

# What to Consider Before Buying a Franchise



Eric T. Schneiderman  
ATTORNEY GENERAL



STATE OF NEW YORK  
OFFICE OF THE ATTORNEY GENERAL  
THE CAPITOL  
ALBANY, NEW YORK 12224

Eric T. Schneiderman  
Attorney General

(518) 474-7330

Dear Potential Franchisee:

By reading this booklet, you are taking an important step toward becoming an educated investor. All too often, franchisees submit complaints to my office regarding matters that would not have occurred if the investor had thoroughly researched the franchise industry and the particular system of which they became a part.

Buying a franchise is a serious investment of time and money for a business you will likely depend on for your livelihood. You should thoroughly educate yourself on the issues faced by franchisees in general and the specifically in the system you hope to join. Do not rush into any decisions.

It is undisputed that there are many individuals who are very happy with their franchises. However, the purpose of this booklet is not to convince you to purchase a franchise; instead, it is to ensure that you have carefully considered many issues unique to the business format of franchising of which you may be unaware, because you are about to spend a significant amount of time and money on a business that will probably be your main source of income.

As you read this booklet, please be aware that it has two goals as its purpose:

- (1) To assist you in avoiding illegitimate franchises set up by unscrupulous individuals seeking unlawful gain; and
- (2) To make you better aware of the franchisor-franchisee relationship and the unequal bargaining power that can exist in such a relationship.

I hope this booklet will assist you in making a decision as to whether franchising or a particular franchisor is right for you.

Sincerely,

Eric T. Schneiderman

# What to Consider Before Buying a Franchise

## New York State Office of the Attorney General

### Don't Let This Happen to You

The terms of the deal were clear. The franchise agreement spelled it all out, and dozens of franchisees invested between \$20,000 and \$50,000. In return, they were given a route along which to sell the franchisor's exclusive line of snack and beverage products. The franchisees ordered the products from the franchisor and sold them to stores, keeping the profit. The franchisor advised the franchisees that they should also buy equipment, rent warehouse space and purchase a truck—and the franchisees complied because they were told it was essential for their business. However, the products arrived months late and when they did arrive on time, they were of poor quality. For instance, the potato chips were stale and there were foreign particles in the beverages. Soon after the new franchisees paid the initial fees, the franchisor closed down his warehouse, stopped answering his phone and disappeared with the franchisees' money.

This case is real.<sup>1</sup> The Attorney General's Office brought an action against the scam artists and achieved a settlement which resulted in a large monetary judgment against the defendants. The victims in this case thought that they were investing in a legitimate franchise business. They were normal, everyday people who lost their life savings because of a lack of thorough research and skepticism. They trusted what they were told instead of doing their homework and checking up on each aspect of the franchise. Consulting with an attorney, accountant, or some other business professional knowledgeable about franchising would have aided purchasers in learning about some of these risks. As it turns out, not only was this "franchise" not registered with the state, but the President and owner had previously been convicted of a felony, a scheme to defraud. If the franchisees had known what to consider when buying a franchise, they would not have invested.

---

<sup>1</sup>*State of New York v. Maricopa Products, Inc., d/b/a Gourmet Food and Beverage; Westcool Beverage & Snacks, Inc.; Wacky Snacks and Beverages, Inc., d/b/a Key Marketing Group; Michael Glass; Peter Glass; Joshua Glass; Adriane Glass; and John Levetown*, Index No. 96/406542.

© 2001, New York State Office of the Attorney General.  
Written by Franchise Section Chief Joseph J. Punturo, Assistant Attorney General William J. Estes and Melanie Schechter.

Free copies of this booklet are available by calling (518) 486-9704  
or online at [www.oag.ny.gov/brochure\\_request](http://www.oag.ny.gov/brochure_request).

## **Warning Signs that You Might Be Getting Involved in a Fraud**

### ***1. Failure to Disclose All Necessary Documents and Details***

The franchisor who does not properly disclose all relevant details to the potential franchisee is probably trying to hide something. The franchise may not be profitable or the franchise may be a scam. Before you sign anything, be sure you learn all of the relevant information, make sure all of your questions are answered fully and be certain that all relevant details are clear.

### ***2. High-Pressure Sales Tactics***

You should never feel pressured to buy a franchise or to make your decision quickly, for any reason. Remember that you are making an investment and you should be cautious with your decision.

### ***3. Claims of Minimal Risk and Promises of Unrealistic Profits***

There is a large amount of risk associated with buying a new franchise. Even the franchisor with the most successful chain cannot legitimately promise that you will make money. Be wary of any franchisor who guarantees that you will definitely make a lot of money with little risk.

### ***4. Unjustified Start-Up Fees***

Initial fees are sometimes very high, but be sure you know where your money is going. Fees that seem too high may very well be just that. Many crooked franchisors have sold franchises and disappeared with the initial franchise fee.

