

# Playing It Right

As an entrepreneur, taking risks is part of your nature. But when it comes to franchise research, it doesn't pay to gamble. Keep these points in mind before choosing a franchise.

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Entrepreneurs and Vegas gamblers have a few things in common: They find thrill in taking risks, play the house odds and don't like losing. They also share this hard fact: A percentage of them do lose.

Franchising has always appealed to entrepreneurs who want better than house odds of success for their hard-earned investment. And while buying a franchise is no guarantee of success, it opens the way for a new bet--sharing a portion of the upside with the franchisor, in exchange for training, assistance and a marketplace identity that softens the downside of an entrepreneur's business risk.

Franchising offers other valuable resources for an investor: information, expertise and support. It transforms the establishment of a new business from a solitary experience into something quite different--a group experience, where members of the group eagerly share their own experience in doing the exact thing you're attempting. Even better, key information about that experience is required by law to be delivered to you before you make the decision to invest in a franchise. You are buying the franchisor's expertise in the process of building a successful new business and putting that expertise to work for your benefit.

Here's what the infomercial won't tell you: You can lose your shirt buying into a franchise, and you have every reason to approach the investment with caution.

**Evaluate Your Hand** The first step in managing your risk when buying a franchise is to do a little personal evaluation and planning so you can narrow down the scope of your choices. Jot down what you think you'll enjoy about owning a business, your personal goals and the franchise

ideas you've seen that appeal to you. Take stock of your resources so you know what you can afford and can assess your borrowing power.

**Get in the Game** How do you take your focused vision to the marketplace and find a great franchise program? One of the best places to start is a franchise business opportunity trade show. You'll find these shows in most major cities nationwide. They're a great introduction to the market. Going to a show gives you a chance to meet with the people who actually offer the franchise. Ask them questions, pester them about the money involved, and, if you're interested, be sure to give them your contact information for a follow-up package.

For everything you need to know about buying a franchise, visit our [Franchise Zone](#).

Spend some time on the Internet looking through franchise information. You'll find a mind-spinning variety of franchise information at sites like Entrepreneur.com. Also, stop by the [FTC's site](#) for some excellent cautionary advice and a look at some of their enforcement activities. If you have your eye on a few franchise programs, find their home pages for some basic information, and sign up to have additional information sent to you. It won't take long before you are inundated with information on the opportunities you have identified.

## Play the Odds

Go through each package until you have a good sense of the programs being described. You will probably have mostly color brochures and application forms--not very meaty stuff. The real prize among the documents that you may receive from a franchisor is the Uniform Franchise Offering Circular (UFOC). This is a multipart document that provides a long narrative about various aspects of the program, along with a copy of up to three years of the franchisor's financial statements and a copy of the standard franchise agreement. All franchisors have a UFOC for their serious prospects. They are required to deliver one of these gems to every prospective franchisee a few weeks before he or she commits money or signs a contract (or at the time of a personal face-to-face

meeting, although that rule is being revised), so you may not receive a UFOC at an early stage of your inquiry. Most companies want to get your application information and financial qualifications before sending out a UFOC. Ask for a UFOC from those franchisors that seriously interest you. Once you have that document, take the time to read it.

The law requires that the UFOC be written in plain English, so reading it shouldn't be a chore. To pave the way, here are highlights of what to look for as you read the UFOC:

- **Item 1:** This general introduction is always worth reading. It summarizes basic information about the franchisor and the offering.
- **Items 2 through 4:** After a recital of the business experience of some of the key people involved, you'll find a description of the company's litigation and bankruptcy history. Don't be alarmed if you see a few lawsuits listed. After all, franchising is a litigious arena--you need to know that going in--and just about all franchisors carry the battle scars of our litigation-prone society. If there is information here that concerns you, such as a really long list of lawsuits brought by or against franchisees, be sure to discuss your concerns with a company representative, with your own attorney and with franchisees you meet in the system. Learn what you can about the franchisor's dispute-resolution style.
- **Items 5 through 7:** These sections list the fees you're required to pay and the company's estimate of your total investment in the franchised business. This is key information for your business planning, so make sure you understand it.
- **Items 8 through 11:** These describe the rights and services you'll receive as a franchisee in the system. Take a careful look at Item 8. It sets out the restrictions imposed on you regarding products and services you offer through the franchised business. Are you required to buy or lease products or equipment from the franchisor? From its affiliates? Are products required to meet the franchisor's specifications? How about rebates--do you receive them for purchases you make from suppliers, or are they paid to the franchisor? Item 10 will summarize financing offered through the franchise system. Look to Item 11 for a detailed statement of the services provided to franchisees by the franchisor.

