BUYING A FRANCHISE A Consumer Guide

FEDERAL TRADE COMMISSION

BUYING A FRANCHISE: A Consumer Guide

When you buy a franchise, you often can sell goods and services that have instant name recognition, and get training and support that can help you succeed. But purchasing a franchise is like every other investment: there's no guarantee of success.

The Federal Trade Commission, the nation's consumer protection agency, has prepared this booklet to explain how to shop for a franchise opportunity, the obligations of a franchise owner, and questions to ask before you invest.

I. The Benefits and Responsibilities of Franchise Ownership

A franchise enables you, the investor or franchisee, to operate a business. You pay a franchise fee and you get a format or system developed by the company (franchisor), the right to use the franchisor's name for a limited time, and assistance. For example, the franchisor may provide you with help in finding a location for your outlet; initial training and an operating manual; and advice on management, marketing, or personnel. The franchisor may provide support through periodic newsletters, a toll-free telephone number, a website, or scheduled workshops or seminars.

Buying a franchise may reduce your investment risk by enabling you to associate with an established company. But the franchise fee can be substantial. You also will have other costs: for example, you may be required to give up significant control over your business while you take on contractual obligations with the franchisor.

Typically, franchise systems have several components.

Costs

In exchange for the right to use the franchisor's name and assistance, you will pay some or all of the following fees.

Initial Franchise Fee and Other Expenses

Your initial franchise fee, which will range from several thousand dollars to several hundred thousand dollars, may be non-refundable. You may incur significant costs to rent, build, and equip an outlet and to buy initial inventory. You also may have to pay for operating licenses and insurance, and a "grand opening" fee to the franchisor to promote your new outlet.

Continuing Royalty Payments

You may have to pay the franchisor royalties based on a percentage of your weekly or monthly gross income. Often, you must pay royalties even if your outlet isn't earning significant income. As a rule, you have to pay royalties for the right to use the franchisor's name. Even if the franchisor doesn't provide the services they promised, you still may have to pay royalties for the duration of your franchise agreement. Indeed, even if you voluntarily terminate your franchisee agreement early, you may owe royalties for the remainder of your agreement.

Advertising Fees

You also may have to pay into an advertising fund. Some portion of the advertising fees may be allocated to national advertising or to attract new franchise owners, rather than to promote your particular outlet.

Controls

To ensure uniformity, franchisors usually control how franchisees conduct business. These controls may significantly restrict your ability to exercise your own business judgment. Here are a few examples.

Site Approval

Many franchisors pre-approve sites for outlets, which, in turn, may increase the likelihood that your outlet will attract customers. At the same time, the franchisor may not approve the site you've selected.

Design or Appearance Standards

Franchisors may impose design or appearance standards to ensure a uniform look among the various outlets. Some franchisors require periodic renovations or seasonal design changes; complying with these standards may increase your costs.

Restrictions on Goods and Services You Sell

Franchisors may restrict the goods and services you sell. For example, if you own a restaurant franchise, you may not be able to make any changes to your menu. If you own an automobile transmission repair franchise, you may not be able to perform other types of automotive work, like brake or electrical system repairs.

Restrictions on Method of Operation

Franchisors may require that you operate in a particular way: they may dictate hours; pre-approve signs, employee uniforms, and advertisements; or demand that you use certain accounting or bookkeeping procedures. In some cases, the franchisor may require that you sell goods or services at specific prices, restricting your ability to offer discounts, or that you buy supplies only from an approved supplier even if you can buy similar goods elsewhere for less.

Restrictions on Sales Area

A franchisor may limit your business to a specific territory. While territorial restrictions may ensure that you will not compete with other franchisees for the same customers, they also could hurt your ability to open additional outlets or to move to a more profitable location. In addition, a franchisor may limit your ability to have your own website, which could restrict your ability to have online customers. Moreover, the franchisor itself may have the right to offer goods or services in your sales area through its own website or through catalogs or telemarketing campaigns.

Terminations and Renewal

You can lose the right to your franchise if you breach the franchise contract. Franchise contracts are for a limited time; your right to renew is not guaranteed.

