Holmes & Lofstrom, LLP
FRANCHISE & BUSINESS COUNSEL

COMING TO AMERICA

THE BUSINESS AND LEGAL ASPECTS OF BRINGING A FRANCHISE SYSTEM TO AMERICA

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Introduction

This paper is part of a set dealing with the business and legal aspects of successfully bringing a franchise system to North America, and particularly to the United States. It covers business-related matters associated with transferring a system to North America and certain legal issues, although further detail regarding the legal aspects of franchise disclosure and, in some of the more commercially significant states, registration and related issues are covered in an accompanying paper.

Note that from a commercial standpoint, entry into the English-speaking portion of Canada will have substantial similarities to those involved in the U.S., although Canada is a distinct market and there are some differences between the legal environment in Canada and the U. S. It's generally agreed that Canada is moving toward legal requirements regarding franchising which are substantially similar to those in the U.S.

The Business Considerations – A Rich Market, But One to be Approached with Care

For a Franchisor based outside the United States, entry into the North American market[1] presents an almost unprecedented range of opportunities, as well as challenges.

The Opportunities

Based on a 2003 PricewaterhouseCoopers study performed for the U.S.-based International Franchise Association, , franchising in the United generated a total economic output of over $1.53 trillion (approximately equal to the Gross Domestic Product of France, the United Kingdom or Italy), or 9.5% of the U.S. private sector economy, provided 18 million jobs (1 out of 7 in the U.S.), including 9.8 million jobs directly, and a payroll of in excess of $500 billion. Total jobs were about equal to the entire durable-goods manufacturing sector or the information and construction sectors combined. Business format franchising, with 622,272 establishments, has an employment level about the same as the financial services industry in the U.S.

It could be fairly said that franchising is the most successful method of product and service distribution developed during the Twentieth Century and its not unreasonable to say that the franchising method of doing business has been most highly developed in North America.

No market is as highly integrated as North America, presenting as few cultural, economic or legal barriers to doing business and none is as commercially dominant (with the possible exception of the European Union.) In recent years, the United States economy has continued to forge forward, having been relatively little affected by

[1] For purposes of this review, the Canadian and United States markets will be considered as a largely integrated whole. While the Canadian market is clearly distinct from the U.S. market, and presents its own range of opportunities and challenges, most foreign-based Franchisors have historically treated the two countries as being largely similar from a business standpoint (noting the special case of Quebec., and its French language-based culture) Mexico represents an entirely different business setting (notwithstanding the ongoing opportunities resulting from NAFTA) and is not covered in this paper, although it is part of North America.

downturns in the rest of the world, probably in large part because it is marked by steady growth, low unemployment and inflation, and rapid advances in technology.

While the United States economy will undoubtedly face periods of slow (or even negative) growth in the future, as it has at times in the past, it's difficult to argue with the proposition that, over the long term, North America will continue to act as a powerful and continuing engine of economic growth and creation of personal wealth, as well as one of the safest economies in which to make an investment in the world.

From a franchising standpoint, North America represents a fertile field for expansion for Franchisors whose concept has already been tested and proven in other markets. Americans (as well as Canadians) are comfortable with franchising as a business model, from a retail (as well as an investment) point of view.

Foreign-based franchisors will encounter a business climate open and accepting of new concepts and neither retail customers nor potential Franchisees will need to be educated to become comfortable with doing business in the franchise format.

In addition, a significant level of business and legal sophistication has developed in North America regarding franchising. While it may be debatable as to whether or not franchising first developed in North America, it clearly has had its greatest success here. For that reason, the regulatory and business environment has been, in effect, "pre-designed" to accept franchising. Neither regulators, prospective Franchisees nor potential retail customers will have any negative attitudes toward a new Franchisor arriving from off shore.

A further benefit of the U.S. (and, to a slightly lesser extent, the Canadian) market is the vast amount of consumer data and market research that is available. The U.S. is probably unique in this respect. It's <u>very</u> easy to do detailed consumer profiling, and foreign franchisors should take advantage of this in terms of determining how they should translate their concept to the North American market.

<u>The Challenges</u>

At the same time, North America presents a series of challenges to the foreign-based Franchisor, as well.

Perhaps the most important is the business one: The North American market is highly competitive, both on a retail level and in the marketplace for prospective Franchisees.

To be successful in a trillion-dollar economy, where franchising has been an accepted method of doing business for many years, a Franchisor will be required to demonstrate that its concept, as well as its execution, are first class. In addition, the Franchisor must show that the market segment chosen, and the Franchisor's approach to it, present the Franchisor (and its Franchisees) with a unique opportunity.

Here's what we mean by that: Retail customers, as well as prospective Franchisees, rarely lack for choices of competitive alternatives, many of which may have an established brand identity, a fully developed system of delivering their products or services to the market and significant resources. If any Franchisor (whether domestic or foreign-based) attempts to compete head on with such a business, and fails to establish a niche presence, unique means of presentation or other competitive advantage, it is highly unlikely to prevail.

For example, it would be a brave entrant into the North American market indeed who would attempt to go into head-to-head competition with established brands in the hamburger, chicken or other fast food categories, or in real estate or travel or any other category where an established Franchisor has already secured significant brand identity.

On the other hand, if a Franchisor can demonstrate that his or her approach to the retail market is likely to present competitive advantages *vis a vis* the competition (or, better yet, there is no significant competition in the market segment or that competition is highly fragmented), the business exercise may have reasonable chances for success.

Additionally, prospective U.S. Franchisees are perhaps the world's most sophisticated. Many (although certainly not all) are multi-unit operators, have university educations and/or have been senior executives in successful corporations.[2] Some (particularly experienced multi-unit operators) may have net worths in excess of that of a new Franchisor and many may have access to sophisticated legal, accounting, tax and business advisors.