## **The Truth about Legitimate Franchises: What Every Investor Needs to Understand**

One reason why many franchises are so successful is because the system creates a certain synergy. Businesses brought together under one trademark can achieve things not possible for individual business people, such as group advertising and buying power. Along with success, however, comes a certain number of failures. There is no guarantee of success. Therefore, it is vital that potential franchisees understand that:

- ***Franchises are not guaranteed to make money.*** Even if you own a business which is part of the most successful franchise in the country or the world, your store may lose money, especially in the beginning. Be prepared to deal with this type of situation.
- ***A franchise is a long-term investment.*** You will **not** get rich quick. It may take you several years to develop your business to a point where you have paid off any loans and are making the amount of money you anticipated. If your business does not make money or you tire of it, you cannot simply close up shop and forget about it. Like it or not, you must continue to work for the full amount of time agreed to in your contract.

- ***Franchisees cannot under any circumstances deviate from the norm.*** You will be told exactly how to run your business, right down to how to organize your finance books or where to keep the napkins. Even if you believe that the franchisor's decision is not the best one for your particular store or regional location, you will be required to follow the rules. If you are a natural entrepreneur who has a creative mind and wants to operate your business your own way, franchising is probably not for you.
- ***A franchise requires a very large amount of money.*** The startup fees may number in the hundreds of thousands of dollars. Make sure you and your family can afford to sustain this kind of loss, should your business fail. There will also be continuous fees for royalties and advertising which will continue for as long as you own the business. They may be quite high and you may not want to pay them after learning the business and doing all the work, but you will be bound to continue to pay them as part of your contract.
- ***You are not guaranteed the right to alternate vending of inventory, product, service or supplies beyond those that are disclosed in the UFOC.*** The franchisor may require you to buy everything you need from an approved vendor or group of vendors. Often, these vendors charge more than independent vendors because they give the franchisor a part of the earnings. Even if you know that you could buy the same items elsewhere for significantly less money, you may be required to use only the vendors accepted by the franchisor. Also, find out what factors could affect the franchisee's ability in the future to obtain essential goods economically from a reliable source.
- ***The franchisor may be bought out or may go out of business.*** If the franchisor sells to or merges with a company that does not understand franchising or if it has different goals that allow the system to deteriorate, you may suffer.

## **Tips for Prospective Franchise Purchasers to Remember**

***1. Make sure the seller of the franchise supplies you with a copy of a prospectus approved by the Office of the Attorney General and that you read it carefully.***

Under New York state law you must receive a prospectus at least 10 business days before you are asked to sign a contract or pay money to the franchisor. When you receive a prospectus you will be asked to sign a receipt for it. Make sure that the date on this receipt is correct, and keep a copy for your records. A dishonest franchisor may attempt to satisfy the 10-day rule by back-dating the receipt without your knowledge. The franchisor may also ask you to consent to the back-dating in order to complete the transaction at an earlier date than allowed by law. You should refuse. The 10-day rule is designed to afford you time to thoroughly examine the prospectus and make an unhurried decision about whether or not to invest in the franchise. To check if a franchise is registered, call the franchise section of the Office of the Attorney General at (212) 416-8236 .

**2. Consult with an attorney, an accountant or another professional with business or financial experience in the field of franchising before paying any money or signing any documents.**

In the business world, you get what you pay for. If you cut corners on professional advice, you will regret it later. You should seek professional legal and/or accounting advice, especially from someone who is familiar with the field of franchising, to help you make an informed decision. An attorney can help you understand the franchise contract, which is part of the prospectus. (See pages 13-14 to learn what questions to ask your lawyer. Also, the American Franchise Association lists attorneys on their website ([www.franchisee.org](http://www.franchisee.org)) who specialize in representing franchisees.) Ask your attorney to explain complex matters such as royalty payments, advertising fees, copyright infringement, and the effect of contract violations. Choosing a lawyer you are comfortable with and that you can afford may take some investigation, but will be worth it. Find out in advance the cost of the initial consultation will be before seeing the attorney.

An accountant can explain the financial statements that are also part of the prospectus. These statements tell you whether the franchisor is financially strong or weak and whether the franchise is profitable or unprofitable. If the franchisor is financially weak, consider very carefully before you buy; the franchisor may be selling franchises as a way of raising cash just to stay in business. The financial statements can also tell you whether the franchisor is devoting sufficient funds to the franchising aspects of the business or keeping most of it as profit. You should not attempt to extract this important information from the prospectus by yourself unless you have considerable background in these matters or in the type of business that you are considering.

Carefully study the estimate of initial expenses contained in the prospectus. Franchisors may underestimate these expenses in an effort to make the cost of purchasing a franchise seem lower than it really is. If the estimate is too low, you may find yourself with insufficient cash to carry on until the business produces a profit. Relying on the UFOC without consulting a professional and hoping that the franchisor has told the truth is setting yourself up for potential fraud. See page 16 for a list of associations and government agencies to help you in your research.

**3. The experience of others is one of the most effective guides you can use to determine how you would do if you purchased a franchise.**

The prospectus should disclose the names and addresses of individuals currently operating franchises in New York and adjacent states. Contact them and ask them how their franchises are doing. Visit the franchised premises and observe the volume and type of business being done. Pay attention to the number of franchises terminated during the past three years—an unusually large number may be a telling sign of how the franchisor does business. The prospectus should disclose the names and addresses of franchisees who have dropped out of the system within the last year. Contact them to find out why they dropped out.