Franchise Terminations

A franchisor can end your franchise agreement for a variety of reasons, including your failure to pay royalties or abide by performance standards and sales restrictions. If your franchise is terminated, you may lose your investment.

Renewals

Franchise agreements may run for as long as 20 years. At the end of the contract, the franchisor may decline to renew. Renewals are not automatic, and they may not have the original terms and conditions. Indeed, the franchisor may raise the royalty payments, impose new design standards and sales restrictions, or reduce your territory. Any of these changes may result in more competition from company-owned outlets or other franchisees.

II. Advance Work: Before You Select a Franchise System

Before you invest in a particular franchise system, think about how much money you have to invest, your abilities, and your goals. Be brutally honest.

Your Investment

- How much money do you have to invest?
- How much money can you afford to lose?
- Are you purchasing the franchise alone or with partners?
- Do you need financing? Where's it coming from?
- What's your credit rating? Credit score?
- Do you have savings or additional income to live on while you start your business?

Your Abilities

- Does the franchise require technical experience or special training or education (for example, auto repair, home and office decorating, or tax preparation)?
- What special skill set can you bring to a business, and, specifically, to this business?
- What experience do you have as a business owner or manager?

Your Goals

Write down your reasons for buying a particular franchise:

- Do you need a specific annual income?
- Are you interested in pursuing a particular field?
- Are you interested in retail sales or performing a service?
- How many hours can you work? How many are you willing to work?
- Do you intend to operate the business yourself or hire a manager?
- Will franchise ownership be your primary source of income or a supplement to your current income?
- Do you get bored easily? Are you in this for the long-term?
- Would you like to own several outlets?

III. Selecting a Franchise

Purchasing a franchise is like any other investment: it comes with risk. When you think about a particular franchise, think about the demand for the products or services it offers, competitors that offer similar products or services, the franchisor's background, and the level of support you will receive.

Demand

Is there a demand for the franchisor's products or services in your community? Is it seasonal or ever-green? Could you be dealing with a fad? Does the product or service generate repeat business?

Competition

What's the level of competition—nationally, regionally, and locally? How many franchised and company-owned outlets are in your area? Does the franchise sell products or services that are easily available online or through a catalog? How many competing companies sell similar products or services? Are they well-established or widely recognized by name in your community? Do they offer a similar product at a similar price?

Your Ability to Operate the Business

Sometimes, franchise systems fail. What will happen to your business if the franchisor closes up shop? Will you need the franchisor's ongoing training, advertising, or other help to succeed? Will you have access to the same suppliers? Could you conduct the business alone if you have to cut costs or lay anyone off?

Before you invest in a particular franchise system, think about how much money you have to invest, your abilities, and your goals. Be brutally honest.

Name Recognition

Buying a franchise gives you the right to associate with the company's name or brand. The more widely recognized the name, the more likely it is to draw in customers.

Consider:

- name and brand recognition for the company and its product or service
- whether the company has a registered trademark
- how long the franchisor has been in business
- whether the company's reputation is for quality products or services
- whether consumers have filed complaints against the franchise with the Better Business Bureau or a local consumer protection agency

Training and Support Services

What training and continuing support does the franchisor provide? Does the franchisor's training measure up to the training for workers in the particular industry? Can you compete with others who have more formal training? What backgrounds do the current franchise owners have? Is your education, experience, or training similar?

Franchisor's Experience

Many franchisors operate well-established companies with years of experience both in selling goods or services and managing a franchise system. Some franchisors started by operating their own business. There is no guarantee, however, that a successful entrepreneur can successfully manage a franchise system. Find out:

- how long the franchisor has managed a franchise system
- whether the franchisor has enough expertise to make you feel comfortable. If the franchisor has little experience managing a chain of franchises, take any promises about guidance, training, and other support with the proverbial grain of salt.

Growth

A growing franchise system increases the franchisor's name and brand recognition and may enable you to attract customers. But growth alone doesn't ensure successful franchisees. Indeed, a company that grows too quickly may not be able to support its franchisees with the support services it promises them. Investigate the franchisor's financial assets and resources; are they sufficient to support the franchisees?