- **Items 12 through 16:** One of the earliest questions asked by a prospective franchisee is "Where is my exclusive territory?" Start at Item 12 for a detailed discussion of the territory you will receive--and be aware that it may not be "exclusive" as you understand that term. Read this item carefully.
- **Items 17 through 19:** Item 17 is a lengthy chart showing you where to find provisions in the franchise agreement on the subjects of term, renewal, transfer and termination. Item 18 tells you if and how a celebrity endorses the franchise. Item 19 sets out all the performance information or earnings claims the franchisor chooses to make. The company is not required to make any performance statements--and most choose not to--but if a claim is made, the law requires the statement and its bases and assumptions to be laid out in Item 19.
- **Items 20 through 23:** Now we are getting to the meat of the coconut. Item 20 is packed with statistics about current franchisees and company-owned units in the system, how many have joined and left the program in the past three years, and projected stats about franchisees and company-owned units to be opened in particular states in the coming year. You'll also find the names, addresses and telephone numbers of existing franchisees, as well as the most recent contact information for franchisees who have left the program in the past fiscal year. Item 21 describes the franchisor's financial statements, which are usually enclosed as an exhibit; Item 22 introduces the franchise agreement form and related documents, which are also generally enclosed as an exhibit. Item 23 is the form of receipt you sign as evidence that you received the required disclosure document.

Once you have digested the UFOC, you still have work to do. To make sure the odds are as balanced as possible, head off to visit as many existing franchisees as you can. Call ahead, and make appointments. Ask the owners if they are happy with the training they received, the ongoing support from the franchisor and the quality of the products and services the franchise program provides. Don't be shy when it comes to asking about sales and profitability. Find out what gross sales they had last year and if this year appears to be on track, or if they expect it will be a stronger or weaker year. If the franchisor provides no earnings information (see UFOC Item 19), these visits are all the more important.

Many people think there is some sort of national clearinghouse to determine whether a franchise is "legitimate." Unfortunately, it's a bit more complicated. If you live in one of the franchise registration states, you can contact state officials to determine if the company is properly registered to sell franchises in your state. If you don't live in one of these states, contact your state's consumer protection agency and ask about the franchisor. The agency might tell you if there are any current enforcement problems or serious complaints on file, but you can expect them to be closemouthed about any current investigations.

You can also contact your local Better Business Bureau (look them up in the phone book or on the Web--start with the national organization at [www.bbb.org](http://www.bbb.org)). The Federal Trade Commission has a great [Web site](#) with a lot of useful investor information, but they can't offer specific information in response to a request about a franchisor. The FTC doesn't require that disclosure be placed on file with their agency, so they can't report anything like a registration status.

Your best barometer of legitimacy is the temperature of existing franchisees in the system. If there are no existing franchisees, carefully evaluate the additional risks (along with the benefits) of being among the first franchisees through the gate. You may have to put up with a rough program that isn't well established, where the company isn't well-positioned to provide comprehensive assistance to its franchisees.

Follow your instincts in the franchise evaluation process. If you find the UFOC is outdated and incomplete, the answers you're getting to your questions don't seem right, or you're hearing serious grumbling from franchisees in the system, be prepared to throw in your hand and move on to the next opportunity.

## Read the Cards

Once you close in on a serious prospect, talk to an accountant or other financial advisor who has experience representing small businesses. Go over the franchisor's financials together (Item 21), so you know whether the company is on firm or shaky financial footing. An attorney experienced in small-business law can advise you on the terms of the franchise agreement, making sure you understand the legal relationship, the

restrictions imposed by the contract and whether you should insist on any changes before signing the agreement. Resist the natural inclination to save a few bucks by not hiring these rather expensive specialists. Consider their services cost-effective insurance.

When all the pieces fall into place, it will feel just right. The trick is working hard and researching an opportunity to pull those pieces together.

**Red flags** Five warning signs that a franchise has problems:

- **Weak financial statements:** There's nothing wrong with a modest net worth in a franchisor, but it should tell you to look for some other track record indicating the company will be in business for the duration of your franchise relationship. Weak financial statements increase your investment risks.
- **High franchisee turnover:** If many owners have left the system in the past year, find out why. The UFOC guidelines require the franchisor to include a list of the names, addresses and phone numbers of everyone who left the system in the preceding fiscal year. Call a few, and ask why they left.
- **No UFOC:** What do you mean, "no UFOC"? The law requires it, no exceptions. Don't believe it if the company rep says "We don't have to give you a disclosure, because we are a private company," or "You won't receive a UFOC because you qualify as a 'sophisticated investor.'" Balderdash.
- **Many lawsuits:** No one knows how many is too many. Too many lawsuits in a system with a few thousand franchisees will be greater than in a system with only a dozen. Discuss the litigation listed in Item 3 with your attorney and the company.
- **No franchisee recommendations:** If the current franchisees do nothing but complain to you about the franchisor and the business they bought, re-evaluate.

**Fourteen states require franchisors to register before offering franchises, including**

State	Agency
California	Department of Corporations
Hawaii	Department of Commerce
Illinois	Attorney General

Indiana	Securities Division
Maryland	Attorney General, Securities
Michigan	Attorney General
Minnesota	Department of Commerce
New York	Department of Law
North Dakota	Securities Commissioner
Rhode Island	Department of Business Regulation
South Dakota	Division of Securities
Virginia	State Corporation Commission
Washington	Department of Financial Institutions
Wisconsin	Commissioner of Securities

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