It is important for you to communicate with every listed franchisee, if this is practical, or a large sample of them, if it is not. The more franchisees to whom you talk, the more you will learn about the franchisor and the chain. (See pages 11-12 for a list of questions to ask franchisees). A franchisor may attempt to supply you with a list of selected franchisees to contact. View this with suspicion. Those on the list may be “shills”—franchisees being paid by the franchisor to give you a good opinion of the business. Indeed, if the franchisees on the list are far away and not likely to

be visited personally, they may not be franchisees at all, just dishonest people on the other end of the telephone.

***4. Look for a territorial protection clause in your contract.***

Encroachment is one of the most litigated issues in franchising. Whether you are a fast food franchisee who finds another unit has opened up a few blocks away, an ice cream franchisee who sees his product being sold in the corner grocery store or a franchisee who discovers that his franchisor is taking orders over the Internet—all of this adds up to lost profits for a franchisee who has spent years building up a business.

Protected or exclusive territory is the area around the franchisee's business location in which no other branch of the franchise is allowed to open a store. The extent of the protected territory may be defined by the radius from the outlet's location, the number of households and businesses in the area, the number of people living in the area, zip codes, state or highway boundaries, or some other measure. Sometimes, the franchisee must meet certain sales quotas or performance standards in order to keep the exclusive territory. Before signing the contract, you should determine if the protected territory is large enough to carry out the franchise's business objectives in light of the competition which will come from other branches of the franchise.

The protected territory clause in the original contract, as discussed above, will clarify exactly what is and is not considered exclusive territory. Courts often uphold the idea that if there is no specific protected territory clause in the original contract, the franchisee has no legitimate encroachment claim, so make sure you are clear on exactly where your franchisor can and cannot open stores. Sometimes, the franchisor will make a deal with an existing franchisee. The franchisor will allow a store to open within the exclusive territory and the franchisee will receive a percentage of the profits from the new store. This is called a reverse royalty.

***5. You should understand that although you will be the owner of your own business and thus bear the consequences of its success or failure, you will not be independent.***

You will be part of a chain and will be expected to conform to certain rules designed to assure that the product or service which you deliver to your customers is of the same type and quality as those delivered by other franchisees in the chain. Uniformity is very important to a franchise chain and you will be required to observe the rules concerning it, even though you may find them ineffective or unprofitable and have better ideas of your own. If you are an independently minded person, franchising may not be for you.

***6. Be aware of non-compete clauses.***

Even after you have relinquished control of your outlet, your contract still holds and it will probably contain a non-compete clause. This section prevents you from owning or operating a competing business within a certain geographical area for a specific time period.

***7. Widespread customer recognition of a trade name is the equivalent of goodwill in franchising.***

The trade name is the symbol of the franchise chain's quality. Anyone familiar with a trade name

has an idea, whether true or false, of the quality that the name represents. The same is true of the name you will be purchasing when you buy a franchise. If the name is unfamiliar to you and your friends, you should ask yourself whether you are getting your money's worth in buying the franchise. If the franchise name is recognizable, you will have a head start in the marketplace. Opening a franchise center may give you the benefit of a well-known reputation, but it is not a guarantee that you will make a profit. No franchisor can guarantee that your outlet will be profitable. Franchising is similar to other businesses in that it takes a large amount of resources, especially time and money, to operate successfully.

No doubt you intend to do your best to see to it that the franchise name will stand for high quality, but the decision is, once again, not entirely in your hands. The performance of the other franchisees in the chain will also affect the quality associated with the name, as will the leadership and imagination of the franchisor itself. If others in the system do a poor job, the ill will which ordinarily attaches to such performance may be transferred to your business. Also, the franchisor's willingness to keep the name before the public through advertising and to keep things up-to-date through research and development is of key importance. A franchisor or other franchisees who fall down on the job may ruin a franchise name no matter how hard you work.

Extra caution should be taken when a franchise is being acquired from a new franchisor or from a franchisor who does not have its trademark federally registered. What type of trademark protection has the franchisor sought? Are there any possible conflicts with its marks that could affect you, the franchisee? In the event a problem arises with the franchisor's mark or if another chain acquires the franchise system, does the franchisor have the right to require the franchisee to change its mark?

***8. Examine the site selection process outlined in the prospectus, as the location of a franchise is very important.***

A poorly selected site may well doom a franchise no matter how attractive its features. Determine what the franchisor will do to assist you in selecting an appropriate site and whether you will be able to change the site if it proves to be unsatisfactory. Find out if relocation rights are granted to the franchisee in the event of condemnation, lease expiration, or pure business results, or is relocation a matter of the franchisor's then-current policy. Is there any type of territorial exclusivity included in the contract? If so, what is the exact nature of any exclusivity or protection granted? Is it contingent upon achieving certain performance levels? If the franchisor's participation in the site selection process appears to be perfunctory, or if the franchisor offers no assistance, think twice about buying. If you are purchasing an existing store or route, find out why the previous franchisee is no longer with the company.