IV. Finding the Right Opportunity

There are many, many ways to find franchise opportunities. Some franchisors have websites with information about their franchises. Franchise expositions are another good source of information, as are franchise brokers—companies or people that specialize in matching individuals with franchise companies. It's always a good idea to visit franchised outlets in your area and talk to the owners about their experience with particular franchisors.

Shopping at a Franchise Exposition

Attending a franchise exposition allows you to see and compare a variety of franchise possibilities under one roof. Before you attend, research the kind of franchise that may best suit your budget, experience, and goals. When you attend, visit several franchise exhibitors who deal with the type of industry that appeals to you. Ask questions.

- How long has the franchisor been in business?
- How many franchised outlets exist? Where are they?
- What is the initial franchise fee? What additional start-up costs can you expect? Are there continuing royalty payments? How much? What do other franchisees pay?
- What management, technical, and other support does the franchisor offer?
- What controls does the franchisor impose?

Exhibitors may offer you incentives to attend a promotional meeting to discuss the franchise in greater detail. These meetings can be another source of information and another opportunity to raise questions. Be prepared to walk away from any franchise opportunity—and promotion—that doesn't fit your needs.

Using a Franchise Broker

Franchise brokers—who also refer to themselves as "business coaches," "advisors," "referral sources," or "sales consultants"—help people who want to buy a franchise. They often advertise on the Internet and in business magazines that they will help you select among various franchise options. Typically, a broker reviews the amount of money you have to invest and then directs you to opportunities that match your interests and resources. A broker also may help you complete applications and the paperwork to consummate the sale. Remember that franchise brokers often work for franchisors, and get paid only if a sale is completed.

Limited Opportunities

Some franchise brokers may claim to be able to match you with "the perfect opportunity" because they represent a wide range of business sellers. That may be true—or not. In some instances, franchise brokers represent only a few franchisors, and, as a result, their suggestions may be limited.

Selection Standards

Some franchise brokers may claim that they will suggest only those franchises that meet certain standards. You may think this means that your financial risk is limited because the broker is weeding out the poor investments. In fact, some brokers represent any franchisor willing to pay them a commission for a sale. If you rely on a broker, be skeptical: you may be directed to a franchise that is failing or that doesn't have a track record.

Upselling

Some brokers earn a flat fee regardless of the price of the franchise they sell; others earn a commission pegged to the price of the franchise the broker sells. The more costly the franchise, the bigger the broker's commission. Some brokers may steer you toward a more costly franchise to beef up their own commission.

Unauthorized or Misleading Earnings Representations

To convince you to buy a particular franchise, a broker may make certain representations about income. Earnings claims may not be true, and sometimes, can be misleading even if literally true. For example, the figures may be based on earnings in an area where demand for the business' goods or services is high. Or the earnings claimed may be based on outdated industry data. In some instances, earnings claims may be gross sales figures: when you factor in likely expenses, actual earnings can be far less. Because earnings representations may be misleading, many franchisors prohibit their sales representatives from making them.

Before using a franchise broker, ask yourself:

- whether you need the services of a franchise broker. Can you get enough information shopping online or reading trade magazines?
- whether the broker is paid by the franchisor. Are there any fees you must pay the broker? If so, how much you are willing to pay?
- whether the broker's commission depends on the price of the franchise. If it does, consider the fact that the broker may be leading you toward a higher-priced franchise. Ask about alternatives in the same field that may cost less.
- how many franchisors the broker represents. If it's a small group, the potential match-ups may be limited.
- how the broker selects franchisors to represent. Are the selection criteria in writing? Ask to see them. How many franchisors has the broker turned down in the recent past?
- about potential earnings claims. Verify whether the franchisor has authorized the claims. Ask the franchisor for the written documentation that lays out the basis for the claims. Think about consulting an accountant to determine whether the claims are reasonable and if they are applicable to where and how you intend to operate your business.

You should receive the names and contact information for other buyers of the franchise—current and former franchisees. Talk to them, rather than relying on information from the broker alone.

Speak to them about their experience within the franchisor.