This level of Franchisee will expect more from the Franchisor than simply an attractive concept. System leadership, proactive management and involvement of the Franchisees in decisions regarding the future development of the system are all hallmarks of successful U. S. franchise systems.

In a very real sense, North American Franchisees may view the franchise relationship in a way unexpected by Franchisors not based in the United States or Canada: Rather than a traditional "top-down" management model, the Franchisees will look on the relationship as one in which they've "hired" the Franchisor to provide leadership and guidance in a highly competitive marketplace.

Many North American Franchisees will expect the Franchisor to not merely help them set up a retail business that is initially successful, but to also regularly develop new products and services, explore new venues for retail presentation of the concept, forge strategic alliances and, in general, answer questions such as

- "What are the competitive challenges we'll face over the next five years?"

- "What special opportunities exist for expansion on the retail level?"

[2] This is not to say that franchises are not still awarded to relatively unsophisticated Franchisees. They are. But that is far less true than just a few years ago and most North American Franchisors have learned that the chances of successful expansion for their entire system may rest, to a large degree, on the business experience, resources and abilities of their Franchisees. Burdening a new concept, in a highly competitive marketplace, with unsophisticated Franchisees, may be an error from which recovery is impossible.

- "What changes can be made in the system that will allow it to maintain a position of market leadership?"

Since most North American Franchisees will, correctly or incorrectly, reach the conclusion, within 12 to 18 months after opening their franchised unit, that they know as much about running a retail unit as the Franchisor,[3] the wise Franchisor will anticipate this development and find ways to harness the energies and creativity of the Franchisees in a positive direction, rather than allowing Franchisees to become complacent and even resentful of the Franchisor and the royalties they must pay.

From a retail level standpoint, an additional factors springs from the size and the diversity of the North American market: differences in tastes and preferences regionally. Certain segments like BBQ have not been successfully franchised on a national basis because each region perceives the product so differently. This factor alone may speak to utilization of test nits prior to entering distinct markets, so as to avoid a scenario in which a franchise is awarded in a new market and is unsuccessful, due to lack of adequate locals tests.

A related issue involves what is usually recommended: a regional expansion strategy at first, focusing on what is likely to be the strongest market for the franchise concept. Attacking the national market from the beginning is often a major mistake for US companies, not only for reasons of regional diversity but also due to considerations of resource allocation and focusing on the areas most likely to succeed, and easiest to service, initially.. These considerations apply to U.S.-based Franchisors and are even more applicable to a foreign entrant to the market>

One final challenge should be mentioned: The American legal system.[4] Americans are, perhaps properly, accused of being one of the most litigious and overlawyered societies on earth. Franchising is not a field which is immune to this and may, in fact, be particularly susceptible to legal disputes and exposure.

To be candid, American Franchisees who have not met their expectations of success will have few, if any, reasons to hesitate to use legal means, if any are available, to place blame at the foot of the Franchisor and use the legal process to obtain compensation. In addition, a group of attorney's specializing in representing disappointed Franchisees stands ready to assist them in this effort, often on a contingent fee basis requiring no investment by the Franchisee.

At the same time, state and federal authorities are prepared, in particularly egregious situations, to use their enforcement powers to proceed against Franchisors who have, in their opinion, violated the law.

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[3] Whether this phenomena is attributable to American's reputation for independence and initiative, or lack of respect for established authority and sometimes unbridled cynicism, we will leave for the reader to judge!

[4] These remarks are limited to the U.S. legal environment. Canadian counsel generally report that the worst features of the American legal system are not present in Canada, although some disturbing tendencies to adopt certain American approaches to the law may be on the horizon.

The good news is that American franchising, arguably the most successful in the world, has evolved to meet this challenge. Experienced franchise counsel have developed systems and documentation, that when faithfully used by Franchisors, can reduce litigation exposure to an entirely manageable level. If that was not the case, American franchising would not have experienced the success it has.

The foreign Franchisor's responsibility, then, is to understand the American legal environment[5], to select counsel with extensive experience and knowledge as to how to navigate those waters and to follow the advice for which the Franchisor is paying!

Strategic and Tactical Considerations.

Only One Chance to Do It Right.

As a practical matter, the foreign-based Franchisor will probably have one, and only one, chance to do it right. If the wrong U.S.-based associates/regional subfranchisors/area developers are chosen, if necessary adaptations on the retail level to the U.S. market are not made or if legal mistakes are made, the system may be seriously wounded and the Franchisor may be faced with uncomfortable alternatives, including buy-outs or litigation, expensive changes to the system or market withdrawal. In any of these cases, re-entry into the U.S. market may be close to impossible.

Those considerations, then, highlight the importance of carefully selecting the U.S.-based professionals with whom you will be working and being confident that your entry into the market has been professionally handled.

The Process Will Probably Take Longer, and Cost More, Than Originally Anticipated.

Estimates of entry costs are exactly that, estimates, and the foreign-based Franchisor should be prepared for the fact that costs can escalate due to factors which no one could have anticipated.

Ways to minimize problems in this area include:

- Doing a business plan with input from personnel experienced in bringing concepts to the U. S.
- Having adequate resources.
- Implementing a limited entry strategy. For example, a system might first select the best possible market in the U.S. and concentrate on that, rather than awarding regional or unit franchises scattered across the entire continent!
- Not making an excessive number of changes in business direction once the project has been begun, referred to in the U.S. as "mid-course corrections."

Being Ready to Adapt your Business Model.

[5] Experienced franchise counsel should include, as part of their services, a training program for Franchisor personnel in the areas of potential exposure and the means to avoid litigation, as well as establishing systems designed to avoid litigation exposure.