***9. Training is one of the distinct advantages of franchising.***

It enables the franchise operator to acquire within a short time the skills that an independent operator might take months or years to acquire. If the training described in the prospectus is not sufficiently detailed, ask about it. Also ask existing franchise operators about the training they received. While a well thought-out training program can be an effective substitute for the trial and error of experience, you should be aware that there is no complete substitute for experience

or natural business talent. Ask any businessperson; learning a business can take years and that one never stops learning.

***10. Look for the existence of franchisee advisory groups and associations.***

Both advisory groups and associations are organizations of franchisees, but they differ in their roles in the franchise chain. Advisory groups are organized by the franchisor and are composed of franchisees and franchisor representatives. They help the franchisor make decisions, voice complaints, and form relationships with other franchisees. Franchisee associations, on the other hand, are usually independent of the franchisor. They have their own system of organization, rules and membership requirements. Franchisees pay dues in order to fund the activities of the association. In some cases, an advisory group and an association coexist in the same franchise chain. If your franchise has an association or advisory group, it usually implies that the franchisor takes seriously the requests and ideas of the franchisees, and these are often the strongest franchises, with franchisees who feel that their voices are being heard. You should speak to representatives from the franchise advisory group/association to ensure that franchisors listen to their franchisees.

***11. Know the franchise seller.***

A franchise agreement is only as good as the people behind it, regardless of how good it looks on paper. The prospectus gives certain information concerning the employment background of the principals of the franchisor and their litigation histories. Check their employment background in the prospectus to see if they have been employed in franchising or a business related to the franchise being sold. Examine their litigation history. An excessive number of claims against them may mean that they have not been performing according to their agreements.

The franchisor's experience in selling franchises and managing a franchise chain is as important to you as the training you will receive to operate your own outlet. If the franchisor has little experience in managing a chain of franchises, you will find that the guidance, training and other support you receive may be unreliable.

## **Frequently Asked Questions about Franchising**

- ***What is a UFOC?***

A uniform franchise offering circular is a detailed disclosure document for each potential franchise purchaser. Included in the disclosure document is over twenty different items of information about the franchise, including the history of the company, required fees and investment costs, information about the franchisor, and any litigation in which s/he has been involved. When you are given the disclosure document, you must sign and date a statement acknowledging that you received it.

- ***What is the regulatory framework governing franchises?***

There are three distinct bodies of law governing franchising: federal and state registration and disclosure laws, "franchise relationship" laws, and "business opportunity" laws.

### *State Franchise Registration and Disclosure Laws*

State registration and disclosure laws provide that, unless an exemption is available, no offer or sale of a franchise can take place until the franchisor has registered a UFOC with the state in which the sale is occurring, the UFOC has been approved and the potential purchaser has received a copy prior to signing any agreements. To be approved, a UFOC must honestly and in detail explain all of the material facts of the franchise and the sale. These registration and disclosure laws are looking to prohibit misrepresentation in the offering of franchises to potential buyers and to make sure that these potential buyers have at their disposal all of the necessary information to make an informed decision. Criminal and civil penalties may apply to franchisors who do not fully disclose all of the necessary information or who misrepresent the truth. Both state and federal agencies permit the UFOC to largely take the form of the UFOC guidelines ([www.nasaa.org/nasaa/scripts/fu\\_display\\_list.asp?ptid=34](http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=34)), promulgated by the North American Securities Administrators Association (NASAA).

### *New York Law*

The New York Franchise Act states that before any franchise sales activity can take place in this state, the franchisor is required to submit a UFOC for approval to the New York State Department of Law. Sales activity in New York includes all situations in which the seller lives in New York, the buyer lives in New York, the deal is made in New York or the store will be located in New York. Should incomplete or questionable material be submitted to the state, the state Attorney General reserves the right to investigate the franchisor and/or the company.

Strict rules govern when the potential franchisee must receive a copy of the UFOC. It must be given to the buyer at least ten days before signing an agreement or at the first meeting of the franchisor and the franchisee, whichever comes first. Failure to comply with these measures could result in an investigation by the Office of the Attorney General, and may also result in a lawsuit.

### *The Federal Trade Commission Franchise Rule*

The FTC Rule states that franchisors must make full pre-sale disclosure in a prospectus, or UFOC. However, unlike the New York State law, the FTC Rule does not require that the prospectus be approved prior to distribution. Enforcement under the Rule is bolstered by penalties of up to \$10,000 per violation.

### *Franchise Relationship Laws*

A franchise agreement, like any other contract, has a fixed term. Also like any other agreement, a franchise contract may be terminated before it actually expires. Eighteen states and the District of Columbia (but not New York) have enacted laws limiting the ability of the franchisor to terminate the deal. Many states require “just cause” for termination. Just cause is defined as the failure of the franchisee to comply with some aspect of the deal as put forth in the contract, as well as the failure of the franchisee to correct, or cure, the problem once it has been pointed out. Other relationship laws address such aspects of the franchise relationship as discriminatory treatment, market protections, ability of franchisees to belong to franchise associations and the minimum advance notice of termination or expiration which must be given to franchisees.

