchisee can afford to charge, Item 12 should say so.

**Item 13. TRADEMARKS**

If a franchisor's name turns out to belong to someone else, and that someone else sues the franchisee for infringement because the franchisee uses the name, does the franchisor have to defend the franchisee? If the franchisee is forced to change its signs, stationery, advertising, and so on, will the franchisor reimburse the franchisee for the expense? This information is contained in Item 13.

**Item 14. PATENTS, COPYRIGHTS AND PROPRIETARY INFORMATION**

Patent, copyright and proprietary information is contained here.

**Item 15. OBLIGATION TO PARTICIPATE IN THE ACTUAL OPERATION OF THE FRANCHISE BUSINESS**

The obligation to participate in the actual operation of the franchise business is contained here.

**Item 16. RESTRICTIONS ON WHAT THE FRANCHISEE MAY SELL**

The restrictions on what the franchisee may sell is contained here.

**Item 17. RENEWAL, TERMINATION, TRANSFER AND DISPUTE RESOLUTION**

The renewal, termination, transfer and dispute resolution terms are contained here.

**Item 18. PUBLIC FIGURES**

If a famous person recommends that franchisees buy a particular franchise, the franchisor is supposed to reveal in Item 18 how much it paid the famous person for making the recommendation.

**Item 19. EARNINGS CLAIMS**

Does anyone make any money with this franchise? If so, the figures can be presented in Item 19. If the franchisor has something to brag about, this is where it should do it. If the franchisor does not give any information in Item 19, you have to ask yourself, why not? The answer is that franchise lawyers spent years telling franchisors how dangerous it is to provide earnings information in case they are sued, so that some franchisors who should be proud of their franchisees' financial performance are afraid to tell anyone.

**Item 20. LIST OF OUTLETS**

Item 20 tells prospective franchisees how many franchises a franchisor has sold and how many of the franchised businesses have survived. If this Item shows there have been lots of terminations, a person might conclude that it is hard to stay in business in this business.

**Item 21. FINANCIAL STATEMENTS**

The last three years of audited financial statements are contained here. Does this franchisor have enough cash to provide the benefits to franchisees that it says it will? The financial statements referenced in Item 21 and attached as an exhibit should provide an answer. If the letter from the auditor at the beginning of the financial statements contains a "going concern" notation--a statement that continued operation of the franchisor's business is in question, watch out! Read the footnotes to the financial statements.

**Item 22. CONTRACTS**

All contracts that the franchisee must sign are contained here.

**Item 23. RECEIPT**

The franchisor will ask you to sign this to prove you received the UFOC.