While great pride may attach to the business model and operating principles used abroad, the franchise system entering the U.S. should maintain an open mind with respect to possible adaptations. Some of these may be suggested by the U.S.-based franchise sales, administration, marketing and operations personnel you will engage, prior to opening any units. Others will suggest themselves as a result of operating your first test unit prior to offering franchises, <u>a step that should almost never be omitted.</u> Experienced franchise professionals generally believe that is that a foreign franchisor needs to establish "proof of concept" in the U.S. (much like any U.S. franchisor should) before franchising. In addition, having a live prototype will also be critical to marketing the franchise.

Our experience has been that while the core principles behind a franchise system's success abroad should never be compromised, no business or operational model can be entirely transplanted to North America without adaptations to be relevant to the new market. The franchise system which is "nimble" enough to make these changes, while not diminishing the factors which made them a success in their home market, is significantly more likely to be successful in North America.

<u>Appropriate Staffing.</u>

Unfortunately, a common mistake made by Franchisors entering any foreign market is assuming that the system can use its existing personnel, based in the home country, on a part-time basis, to manage the transition to the foreign market. That is rarely the case.

The most significant investment involved in bringing a franchise system to the U.S. is probably the human one and it's unusual to be able to make an entry into the largest market in the world without detailing a member of your home office staff to manage that process. If that individual is not going to be based in the U.S., then he or she should be working closely with a U.S. national, including making frequent visits. One can almost guarantee that adopting a "wake me up when it's over" approach to coming to America will simply not do the job.

A related mistake is assuming the franchise system entering the U.S. can make the transition without support from personnel with international experience. The investment involved, the rewards for successful entry into the world's largest market and the negative consequences of not doing it properly, simply make that not a viable option, and allowing your U.S.-based associates to learn how to bring a system to the U.S. on your project is simply unacceptable. They should already have the requisite experience and skill sets.

Therefore, appropriate staffing involves investment of human resources at a level commensurate with the task, in terms of both your home office personnel (one of whom should be designated to have overall responsibility for success of the project and act as liaison), adequate staffing in the U.S. and selection of U.S.-based personnel with international-specific experience.

<u>Identifying the U.S. Partner and Related Due Diligence.</u>

Whether the system entering the U.S. market has chosen a subfranchising, area development or individual unit strategy, the choice of the right U.S. "partners" will be critical.

The most common mistake which we have seen in this area is for the Franchisor to award rights without doing adequate due diligence, and selecting U.S. "partners" merely on the basis that they have approached the foreign system and seem to have adequate financial resources to write the initial check!

In fact, the approach should be entirely different. The primary questions to be asked are something like the following:

"What does this candidate bring to our system that (a) is anything more than a warm checkbook" and (b) makes him/her the best possible partner in California, New York, etc.?"

"What is the ideal profile of a candidate for this relationship, and how close does this candidate come to that ideal?" (For instance, it's probably appropriate for the system entering the U.S. to adopt the attitude that it will want to sell the Southern California Region only once and should make sure it will not need to resell it after the first purchaser fails!)

"Does this candidate have adequate financial resources to fulfill his development responsibilities?"

"Does this candidate have any experience, and a demonstrated track record of success, in either (a) franchising (including franchise sales), (b) the business to be franchised or (c) any related business?"

"Does this candidate bring any synergies to the business model? For example, relationships with suppliers, access to favorable financing, real estate, related businesses that can benefit, or benefit from, the business to be franchised, etc."

"What does a due diligence background check reveal (be sure to observe all legal requirements in obtaining such information.) For example, is there a history of litigation, bankruptcies, etc.?"

<u>Business Plan Analysis on the Franchisee Level.</u>

Franchise systems entering the U.S. often (but not always!) spend a substantial amount of time selecting the mode of entry (subfranchising, area development, area representative or individual unit strategy, or other alternatives), but fail to consider the practicality of the business model from the standpoint of the Franchisee or Regional Subfranchisor. The concern, of course, is whether or not the financial and operational plan provides a reasonable chance for success on the <u>Franchisee</u> (or Regional Subfranchisor) level.

For example, regional subfranchising involves a separate layer of costs (not only will the Franchisor be taking a percentage of unit level gross revenues, so will the Regional Subfranchisor.) Will unit level operations support those costs and leave a reasonable level of return on investment, income and cash flow for the unit Franchisee?

Similarly, territorial considerations can be critical. Awarding rights to the entire U.S. must be approached with caution, as would awarding rights to a large market such as California, with over 10% of the U.S. population.

Similarly, close thought must be given to issues such as:

<u>Scope of Territorial Protection</u>. Will the award of territorial rights preclude the Franchisor from offering products or services through the Internet, from alternative venues or to select target markets?

<u>Nature of Territorial Rights.</u> Does the Franchisee have absolute rights or are they in the nature of a right-of-first-refusal or otherwise limited?

<u>Conditions on Rights</u>. Are the rights conditional, for example being tied to a development schedule or achieving specific sales levels? If so, what are the appropriate targets to be met?

The Vital Details.

From an operational standpoint, no attempt at entering the North American market should be made without a thorough review, supported by input from individuals experienced in that market and international franchising, of the practical details related to any business operation in another country.

Among others, areas needing attention will include the following:

- Product Sourcing.
- Training, Operations and Marketing Manuals.
- Real Estate and Alternative Venues.
- Research re Competition, Potential Consumer Acceptance and Related Economics.
- Staffing Ongoing Support and Guidance.
- System Compliance and Enforcement.

While the details of those areas are system-specific, and are beyond the scope of this paper, their importance to practical business success remains paramount.

Also, remember that as units open they may experience initially high levels of sales, due to the novelty of the concept, and those early results may be followed by a drop-off in revenues, which take some period of time to return to the initial level of success. Therefore, Franchisors should be cautious in assuming that initial results will be a valid guide to long-term prospects.