### *Business Opportunity Laws*

Twenty-three states have enacted business opportunity laws. These laws regulate the sale of opportunities to engage in new business ventures, so they often impact franchises. The laws require registration and disclosure in the same manner as state franchise registration laws do and usually also require the posting of some kind of financial security investment. Some states exclude franchise offerings from business opportunity laws because they comply with federal or state franchise regulations, while other states hold franchises to both the business opportunity laws and the state regulations.

## **The Costs of Buying and Owning a Franchise**

Make sure you are prepared to make an investment of a large magnitude before you buy. Compare your estimates with the estimates of other franchise chains. Will you get a better deal from a competitor's franchise?

### ***Initial Franchise Fee***

This includes all fees and payments for products and services received from the franchisor before the business opens. The initial franchise fee is usually non-refundable and paid up front. In some cases, it is payable in installments, but the franchisor must disclose the terms of payment in the contract. Sometimes the initial franchise fee is deferred or placed into an escrow account until the franchisor has completely performed all of its obligations to help the franchisee start up the business. This usually indicates that the franchisor is financially weak or that the franchise is newly organized.

### ***Other Fees***

These fees are usually explained in the form of a table which clarifies how much money must be paid to whom and when such payments are due. This may include, but is not limited to, fees for royalties, advertising, transfers (payable only upon a transfer of the franchise agreement), renewal (payable only upon renewal of the franchise agreement), training, additional support and assistance, and membership in a franchisee membership organization.

### ***Financing the Franchise***

Any financing arrangements offered by the franchisor are contained in the UFOC. Often, this part will simply indicate that the franchisor does not provide any type of financing. If any financial aid is provided, the amount, interest rate, required collateral, potential liabilities upon default and any other terms and conditions must be included. Remember that you do not have to use the franchisor or its lender simply because they offer to help. Compare loan and lease services at other financial or leasing organizations as well.

## **Rights and Responsibilities of the Franchisee and Franchisor**

### ***Franchisee Obligations***

The UFOC contains information regarding the franchisee's obligations to buy or lease from the franchisor or a supplier designated by the franchisor. The franchisor must also disclose any revenues or other benefits it received as a result of any required purchases or leases. Don't forget

that there are many costs not paid by the franchisor. Be sure to include these in your financial estimates.

Make sure you understand the circumstances under which you and your family members may be held personally liable. Under what circumstances will you be personally liable when a customer, vendor or other person sues? Who will be responsible for the various obligations under the contract? Are there restrictions on other activities of the franchisee and his/her family members with regard to ownership, employment, participation in competitive businesses, etc? Do certain restrictions conflict with any current or foreseeable business interests of the franchisee or family members?

### ***Franchisor Obligations***

The franchisor's obligations lie in many different areas, such as obligations prior to the business opening, obligations during the term of the franchise agreement, obligations relating to site location, obligations to provide a training program, and an estimate of the length of time needed to open a center following the signing of a franchise agreement or the payment of a fee to the franchisor.

Ask if there is an operations manual. If so, read it carefully. It will tell you what standards of operation the franchisor expects of the franchisees. You may have to sign an agreement to keep the contents of the manual confidential. Does the manual provide for all aspects of the business? Does it contain an accounting or inventory system? If any of the systems are computerized, is the cost of the computer included in the amounts paid to the franchisor as part of the initial franchise fee?

Find out what training you will receive. Will you learn by hands-on experience at another franchise outlet? If so, how long will you be expected to work there? Will you be paid? Are you the only one who will be trained or will any employees be trained as well? Is there a course? How long is it? What type of ongoing training, management assistance and advice will you receive if and when problems arise? The amount of training you will need will depend on your present business knowledge and experience and on the operating standards you will be expected to keep.

### **Earnings Claims**

The franchisor is not required to include an earnings claim in the UFOC. In fact, according to the book *Franchising for Dummies*,<sup>2</sup> only about 25% of franchisors do so. **If the franchisor does not make a claim of this sort, discussing projected earnings is prohibited, whether it is orally or written on the proverbial "cocktail napkin."** There are many reasons why the franchisor may choose not to include an earnings claim in the prospectus. If the numbers turn out

---

<sup>2</sup>*Dave Thomas and Michael Seid, Franchising for Dummies (2000).*

to be inaccurate or misleading, the franchisee can sue and the franchisor may even be held personally responsible and face both civil and criminal charges.

Be skeptical about earnings claims that are presented. A franchisor will only make an earnings claim to portray the business in a positive light; for example, s/he may creatively use a small portion of franchised units in making the earnings claim. Determine how the franchisor arrived at the numbers s/he gave you. For the franchises whose numbers were used, where is each business located? What is the competition there? How long has that branch been in business? Also, understand that it takes a while for a new business to turn a profit, so even if you are given an earnings claim, you may not realize that kind of profit for at least a few years.