V. Investigating Before You Invest

The All-Important Disclosure Document

Before you invest in any franchise system, get a copy of the franchisor's disclosure document. Under the Franchise Rule, which is enforced by the FTC, you must receive the document at least 14 days before you are asked to sign any contract or pay any money to the franchisor or an affiliate of the franchisor. You have the right to ask for—and get—a copy of the disclosure document once the franchisor has received your application and agreed to consider it. Indeed, you may want to get a copy of the franchisor's disclosure document before incurring any expenses to investigate the franchise offering.

The franchisor may give you a copy of its disclosure document on paper, via email, through a web page, or on a disc. The cover of the disclosure document should have information about its availability in other formats. Make sure you have a copy of the document in a format that is convenient for you, and keep a copy for reference.

Read the entire disclosure document. Don't be shy about asking for explanations, clarifications, and answers to your questions before you invest. Among the key sections in a complete disclosure document are:

Franchisor's Background

This section tells how long the franchisor has been in business, likely competition, and any special laws that pertain to the industry, like any license or permit requirements. This will help you understand the costs and risks you are likely to take on if you purchase and operate the franchise.

Read the entire disclosure document. Don't be shy about asking for explanations, clarifications, and answers to your questions before you invest.

Business Background

This section identifies the executives of the franchise system and describes their experience. Pay attention to their general business backgrounds, their experience in managing a franchise system, and how long they've been with the company.

Litigation History

This section discusses prior litigation—whether the franchisor or any of its executive officers have been convicted of felonies involving fraud, violations of franchise law, or unfair or deceptive practices law, or are subject to any state or federal injunctions involving similar misconduct. It also says whether the franchisor or any of its executives have been held liable for—or settled civil actions involving—the franchise relationship. A number of claims against the franchisor may indicate that it has not performed according to its agreements, or, at the very least, that franchisees have been dissatisfied with its performance.

This section also should say whether the franchisor has sued any of its franchisees during the last year, a disclosure that may indicate common types of problems in the franchise system. For example, a franchisor may sue franchisees for failing to pay royalties, which could indicate that franchisees are unsuccessful, and therefore, unable or unwilling to make their royalty payments.

Bankruptcy

This section discloses whether the franchisor or any of its executives have been involved in a recent bankruptcy, information that can help you assess the franchisor's financial stability and whether the company is capable of delivering the support services it promises.

Initial and Ongoing Costs

This section describes the costs involved in starting and operating a franchise, including deposits or franchise fees that may be non-refundable, and costs for initial inventory, signs, equipment, leases, or rentals. It also explains ongoing costs, like royalties and advertising fees. In addition, ask about:

- continuing royalty payments
- advertising payments, both to local and national advertising funds
- grand opening or other initial business promotions
- business or operating licenses
- product or service supply costs
- real estate and leasehold improvements
- discretionary equipment, such as a computer system or a security system
- training
- legal fees
- financial and accounting advice
- insurance
- the costs of compliance with local ordinances, such as zoning, waste removal, and fire and other safety codes
- health insurance
- employee salaries and benefits

Starting your business may take several months. Estimate your operating expenses for the first year and your personal living expenses for up to two years. Compare your estimates with what other franchisees have paid and with competing franchise systems. You may be able to get a better deal with another franchisor. An accountant can help you evaluate this information.

Restrictions

This section tells whether the franchisor limits:

- suppliers from whom you may purchase goods
- the goods or services you may offer for sale
- your customers
- where you can sell goods or services
- your use of the Internet to sell goods or services to customers in and out of your territory and the right of the franchisor (or other franchisees) to use the Internet to solicit customers or to sell in your territory

These kinds of restrictions may limit your ability to exercise your own business judgment in operating your outlet. That said, if the franchisor does not limit the territory where each franchisee can sell, the franchisor and other franchisees may compete with you for the same customers, either by establishing their own outlets, or by selling to customers in your area through the Internet, catalogs, telemarketing, and the like.

Terminations

This section spells out the conditions under which the franchisor may end your franchise and your

obligations to the franchisor after termination. It also defines the conditions under which you can renew, sell, or assign your franchise to others.