Franchise Marketing Strategy

Since the success of any franchised concept depends on success in awarding franchises, it's almost impossible to underestimate the importance of developing a marketing plan for generating franchise leads. Once the foreign entrant has done all of its homework to test the concept, the next major step is to find the right candidates. This requires money and planning, and franchise marketing is a highly specialized art involving print, Internet, public relations, selection of marketing personnel and/or brokers, other lead sources and legal compliance. The foreign entrant should be sure to work with a marketing firm that is familiar with marketing franchises, not simply products/services.

The Exit Strategy.

No major business investment should be made without examination of a possible exit strategy, particularly if the investment does not return the levels of success hoped for. Working with experienced legal and business advisors, franchise systems entering the U.S. should establish the appropriate plan to be implemented if withdrawal from the market seems appropriate.

A North American Franchising Philosophy

"Building the Brand"

Given the tremendous success of the franchised form of doing business in North America, it's understandable that some entrants into the market may consider franchising their businesses in the United States or Canada as an almost "automatic" road to success.

The reality is different. No method of business, including franchising, guarantees success, either for the Franchisor or the Franchisee. In fact, relatively few franchise systems, whether domestic in origin or "imported," ever achieve true market dominance.

Those that do have a number of factors in common, perhaps the primary one being that they share a belief in a guiding principle for the development of their franchise systems: "Building the brand."

To understand the importance of "building the brand," let's examine some basic propositions that have guided the development of franchising in North America. These may be helpful for the foreign-based system, so as to understand some of the underlying philosophical assumptions shared by the Americans with whom they will be working.

1. Franchising makes sense at the retail level <u>only</u> if belonging to a franchise system gives the retail units competitive advantages that more than make up for the costs of belonging to the system.

2. If belonging to the franchise system does not give the Franchisee a <u>competitive advantage</u>, as compared to other participants in the industry, the franchised units will not be successful, since they have to bear the additional costs of royalties, mandatory advertising contributions, etc., may be less agile in reacting to market changes, etc. And, <u>if the retail units are not successful, the system will not be successful</u>.

3. The primary factor in increase in value of a franchised retail unit is the component related to the value of the brand. This is why a McDonald's restaurant is more valuable than a David's diner! If the brand does not increase in value, the franchised units will not increase in value.

4. The Franchisor and its Franchisees have, therefore, a single, unifying objective:

   Building the value of the brand.

5. **<u>All</u>** other business objectives are secondary. Retail chains that do not build the value of their brand — to be blunt — fail.

6. **<u>Brand value is more important than anything else</u>**, including product quality. The American Franchisors who dominate their markets did <u>not</u> become industry leaders based on supplying a superior product – McDonalds is probably an almost perfect example of this.

7. Successful franchise systems are <u>uniformly</u> characterized by the overall strength of the system and consistent application of standards, operating systems and uniform presentation to the consuming public.

8. The brand is valuable only to the degree that a strong system, with competitive retail advantages, is present.

9. At least in North America, there just aren't very many examples of successful franchise systems which have varying standards, a poor record of franchisees following the system, inconsistent presentation of the product or service, etc.

10. In a successful franchise system, the customer's loyalty is to the brand, **<u>not</u>** to the individual unit, as emotionally difficult as that may be for Franchisees to accept. In fact, this condition is <u>vital</u> to the success of the system and the Franchisee's recovery of their investment.

For example, if all a Franchisee has to sell a buyer of his or her business is the value associated with the Franchisee's personal skills and related customer goodwill, the buyer will not be likely to place a high price on a business, at least where the seller will be leaving the day-to-day management. On the other hand, if the business has value associated primarily with the brand, that is something any buyer can take advantage of and will pay a fair price to receive.

11. What's critical from the retail consumer standpoint is creating a "comfort zone" through consistent operational and marketing systems.

    A franchise system does this by doing three things:

    - Making itself unique as compared to the competition.
    - Avoiding confusing the customer.
    - Consistently presenting a well recognized product or service.

    The successful franchise system does this through building brand identity and providing a consistent presentation of the product/service and the marketing message.

12. The job for the Franchisor is, therefore, to think deeply about how the system will articulate its uniqueness in a way that gives the Franchisees a competitive advantage, to build value in the brand, exploit competitive opportunities by "leveraging" on the already established brand value and to foresee and counteract competitive challenges, as well as anything that might diminish the value of the brand.

13. The job for the Franchisee is to consistently implement that system, thereby building value in the brand and their individual franchised unit, while providing "real life" input back to the Franchisor as to how the system can be improved from an operating standpoint.

14. All franchise systems face what we call "centrifugal pressures": Without strong standards and the Franchisees' emotional commitment to them, human nature is such that people will go their separate ways and the system will fail due to inconsistent messages to the consumer and a loss of strong brand identity.

15. To build and maintain brand quality, methods must be designed into the franchise system to maintain value in the brand and remove those few Franchisees who threaten to diminish the value of the brand.

16. For the Franchisor, success will be based not on his or her knowledge of the underlying retail business, or even the quality of the product or service, but on the ability of the Franchisor to learn the skills related to franchising, which is a profession in and of itself.

17. For the Franchisee, success will be based on the Franchisee's ability and willingness to work within a pre-existing system, helping to build the value inherent in the brand.

Legal Aspects – A Puzzle that Can be Solved

Executive Overview

- Franchising in North America represents a unique combination of business opportunities and legal challenges; those include the largest and most attractive market in the world, coupled with a, to put it graciously, unique legal system.

- Risks related to the American legal environment are faced by all Franchisors, including U. S.-based as well as foreign, and are effectively solved by each on a daily basis. If that was not the case, franchising would not be as successful in the U.S. as it is.

- Proven techniques have demonstrated that legal challenges can be reasonably minimized and should not act as an insurmountable barrier to entry into the North American market, any more than they have been for successful development of U. S.-based concepts.

- A regional subfranchising strategy, as commonly used, presents both risks and advantages as compared to direct franchising or other models.

- Careful planning from a legal standpoint, as well as use of proven legal techniques, should be successful in avoidance of legal problems.