If an earnings claim is made, a description of the factual basis behind those numbers must be included as well. If an earnings claim is not made, there are still ways of estimating how much money any given unit of the franchise might make. Ask other franchisees in the system how much they net and gross monthly. They are not required to disclose this type of information, but often they will at least give you an idea of the amount of money their businesses draw in. If the franchise is a public company, it is required to provide the Securities and Exchange Commission with financial reports. You can get a copy of these reports from a stock broker or on the SEC website at [www.sec.gov](http://www.sec.gov) in the EDGAR database.

## **Advertising**

Most franchisors require franchisees to give a certain amount of money each year to the franchisor for national advertising campaigns. This is a perk of being part of a franchise, since most local businesses cannot afford to advertise on the national or even the regional level. The national advertising fee is usually determined based on some percentage of sales, although it is occasionally a flat rate. You may be asked or required to join a local or regional group, putting money into a fund for advertising in the area. Pooling money in this fashion is usually beneficial because it allows for more ads to be produced and for each one to be shown more often.

Like every other aspect of the franchise agreement, however, the advertising fee section requires cautious review before signing the contract. Where does the money go exactly? What happens to any extra funds at the end of the year? Is the franchisor permitted to change the requirements at any point? Do the franchisees have any input in the matter? Who creates the ads? Do all stores contribute at the same rate?

## **Renewal, Termination and Transfer**

### ***Renewal***

If you are content with the level of business you are doing at your unit of the franchise, you will probably want to renew your franchise agreement. You must, however, make sure that the franchisor wants to renew with you. The franchisor reserves the right to refuse to grant you a renewal, usually due to extenuating circumstances. For instance, if you are behind in your royalty payments or do not comply with regulations regarding some other aspect of the business, the

franchisor may not want to continue doing business with you. In some cases, renewal clauses are included in the initial contract. Some franchises do not permit renewals at all, while others limit the number of times you can renew.

The franchisor will probably charge a renewal fee. It should be less than the initiation fee you paid when you bought the franchise, because this time you are starting with a solid base instead of starting at ground zero. You do not need to buy equipment, train employees, etc. because those aspects of the business are already in place. However, be aware that renewal is often a time when a franchisor will mandate a significant change or expense in the operation of the franchise which you may not have anticipated.

Be aware that the franchise system and the marketplace are subject to change. The last agreement you signed may have been written 10 or 20 years ago, and will probably need to be updated to keep up with current trends. Look out for changes in royalty and advertisement fees, territorial rights, remodeling requirements, new equipment, training requirements, renewal terms and material terms of the relationship, such as dispute resolution. These are the aspects which are probably most likely to change. Also note whether the Internet has affected your business. You or the franchisor, or both, may want to address this in the renewal agreement.

### ***Termination***

Termination is also a highly litigated area in franchising. Note what your initial agreement says about each side's right to terminate the relationship. The franchisor is usually allowed to terminate the agreement if s/he can prove that there is just cause for doing so. This means that the franchisee must fail to uphold some part of the agreement, which would justify the franchisor's decision to terminate. Therefore, it is of the utmost importance that you understand each provision under which the franchisor has the right to terminate the agreement. These should be clearly stated in the original contract. Also, see what the contract says about the franchisor giving you notice of your failure to complete some aspect of the agreement. Will you have time to correct the error before the franchisor moves ahead with termination of the agreement?

### ***Transfer***

It may seem odd to think about selling your franchise before you have even purchased it, but a prudent investor will do so now in order to prevent problems later. Check your contract to see what the rules relating to transfer agreements are. Some franchises do not allow transfers of any kind, while others have specific rules governing procedure.

Your franchisor may have a right of first refusal if you decide to sell. This means that if a potential buyer makes an offer, the franchisor has the right to match the buyer's price and, in effect, buy out the business from right under the potential buyer.

Your franchisor may also have a right to reject potential buyers. This can be extremely frustrating for a franchisee looking to sell and may also result in a franchisee selling his/her franchise for much less than he or she wanted to. This is usually done in an effort to find more potential buyers, hopefully one who will be acceptable both to you and to the franchisor.

New buyers do not want to come in at the very end of the line, they want to come in while your franchise is still up and running and has a long life. Therefore, contracts with years left on them and with renewal options are very valuable, as are leases which are not yet due.

## **Dispute Resolution**

Both the franchisor and the franchisee will probably want to settle any disputes in the least costly, least time-consuming, least adversarial way possible. One option is arbitration. The arbitration proceeding may be court-supervised or before a private third party. Many franchise agreements require arbitration as the sole means of dispute resolution. Franchisors may also mandate that any arbitration take place in the franchisor's home city, which can be a significant cost to franchisees.

In some cases, it is necessary to have a court decide on an answer to your problem. This is where it is particularly important to understand what is stated in the contract. Can you afford litigation? Will you be required to litigate in the jurisdiction where your business is located, or must you file suit in the state or country where the franchisor is located? This may vary, so make sure you are aware of the contract terms before you sign the contract.