Training

This section explains the franchisor's training and assistance program. Check for information about:

- who is eligible for training
- whether new employees are eligible for training and, if so, at what cost. Who pays?
- how long the training sessions take. How much time is spent on technical training, business management training, and marketing?
- who conducts the training and their qualifications
- whether the company offers ongoing training and at what cost
- support staff available for trouble-shooting: Are they assigned to your area and how many franchisees they are responsible for?
- whether on-site individual assistance is available and at what cost

The training you need will depend on your business experience and your knowledge of the franchisor's goods and services. If you have doubts about whether the training offered is sufficient to give you the tools you need to handle day-to-day business operations, consider another franchise opportunity.

Advertising

This section has information on advertising costs. Franchisees often are required to contribute a percentage of their income to an advertising fund. Find out:

- what part of the advertising fund is devoted to administrative costs
- what other expenses are paid from the advertising fund
- whether franchisees have any control over how the advertising dollars are spent
- what advertising promotions the company has already engaged in and what's on the drawing board
- what percentage of the fund is spent on national advertising
- what percentage of the fund is spent on advertising in your area
- what percentage is devoted to selling more franchises
- whether all franchisees contribute equally to the advertising fund
- whether you need the franchisor's consent to develop and buy your own advertising
- whether there are rebates or advertising contribution discounts if you do your own advertising
- whether the franchisor gets any commissions or rebates when it places advertisements, and who benefits from those—you or the franchisor

Current and Former Franchisees

This section has very important information about current and former franchisees. Many franchisees in your area may mean more competition for customers. The number of terminated, cancelled, or non-renewed franchises may indicate problems.

Some companies may repurchase failed outlets and list them as company-owned outlets.

Look for contact information for current franchisees and franchisees who have left the system within the last year; talking to them may be the most reliable way for you to verify the franchisor's claims. Visit or phone as many of the current and former franchisees as possible to chat about their experiences, and the volume and type of business they're doing. Note that some of them may have signed confidentiality agreements that prevent them from speaking with you. If that's the case, try contacting others on the list.

If you buy an existing outlet that was reacquired by the franchisor, the franchisor must tell you who owned and operated the outlet for the last five years. Several owners in a short time may indicate that the location isn't profitable or that the franchisor hasn't supported that outlet as promised. Consider contacting several previous owners to learn more about their experience operating the particular outlet. You will want to learn:

- how long the franchisee operated the franchise
- where the franchise was located
- whether they were able to open the outlet in a reasonable time
- their total investment, including any hidden or unexpected costs
- how long it took them to cover operating costs and earn a reasonable income
- whether they were satisfied with the cost, delivery, and quality of the goods or services they sold
- their backgrounds before becoming a franchisee

Talking to current franchisees and franchisees who have left the system within the last year may be the most reliable way for you to verify the franchisor's claims.

- whether the franchisor's training was adequate
- whether the franchisor provided ongoing help
- their satisfaction with the franchisor's advertising program
- whether the franchisor fulfilled its contractual obligations
- whether the franchisee would invest in another outlet
- whether the franchisee would recommend the investment

Some franchisors may give you a separate reference list of franchisees to contact. To ensure that you get the full picture, you may want to contact at least some references listed in the disclosure document that are not on the separate list.

Associations of Franchisees Operating Similar Outlets

There's no question that the disclosure document is critical reading for potential franchisees. Associations of franchisees who are operating similar outlets are another important source of information. Whether or not these associations are sponsored or endorsed by the franchisor, they can provide information about the state of the relationship between the franchisor and its franchisees. You may want to ask a franchisee association about:

- its membership
- its history
- its goals
- its relationship with the franchisor
- any benefits in buying from one franchisor versus a competitor
- any problems franchisees are facing in the operation of their outlets

Earnings Information

You may want to know how much money you can make if you invest in a particular franchise system. Be careful. Earnings information can be misleading. Insist on written substantiation for any information you may receive that suggests your potential income or sales.