Introduction

Mature and successful franchise systems based outside the United States generally come to a point where they seriously consider expansion into North America, whether as a result of saturation of the local market, natural desire to add additional units or through receipt of inquiries from the U. S. or Canada.

For many such franchise systems, a major concern is the U. S. legal environment, with its reputation for complex regulations, out-of-control juries, multi-million dollar verdicts and a penchant for solving problems in the courtroom rather than through discussion and compromise.

While these elements of the U. S. legal system (and, to a lesser extent, those of Canada) have been exaggerated in some areas, it’s not unfair to say that some of these factors do, in reality, exist, including in the franchise field and that the reality of those legal challenges must be guarded against.

What’s not as well known is that:

1. U. S.-based franchise systems have dealt with this legal system for over forty years and have successfully developed techniques for reducing legal risks to an entirely acceptable level, from a business standpoint, and

2. Those pre-developed techniques have equal application to the protection of franchise systems coming to North America from abroad and should be as successful in the hands of foreign systems as they have been for the vast majority of U. S.-based systems.

Business Opportunities and Legal Challenges – Solving the Puzzle

North America represents perhaps the most attractive market for franchise expansion in the world, particularly for companies with mature and successful systems developed abroad. Some of the reasons for this include the following:

- A combined Gross Domestic Product (U. S. and Canada) in excess of ten trillion US dollars, the largest in the world, and a total population above 300,000,000, with high levels of savings, disposable income, and readiness to embrace new concepts.

- Ready acceptance of, and familiarity with, the franchise form of distribution by prospective Franchisees, retail customers, suppliers, landlords, lenders and even government agencies.

- A franchise-friendly market, with consumers ready to accept new products and services for which there may be limited competition in the U.S. and with sophisticated legal systems and methods of doing business, and highly educated and literate employees and professional support networks.

- A stable and low-risk political/economic environment.

At the same time, expansion into North America presents a series of unique legal challenges and questions to be answered, among them the following;

- The US legal system, even more than that of Canada, is complex and more prone to litigation than it should be. While those complexities and litigation exposure can be dealt successfully dealt with (as thousands of US franchise systems, as well as "imported" systems, do every day), in part through support of experienced U. S. legal counsel, doing business in the US legal environment is both more complex and expensive than in most other countries.

- "Common sense" and good will don't always guarantee that the Franchisor will be insulated from potential legal exposure. Some franchise laws are inherently difficult to justify or understand (for example, providing a disclosure document to a prospective Franchisee 10 business days before the sale is appropriate, while missing the deadline by one day is illegal and exposes the Franchisor to returning all funds to the Franchisee, even without proof of any actual harm to the Franchisee.)

- A patchwork quilt of regulations exists due to the U. S. federal and state legal systems, whereby an activity entirely legal in one jurisdiction may be illegal in another.

So, the foreign-based franchise system is presented with a puzzle: How can the Franchisor access the richest market in the world, while avoiding legal entanglements?

And like most puzzles, there is an answer: Use the same proven professional support, techniques and systems that have served for years to effectively protect foreign and U. S. franchise systems, some details of which are laid out below.

<u>Systems and Techniques for Avoiding Legal Exposure</u>

<u>Step 1.</u> Experienced professional support.

Just as any journey is made easier with the support of a competent guide, the transition to North America will be greatly assisted by competent franchise counsel.

What that counsel can contribute goes beyond technical legal knowledge; it should include the real-life experience of working with a series of international franchise systems and having observed their successes and challenges – experience and lessons in best practices that can be passed on to new clients, shortening their learning curve and minimizing the possibility of potential problems.

Characteristics of U. S. legal counsel should include the following, at a minimum:

- Experience in bringing foreign-based concepts to the U. S. and Canada.

- In-house staff experience with one or more major international franchise systems, so as to have "seen it done right, from the inside."

- Detailed knowledge of not only federal and state franchise laws, but a personal working relationship with franchise regulators in each state and on the federal level.

- Multi-year experience in working with all levels of franchise systems, including subfranchising, allied with sensitivity to practical business concerns.

- Extensive reference list which can be verified by prospective clients.

- Wide-ranging affiliations in franchising for referrals to experienced franchising professionals.

- Membership on a senior level in state and national franchise organizations.

<u>Step 2.</u> Use of a North American subsidiary.

One technique used by many franchise systems entering the North American market is to organize a subsidiary, in the U. S., especially for the purpose of franchising in the U.S. This can have the benefit of limiting any liabilities incurred in North America to that operation, and thereby reduce the potential exposure of the foreign parent corporation, or its officers, directors and owners, to liabilities incurred in the U. S.

While there are a series of factors to be examined prior to taking this step, we generally suggest that foreign-based franchise systems give consideration to this precaution.

<u>Step 3.</u> Understanding the rules.

The federal and state/provincial rules relating to franchising, while generally more complex than those in other countries, are understood and effectively worked with by thousands of U. S. and Canadian-based Franchisors and their staffs on a daily basis.

What U. S./Canadian-based franchise systems can understand and work with can be equally well understood by incoming franchise executives. A commitment to being educated (see Training below) in the relevant rules, and referring complex questions to counsel, as well as to installing administrative systems designed to comply with the rules, should suffice.

<u>Step 4.</u> Training.

In franchising, as in most other business areas, details matter and a franchise system's understanding of those details, as they relate to American and Canadian franchise laws, goes a long to effectively reducing exposure.

Operational and administrative personnel, including particularly those involved in the franchise sales process, should have three levels of understanding of North American franchise laws and regulations:

- A basic knowledge of the rules as they relate to the areas in which specific personnel are involved: franchise registration and disclosure rules for franchise sales/development personnel, franchise relationship regulations and anti-trust laws for operations managers, etc.

- The ability to apply this knowledge on a case-by-case basis, often using forms and procedures developed by outside counsel.