Another method of dispute resolution is mediation. A mediator will facilitate the process and help both sides clarify their arguments, but will not make a judgment on the matter. The franchisor and franchisee will resolve the dispute themselves, making all of the major decisions together. Therefore, none of the decisions made are binding.

The difference between arbitration and mediation is that an arbitrator renders a decision which must be followed, while a mediator shuttles between the two parties, attempting to discern their needs and ultimately bring them together while suggesting creative conclusions. Mediation should be used only if you wish to continue operating as a franchisee. If there is little or no trust between you and the franchisor, mediation will likely only cause more trouble.

## **Important Questions to Ask Present or Former Franchisees**

Call and visit several branches of the franchise. It is important to see how they operate. Be considerate of the franchisees you talk with. They do not have to talk with you and it would be unfair to expect them to spend time with you during their busiest hours. Explain who you are and ask when would be a good time for them to talk with you. Have questions ready when you speak with them.

- Why did you select this particular franchise system over others in the same type of business?
- What was your employment background prior to becoming a franchisee?
- Did you get the training, quality products and support you paid for and were promised? Did the promised training take place when you needed it and did the training prepare you to compete with other businesses providing similar products

or services?

- What problems did you encounter with the franchisor, the site, establishing your business and how did the franchisor respond to problems?
- How would you describe your overall franchisor/franchisee relationship?
- Is there a franchisee association or advisory council? Was there some incident or problem that caused the franchisees to band together? How long has the association existed? Who controls the association, the franchisees or the franchisor? What current issues are being dealt with? Is there a meeting scheduled that I could attend?
- What is your opinion about how competitive your franchise is with similar businesses? What, if any, trends do you see in the industry, in the franchisor's business, and in your particular market area?
- Are there any other franchisees or former franchisees whom you might recommend I contact?
- How often have you found it necessary to refer to your franchise agreement after your business opened? Did the agreement provide the answer to your questions? What do you wish the agreement had included? If many franchisees are turning frequently to their agreements to solve problems with the franchisor, the franchisor/franchisee relationship may not be a healthy one.
- Consider asking a cooperative franchisee if you could work with her/him for a period of time for free before you commit to buying your own franchise.
- If the person is a former franchisee:
  - Why did you leave the franchise system?
  - Did the franchisor cooperate in helping you sell your franchise?
  - Do you own any other franchise or would you buy a franchise from a different franchisor?
  - If there was a termination or nonrenewal, did the franchisor explain why and provide a reasonable opportunity for you to cure the problem?

## **For Further Information**

The Attorney General recommends that investors contact both these and other regulatory agencies and industry associations in researching potential franchise investments.

### **GOVERNMENT AGENCIES**

*The Federal Trade Commission  
Consumer Response Center  
600 Pennsylvania Avenue, NW  
Washington, DC 20580  
(877) 382-4357  
[www.ftc.gov/bcp/franchise/netfran.htm](http://www.ftc.gov/bcp/franchise/netfran.htm)*

The Federal Trade Commission regulates franchising on the national level. They are responsible for enforcing the FTC Rule, eliminating unfair or deceptive practices, prosecuting violators of franchising laws and consumer education.

*New York State Office of the Attorney General  
Investor Protection Bureau  
Franchise Section  
120 Broadway, 23<sup>rd</sup> Floor  
New York, NY 10271  
(212) 416-8200*

[www.oag.ny.gov/franchise/franchise.html](http://www.oag.ny.gov/franchise/franchise.html)

The Office of the Attorney General (“OAG”) regulates franchising in New York State and accepts written complaints regarding franchisor fraud. Franchise prospectuses can also be obtained from the OAG for .25 cents per page by making a written request and faxing it to the FOIL Officer at (212) 416-8816. The website contains state and federal franchise laws and regulations, appropriate forms to be filed by franchisors and links to other sites.

*United States Small Business Administration (New York Regional Office)  
26 Federal Plaza, Suite 3100, New York, NY 10278  
(212) 264-4354*

[www.sba.gov/hotlist/franchise.html](http://www.sba.gov/hotlist/franchise.html)

The Small Business Administration provides loans to help small businesses get started and keep running efficiently. They also provide information about starting a small business, as well as upkeep, financing, statistics and disaster protection of your business.

## INDUSTRY ASSOCIATIONS

*American Association of Franchisees and Dealers*  
*PO Box 81887, San Diego, CA 92138-1887*  
*(800) 733-9858*  
*www.aafd.org*

The American Association of Franchisees and Dealers is a national non-profit trade association which represents the concerns and interests of franchisees and independent dealers throughout the United States. Their mission is to bring complete fairness to franchising, and they aim to accomplish this goal by providing its members with legislative and legal advocacy, education, accreditation, market support services and a strong code of ethics.

