Secondhand Store

Destination: Buying a used franchise? Here's how to make the right moves.

Andrew A. Caffey | December 1, 2000

URL: http://www.entrepreneur.com/article/34638

You've found a business you want. It looks neglected, but it's in a great location and can be spruced up inexpensively. You know your energetic management style can lift employees' spirits. If you get a good price and some owner financing, this could be The One.

By the way, it's a franchise.

The franchise world is nearing the end of 10-and even 20-year contract terms for many first-generation franchise owners. As a result, hundreds of existing businesses are coming onto the market as that generation cashes out and heads for retirement. For savvy investors, that spells opportunity.

Buying an existing franchised business can offer terrific benefits to the buyer: a solid training program, a strong name, pooled advertising, a protected territory and continued support in the operation of the business. Still, the franchise relationship must be thoroughly investigated. The last thing you want is to be surprised at the closing table, when it's too late to back out of the deal.

Here are the steps you should be aware of to ensure a smooth road to your purchase:

Attorney's Assessment Buying an existing business is a complicated matter; buying a franchised business is even more difficult. It's a mistake to undertake such a task without the assistance of an experienced attorney.

The attorney will ask whether you're buying the stock of an existing corporation or the assets of the existing business. Buy the stock of a corporation and you'll assume all its liabilities; buy the assets and you'll leave most of those liabilities behind. But you must think about your own ownership structure. Will you hold the assets, including the franchise rights, in your own name or form a corporation, partnership or limited liability company to hold them? The tax implications of these decisions may be dramatic. An experienced attorney can help you consider these ideas.

The Franchisor's Approval Almost all franchise agreements reserve the franchisor's right to approve any transfer of the franchise. That consent depends on some conditions. For example, franchisors typically want you to upgrade the business and equipment to current system specifications, or send managers to training at franchisor headquarters. Learn early on whether these expenses are required.

Study the franchise agreement so you understand the approval process and the franchise rights you'll receive. You may have to sign a new franchise agreement, either for the balance of the seller's term or for a new term, and the contract may be different than the contract your seller signed.

Ask the franchisor for a current UFOC, which contains a copy of the franchise agreement. Don't assume your rights will be the same as the seller's. Ask your lawyer to review the contractual rights conveyed in a proposed transfer. Is the fee structure the same? Will you receive a full term? In one restaurant franchise, the 10-year renewal requirement is unaffected by a transfer; if you buy the business in the ninth year of the term, you could pay a substantial renewal fee once you take over.

If a particular franchisor has changed the definition of its territorial protection five times in the past 10 years, make sure to review the contract to confirm your territorial rights.

Sight of First Refusal Many franchise agreements reserve the franchisor's right of first refusal on any proposed transfer of the business. If you make an offer, the franchisor has the right to match it. The best-case scenario is that the franchisor has never exercised that right and indicates it doesn't intend to begin now. Your lawyer should try to get a written statement from the franchisor waiving the right of first refusal before you spend too much time and money investigating the transaction and make a formal offer.

Transfer Fees Although the existing franchise agreement will probably impose fees on the existing franchisee for the right to transfer, these fees usually fall on the buyer. Transfer fees, which can surpass $10,000, cover the franchisor's costs of reviewing the transaction, qualifying the buyer and training the buyer and his or her managers. Some franchise systems assess a transfer fee that's a percentage of the purchase price. Depending on the transaction's value, these fees may jump into the $30,000 or $40,000 range. Be sure to fold the transfer fees into your calculations of your offering price.

Personal Guarantee Most franchisors require the owners of a corporation or LLC, and often their spouses, to sign personal guarantees of the entity's obligations. As far as the franchisor is concerned, guarantees eliminate the liability protection afforded by your corporation. Franchisors insist on guarantees for substantiation of the franchise agreement. Small franchisee corporations can be stripped of their assets, leaving the franchisor without recourse. Take the personal guarantee requirement into account as you plan the transaction and your liability for the debts of the business. Buying an existing franchise can be a great investment. Look closely at its sales history and work with a good accountant to determine how and where to make money. Your success depends on your willingness to explore the interesting new legal dimensions created by the franchise relationship.

Buy, Buy, Buy

By Devlin Smith

After 16 years as a manager and supervisor in the automotive repair industry, Mike Mercado, 44, was burned out. He'd long considered purchasing a repair franchise of his own or even buying an existing location.

Then Mercado's wife, Laurie, 44, an accountant for franchisor Logan Farms Honey Glazed Hams Inc. and some of its franchisees, suggested her husband speak with a franchisee interested in selling.

"After doing some homework, looking at the store and talking to customers, vendors and stores in the area, I approached the gentleman who owned the store, and we agreed on the terms," Mike says. Despite his research, he regrets not looking at the equipment more carefully during his walk-through of the franchise. After the store changed hands, some equipment broke. Mike suggests including a clause in your contract stating that, for 45 or 60 days after the store is sold, the previous owner will pay for equipment repair.

Mike also emphasizes the importance of getting insiders' perspectives before making a decision. "If you want to find out what's really going on in the franchise system, talk to some of the other franchisees," he says.

This year, business at the Mercados' three Houston-area stores has increased at least 25 percent. They're considering purchasing more locations, and maybe opening a new store. "At some point," he says, "we'll take the plunge."

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