- A sensitivity to when to pick up the phone and receive the benefit of outside counsel's advice and experience, in unusual situations or where the risks of an uninformed decision might be particularly severe.

Counsel should be able to educate the senior executives, administrative staff, regional personnel and others as to applicable rules and practices and to assist in the establishment of administrative systems and appropriate procedures, as discussed below.

Step 5. Administrative systems.

One insight which we've gained over the years is that nearly all instances of legal exposure can be successfully addressed through appropriate documentation and procedures. This is particularly true in the North American context, where a knowledge of the specific legal challenges that may arise, leads to a appropriate administrative systems and a paper trail designed to protect against potential liability, as it does for all sophisticated North American Franchisors.

For example, if one of the challenges offered by disappointed Franchisees may be a claim that the Franchisor made promises of specific levels of financial results prior to the award of the franchise, a disclaimer signed by the prospective Franchisee that no such promises were made or relied on, or use of formal earnings claims as allowed by law, have been found by courts to be effective in prevailing over such a claim.

Similarly, if (as is the case) Franchisors are generally required to provide a disclosure document at a specified point in time prior to making the franchise award, a procedure (including checklists and various supporting documents) whereby a paralegal reviews the documentation prior to clearance for the award should act to make sure that all timing requirements have been met.

Step 6. Disclosure document preparation.

Key to protecting the franchise system from legal exposure is knowledgeable preparation of the franchise disclosure document (the Uniform Franchise Offering Circular, or UFOC, which is due to undergo revision in the near future.)

To be effective, that document should not be prepared merely as a set of responses to a questionnaire, but should be tailored to bear in mind the specific business dynamics of the franchise concept in question and in anticipation of the areas of exposure that may exist.

For example, a franchise concept which can only be successful where the operating franchisee has good personal sales skills should prominently note that fact in the disclosure document (and the franchise agreement) and create an expectation that success is likely to be achieved only when those sales skills are appropriately applied in the franchise business.

Step 7. Franchise Agreement provisions.

Over the years, U. S.–based franchise systems and their counsel have found that specific provisions in their franchise agreements have been highly effective in reducing or eliminating potential liability. While not wanting to turn this into a legal treatise, some of those provisions would include:

- Waiver of jury trials.
- Mandatory mediation and arbitration.
- Limitations on damages.
- Requirements that the Franchisee deliver general releases at specific points in the relationship (transfer, award of an additional franchise, renewal, etc.)
- Clarity of language in areas such as territorial rights.
- Disclaimers of earnings projections, etc.

Step 8. Exit Strategies

Finally, it's probably fair to say that no wise businessperson enters into any new arrangement without a clearly developed exit strategy. This is no less true with franchise relationships, and a properly designed franchise system will include mechanisms for terminating the franchise relationship with minimal "drama" and potential for making the lawyers rich.

These mechanisms can include performance clauses, buy-back arrangements, requirements for transfer by the Franchisee, etc. and all such alternatives should be examined prior to completion of system design.

Alternative Structures and Strategies

By way of background, Franchisors planning on entering the North American market should be aware of the structures most commonly used.

There are four primary structures foreign-based systems may use for franchising in North America:

Direct Franchising

In this model, the foreign-based Franchisor (or, as we generally recommend, a company formed for the purpose) directly awards operating unit franchises in the U. S. and Canada so that, for example, a Franchisee in Atlanta has essentially the same relationship to the Franchisor as a Franchisee in Sydney.

This structure maximizes control by the Franchisor and minimizes certain risks, but can involve slower growth and will often require a higher level of financial commitment and allocation of management resources.

Area Development Franchising

Here, the structure is largely similar to the direct Franchising model, but with the variation that area franchises are awarded (for example, for all of Dallas), with the requirement that the Area Franchisee open a specified number of units over a defined period of time. Generally, the Area Franchisee pays an area fee, above and beyond the franchise fee for each individual unit, and receives territorial protection for the entire area, for at least the time he or she is required to meet their development obligations.

This approach can result in capital infusions to the Franchisor (in the form of area fees) and may attract more sophisticated and better financed Franchisees, as well as advancing the schedule for franchise unit roll-outs, but experience indicates that a substantial number of Area Developers fail to meet their development schedules, requiring that the Franchisor have an appropriate pre-designed exit strategy to deal with such situations.

Area Representative Franchising

In this approach, rights are awarded to an individual or company (the "representative") to offer unit franchises within a territory on behalf of the Franchisor, with the representative to receive a portion of the initial franchise fees paid by unit Franchisees, as a return on the representative's investment in paying for the regional rights. In many cases, the representative also provides after sales service and support to the unit Franchisees, receiving a percentage of royalties paid. However, the Franchise Agreement remains directly between the Franchisor and the unit Franchisee.

Advantages and disadvantages are similar to those involved in the Area Development model, coupled with significant loss of control with respect to the franchise sales process and quality of support given to unit Franchisees.

Regional Subfranchising

This is the model most often used in international franchising, although it is not always the one we recommend.

In this approach, the foreign-based Franchisor does not award any unit-level operating franchises but instead only awards regional subfranchises covering large areas (all of Southern California, for example, or a single state or group of states), for which it may be paid hundreds of thousands of dollars each The regional Subfranchisor, in turn, offers and awards unit franchises, and provides nearly all after-sales service and support to the unit-level operating franchises. Initial franchise fees and royalties are split between the Franchisor and the regional Subfranchisor, with the majority generally going to the Regional Subfranchisor, if it is providing the majority of the services.

This methodology offers the possibility of rapid expansion, along with substantial fees to the foreign-based Franchisor, but also poses special risks. Errors in complying with complex legal requirements may haunt the development of the system and even pose risks to the Franchisor. The universe of potential regional Subfranchisors, who can ethically, competently and effectively sell franchises and support the adequately is highly limited.