*American Franchisee Association*  
*53 West Jackson Boulevard, Suite 250, Chicago, IL 60604*  
*(312) 431-0545*  
*www.franchisee.org*

The American Franchisee Association is a national trade association of franchisees and dealers who own franchise outlets throughout the country. The AFA advocates for changing the rules and laws that govern franchising on both the state and national levels. The AFA always advocates the franchisee's position and communicates with federal lawmakers about the shortage of laws governing the relationship between franchisors and franchisees.

*Asian American Hotel Owners Association*  
*66 Lenox Pointe, NE*  
*Atlanta, GA 30324*  
*(404) 816-5759*  
*www.aahoa.com*

The Asian American Hotel Owners Association aims to create a healthier franchise system through both advocacy and education. The AAHOA organizes seminars and programs to help its members become better businesspeople and to run and grow their businesses more effectively. These include programs and seminars for certified hotel owners and for people who own more than one unit of a franchise, as well as regional programs about issues facing hoteliers.

*International Franchise Association*  
*1350 New York Avenue, N.W., Suite 900, Washington D.C. 20005-4709*  
*(202) 628-8000*  
*www.franchise.org*

The International Franchise Association seeks to protect, enhance and promote franchising. The IFA achieves this end by holding in high esteem the virtues of trust, truth, honesty, mutual respect and open and frequent communication, the foundations of franchising. They can answer virtually any questions and have many programs and services to help franchisees succeed.

*International Franchise Association: Franchising Basics and Franchise Compliance Program*  
<http://ifa.intralearn.com>

These programs are intended to help both franchisors and potential franchisees learn important information about franchises and franchise law. Each section discusses a different facet of franchising and has a quiz at the end to ensure that users have retained what they have read. The basic program for franchisees is an excellent way to learn important rules and regulations. The franchisor program is more involved but is also an extremely helpful tool for both franchisors and franchisees.

*North American Securities Administrators Association*  
*10 G Street, N.E., Suite 710, Washington, D.C. 20002*  
*(202) 737-0900*  
*www.nasaa.org*

The North American Securities Administrators Association is a voluntary association whose membership includes many state, provincial and territorial securities administrators in the United States, the District of Columbia, Puerto Rico, Canada and Mexico. In the US, NASAA acts as the voice of the 50 state securities agencies responsible for investor protection and efficient capital formation by providing the public with information on these subjects.

## **OTHER RESOURCES**

*The Better Business Bureau (New York Regional Office)*  
*257 Park Avenue South, New York, NY 10100*  
*(212) 533-6200*  
*www.bbb.org/library/busfranc.asp*

The Better Business Bureau's mission is to foster consumer confidence and promote the highest ethical relationship between businesses and consumers.

*New York State Bar Association*  
*Franchise, Distribution and Licensing Law Committee*  
*One Elk Street*  
*Albany, NY 12207*  
*(518) 463-3200*  
*www.nysba.org/sections/business/franlaw/index.html*

The New York State Bar Association serves as an advocate for both attorneys and for the public. The NYSBA acts as the voice of New York State's attorneys by proposing rules for professional ethics and responsibility.

Copies of this brochure and other New York State Attorney General publications are available at the Attorney General's website ([www.oag.ny.gov](http://www.oag.ny.gov)) or from the any office listed below.

## REGIONAL OFFICES OF THE ATTORNEY GENERAL

### **Albany**

State Capitol  
Albany, New York 12224-0341  
(518) 474-7330

### **Binghamton**

44 Hawley Street, 17th Floor  
Binghamton, New York 13901-4433  
(607) 721-8778

### **Brooklyn**

55 Hanson Place, Suite 752  
Brooklyn, NY 11217  
(718)722-3949

### **Buffalo**

350 Main Street Suite 300A  
Buffalo, New York 14202-3473  
(716) 853-8400

### **Harlem**

163 West 125th Street  
New York, NY 10027  
(212) 961-4475

### **Nassau**

200 Old Country Road, Suite 460  
Mineola, New York 11501-4241  
(516) 248-3300

### **New York City**

120 Broadway  
New York, New York 10271  
(212) 416-8345

### **Plattsburgh**

70 Clinton Street  
Plattsburgh, NY 12901-2818  
(518) 562-3282

### **Poughkeepsie**

235 Main Street - 3rd Floor  
Poughkeepsie, NY 12601-3194  
(845) 485-3920

### **Rochester**

144 Exchange Boulevard  
Rochester, NY 14615-2176  
(716) 546-7430

### **Suffolk**

300 Motor Parkway  
Hauppauge, NY 11788  
(631) 231-2424

### **Syracuse**

615 Erie Boulevard West  
Syracuse, NY 13204-2465  
(315) 448-4800

### **Utica**

207 Genesee St. --Rm 508  
Utica, NY 13501-2812  
(315) 793-2225

### **Watertown**

317 Washington Street  
Watertown, NY 13601-3744  
(315) 785-2444

### **Westchester**

101 East Post Road  
White Plains, NY 10601-5008  
(914) 422-8755

### **Consumer Complaint Number:**

**1-800-771-7755**

### **For the Hearing Impaired:**

**1-800-788-9898**

### **Visit our website at:**

**[www.oag.ny.gov](http://www.oag.ny.gov)**