Franchisors are not required to disclose information about potential income or sales, but if they do, the law requires that they have a reasonable basis for their claims and that they make the substantiation for their claims available to you. When you review any earnings claims, consider:

Sample Size

Say a franchisor claims that franchisees in its system earned $50,000 last year. The claim may be deceptive if it doesn't represent the typical earnings of franchisees. The disclosure document should tell the sample size and the number and percentage of franchisees who reported earnings at the level claimed.

Average Incomes

A franchisor may claim that the franchisees in its system earn an average income of, say, $75,000 a year. Average figures tell very little about how individual franchisees perform. An average figure may make the overall franchise system look more successful than it is because just a few very successful franchisees can inflate the average.

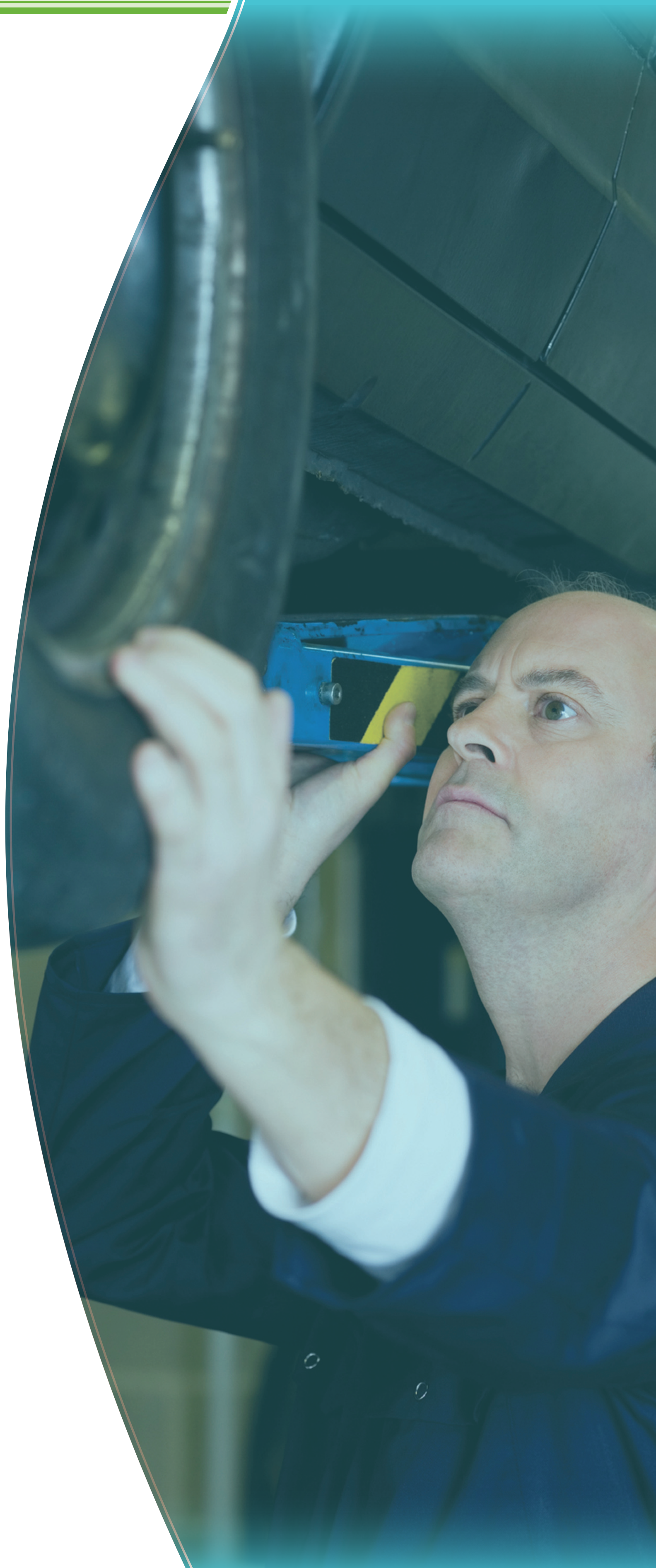
Gross Sales
Some franchisors provide figures for the gross sales revenues of their franchisees. These figures don't really tell about the franchisees' actual costs or profits. An outlet with a high gross sales revenue on paper may be losing money because of high overhead, rent, and other expenses.