Planning, Market Research and Test Units

As noted above, solid planning and professional support will be vital to any expansion strategy. In particular, the foreign-based Franchisor must do the hard work of determining both the attractiveness of its concept in North America and the adaptations necessary to make retail units viable in a new environment.

Labor requirements, real estate matters, availability of supplies, government regulations, actual and potential competition and a host of other factors will enter into the changes necessary to adapt a concept and sophisticated Franchisees will want evidence that, as they say in Texas, "this dog will hunt" in a new environment.

One method of performing this adaptation, which we generally recommend, involves the setting up and operation of a model or test unit in the US. Frankly, nothing substitutes in the adaptation process for actual operation of a unit in the area in which one intends to franchise, or can be as powerful a sales tool when the time comes to award franchises. In addition, the adaptation which results from operation of one or more test units greatly minimizes the risks of delivering a flawed franchise concept to Franchisees, and effectively reduces the potential for related liability.

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Supporting Materials

Structuring the International Franchise Relationship

1. **General**

Prior to beginning any negotiations, the Franchisor should have a clear picture of the basic structure it will use in franchising operations in a foreign location. Alternative structures are discussed below (in Section 2), but a preliminary business evaluation must be made by the Franchisor of its history, traditional methods of doing business, resources and the prospective foreign environment before the alternative structures can be evaluated.

2. **Alternative Structures**

2.1. **Direct Franchising** (By the Franchisor or through a, generally, U.S.-based wholly-owned subsidiary.)

This structure involves a direct contractual relationship between the Franchisor (or a wholly-owned subsidiary) and one or more local Franchisees in the foreign country on a unit-by-unit basis without the involvement of any third party. In essence, the individual Franchisee in Dallas is dealt with under the same structure as used for the individual Franchisee in Paris.

This approach may be indicated when:

1. The number of units to be placed in the country is small.
2. The nature of the business does not require extensive support of, or co-ordination of activities between, units.
3. Training, supplies and other functions can be effectively rendered from the home country.
4. Distances and cultural differences between the countries are small and communication is relatively easy (U.S./Canada)

Advantages:

1. Direct relationship with the Franchisee facilitates operational control and regulation of advertising, marketing, etc.
2. Revenue received by the Franchisor (initial franchise fees, royalties, equipment sales, etc.) is maximized and is not shared with any third party.

Disadvantages:

1. It may be costly to train and service Franchisees in remote locations.
2. Greater difficulty in initial franchise sales (lack of a local representative, perceived lack of “commitment,” cultural barriers, etc.).
3. May require establishment of an office in the foreign country to sell and service franchises and this may generate adverse tax and other consequences.
4. Lack of familiarity with local customs, commercial practices, etc.
5. Franchisor assumes all risks if the franchising venture fails.

2.2 **<u>Direct Franchising</u>** (Using a Subsidiary or Branch Office Resident in the Foreign Country)

This approach is substantially identical to that outlined above except that the Franchisor organizes a subsidiary in the foreign country to sell and service franchises. That subsidiary will execute the franchise agreements with the local Franchisees and is technically their "franchisor." The choice between a branch office and a subsidiary is generally driven by tax, trademark, public relations and legal considerations.

Advantages:

1. Establishment of a local office (in whatever format) makes franchise sales and service and support easier.

2. Use of local personnel increases familiarity with the market, suppliers, sites, etc.

3. Allows establishment of a "pilot" or demonstration facility with spin-off benefits for franchise sales, training, market research and contribution to bottom line.

Disadvantages:

1. Additional up-front financial and human resource investment is necessary.

2. Establishment of a "pilot" or demonstration facility may divert management attention from franchising and into operational details.

3. Senior management of Franchisor is still unfamiliar with local customs, etc.

4. Establishing local branch or subsidiary may incur additional taxes.

5. Some countries may require local ownership or control of a subsidiary.

6. Direct franchising is generally not recommended unless the foreign Franchisor develops a successful prototype and appoints an appropriate level and quality of support staff within the U.S.

> in place within the US.

2.3. **Area Development Agreements**

This format is nearly identical to direct franchising, involving a direct contractual relationship between the Franchisor and the Franchisee/Area Developer and no third party being involved, with the added feature that the Area Developer is granted an "exclusive" territory (which may include a portion of a country, all of a country or a number of countries) for the placement of a number of retail units and with a required development schedule (X number of units must be opened in Y period of time.)

This approach may be indicated when:

1. A prospective Area Developer has adequate sophistication and resources to properly develop the area and would be unlikely to make the necessary investment without assurance of "exclusive" rights.

2. More rapid expansion is required than may be achieved by selling units one-by-one.

3. The Franchisor wishes to limit the number of Franchisees in a country or market area, while retaining direct control over the franchising process.

Advantages:

1. Increased marketability of the franchise to large investors.

2. Area Developer may be well funded and a businessperson of proven ability.

3. Reduced marketing, training, assistance in start-up, etc. costs since the franchise has to be "sold" only once and the Franchisee rapidly becomes knowledgeable in the business.

4. Reduced ongoing cost since the Franchisor will have to deal with only one Franchisee per "area."

5. A substantial development fee (generally 1/2 of the individual franchise fee for each unit covered by the Agreement) is paid on the signing of the Development Agreement and the balance of additional fees may be paid on the signing of the Franchise Agreements covering each unit.

6. Fees generated by the operating units are not split with any other party.

Disadvantages:

1. Failure of the Area Developer may be catastrophic for the Franchisor's reputation in the country, or a particular market (many eggs are placed in one basket.)

2. If the Area Developer succeeds in its development plans, it may grow to the point where it has significant negotiating leverage *vis a vis* the Franchisor, possibly even allowing a "breakaway" situation to develop.

3. Unit franchise fees are generally fixed at the time of signing the Development Agreement and cannot increase if the Area Developer meets the schedule.