Net Profits
Franchisors often do not have data on net profits of their franchisees. If you get net profit information, ask whether it includes information about company-owned outlets; they often have lower costs because they can buy equipment, inventory, and other items in larger quantities, or they may own, rather than lease, their property.

Geographic Relevance
Earnings may vary with geography. If it's reported that a franchisee earned a particular income, ask about the franchisee's location. The disclosure document should note geographic or other differences among the group of franchisees whose earnings are reported and your likely location.

Franchisees' Backgrounds
Keep in mind that franchisees have different skill sets and educational backgrounds. The success of some franchisees doesn't guarantee success for all.

Reliance on Earnings Claims
Franchisors may ask you to sign a statement—sometimes presented as a written interview or questionnaire—that asks whether you received any earnings or financial performance representations during the course of buying a franchise. If you heard or got any earnings representations, report it fully during an interview or on a questionnaire or other statement. If you don't, you may be waiving any right to contest the earnings representations that



were made to you and that you used to make your decision to buy.

Financial History

The disclosure document gives important information about the company's financial status, including audited financial statements. You can find explanatory information about the franchisor's financial status in notes to the financial statements. Investing in a financially unstable franchisor is a significant risk; the company may go out of business or into bankruptcy after you have invested your money.

It's a good idea to hire a lawyer or an accountant to review the franchisor's financial statements, audit report, and notes. They can help you understand whether the franchisor:

- has steady growth
- has a growth plan
- makes most of its income from the sale of franchises or from continuing royalties
- devotes sufficient funds to support its franchise system

VI. Before You Sign the Franchise Agreement

The company's disclosures may change between the time you receive the disclosure document and the time you sign the franchise agreement. For example, the company may have updated its disclosures; it is required to do that at least annually after its fiscal year ends. You have the right to ask for a copy of any updated information before you sign the franchise agreement. An updated disclosure document may indicate the filing of new suits by or against the franchisor, changes in the franchisor's management team, new financial data, and more current financial performance data, among other information.

Additional Sources of Information

Accountants and Lawyers

In addition to reading the company's disclosure document—including any updates—and speaking with current and former franchisees, consider talking to an accountant and a lawyer. An accountant can help you understand the company's financial statements, develop a business plan, assess any earnings projections and the assumptions they're based on, and help you pick a franchise system that is best suited to your investment resources and your goals.

A lawyer can help you understand your obligations under the franchise contract. These contracts usually are long and complex. A contract problem that arises after you have signed the contract may be very expensive to fix—if it can be fixed at all. Choose a lawyer who is experienced in franchise matters, but rely on your own lawyer or accountant for a recommendation, rather than the franchisor's recommendation.

Banks and Other Financial Institutions

These organizations can offer an unbiased view of the franchise opportunity you are considering. They should be able to get a Dun and Bradstreet report or similar financial profile of the franchisor.

Better Business Bureau

Check with the local Better Business Bureau (BBB) in the city where the franchisor has its headquarters. Ask whether there are complaints on file about the company's products, services, or personnel.

Government

Several states regulate the sale of franchises. Check with the state office that regulates franchising—it may be the Office of the Attorney General—for more information about your rights as a franchise owner in your state.

The Federal Trade Commission (FTC) enforces the Franchise Rule. The FTC publishes a number of business guides—for example, Getting Business Credit, Dot Com Disclosures, Business Guide to the Mail and Telephone Order Merchandise Rule, and Complying with the Telemarketing Sales Rule that may be helpful to your business.

The FTC works for the consumer to prevent fraudulent, deceptive, and unfair business practices in the marketplace and to provide information to help consumers spot, stop, and avoid them. To file a complaint or to get free information on consumer issues, visit ftc.gov or call toll-free, 1-877-FTC-HELP (1-877-382-4357); TTY: 1-866-653-4261. The FTC enters Internet, telemarketing, identity theft, and other fraud-related complaints into Consumer Sentinel, a secure online database available to hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

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