4. Finding a suitable Area Developer is more difficult than finding individual Franchisees.

5. Individual unit managers will be employees, not Franchisees, and may lack the motivation present with ownership.

6. A substantial number of Area Developers fail to meet their development schedule.

2.4. Regional Subfranchising

In this approach the Franchisor (sometimes called the Master Franchisor) grants a Master Franchise, for a territory covering a country, group of countries or portion of a country, to a Subfranchisor (sometimes called the Region.) The Subfranchisor sells and services individual franchises for Local Franchisees throughout the Regional (subfranchised) territory, generally on an individual (but conceivably on an area development) basis. The Franchisor does not have any direct contractual relationship with the Local Franchisees and has no direct legal obligations to them. As a practical matter, the Subfranchisor ("Region") acts as the franchisor in the country, group of countries or portion of a country.

This approach may be indicated when:

1. The Franchisor already uses subfranchising in its home country.

2. The Franchisor lacks the resources (human and financial) to directly engage in the sale and servicing of franchises in the foreign country.

3. Rapid expansion into the foreign country is necessitated by competitive circumstances (a limited window of opportunity until competitive systems imitate the business model.)

4. Significant cultural differences, great distances or other factors make it difficult to do business without a local management team.

[<u>Note:</u> Surveys indicate that over 50% of U.S. Franchisors franchising outside the U.S. and Canada utilize the subfranchising method of internationalization, probably primarily for reason no. 2 above.]

<u>Advantages</u>:

1. Initial Regional Franchise Fee paid by the Subfranchisor may be a significant sum.

2. Subfranchising may be one of the few ways that a Franchisor with limited capital can enter a foreign market, since investment of capital and human resources is minimized.

3. Subfranchising can offer at least the potential of rapid expansion in a foreign market.

4. Direct financial exposure of the Franchisor to potential losses is minimized.

5. The foreign Subfranchisor is intimately familiar with local customs, business methods, suppliers, sites, etc.

6. The foreign Subfranchisor has made a substantial investment and is less likely to "walk away" from its commitment to success of the franchising venture.

<u>Disadvantages</u>:

1. Fees (initial franchise fees, royalties, etc.) generated by the operating units are shared with the Regional Subfranchisor, who will generally retain between 70% and 85% of this income.

2. The Franchisor has largely given up control of the franchise system in the foreign country. Selection of Franchisees, sites and even operating methods may be largely outside the control of the Franchisor. While legal steps can be taken to enforce system standards, they are <u>extremely</u> expensive and time-consuming.

3. If the Subfranchisor is ineffective, failing to sell franchises and/or properly service them, expansion into the foreign market may be crippled.

4. It is generally difficult to terminate the Franchisor—Subfranchisor relationship.

5. Finding a competent Subfranchisor may be difficult, especially since skills in both franchise sales and operations/support are necessary.

6. Failure of the Subfranchisor may require the Franchisor to take over the system in the foreign country. Significant difficulties may arise where the Subfranchisor controls leases, non-competition agreements may be unenforceable, etc.

2.5. **Area Representative Agreements**

This approach involves the appointment of a representative to sell and service franchises in a foreign country for a limited period if time. The Local Franchisee has a contract directly with the Franchisor, but most of the services normally provided by the Franchisor (site selection assistance, initial and on-going training, managing local advertising co-ops, handling relations with suppliers, etc.) are provided by the Area Representative. The Area Representative is paid a sales commission with respect to the initial franchisee fee paid by unit Franchisees, and a portion of the ongoing royalty stream (up to 50%) so long as it provides such services. The Area Representative may or may not pay anything to the Franchisor for the relationship.

This approach may be indicated when:

1. A Franchisor wishes to obtain the services of a local associate to sell and service franchises but does not wish to give up as much control as in subfranchising.

2. The Franchisor has, in some cases, decided to forego any upfront payment for area rights in exchange for retaining a greater percentage of ongoing royalties, etc.

Advantages:

1. Access to a local management team for franchise sales and service.

2. Less loss of control since there is a direct contract between the Franchisor and the Local Franchisee.

3. The Franchisor retains a greater percentage of royalty income generated by the Local Franchisee.

Disadvantages:

1. The Area Representative, having not made a possibly more limited up-front investment in any area rights, and only being entitled to a lower percentage of royalty income for services, may not be as committed as the Subfranchisor, may provide fewer quality services and may more easily “walk away.”

2. Area representative arrangements are relatively uncommon in international franchising. Lack of familiarity with the structure in foreign countries may make it less likely to find a willing and competent participant, especially if no “ownership” with respect to a territory has been granted.

2.6. **Joint Ventures**

In this scenario, the Franchisor enters into a Joint Venture Agreement with a foreign individual or company to establish a joint venture company (generally a corporation.) The joint venture company is then licensed by the Franchisor to do one or more of the following: open company-owned units, engage in direct franchising or act as a subfranchisor. The Franchisor retains equity in the joint venture company.

This approach may be indicated when:

1. Local legal restrictions make it impractical to do business in any other way.

2. The Franchisor wishes to retain equity, but limit its exposure and investment.

<u>Advantages</u>:

1. Involvement with a local company familiar with the market, etc.

2. Local partner has made a significant investment.

3. Sharing of risks.

4. Access to local government grants, subsidies, etc.

5. Possible favorable tax treatment.

6. Possibly greater control by the Franchisor over the franchise system in the foreign country.

<u>Disadvantages</u>:

1. Sharing of profits.

2. Issues of control, potential buy-outs, etc. must be resolved.

3. Possible deadlocks.

4. The Franchisor may be required to make a significant capital investment.

5. In the event of a dispute, the Franchisor, as a foreign national, will always be at a disadvantage in local courts.

6. Possible difficulties in repatriation of profits to the Franchisor if unanimous consent is not obtained.

2.7 **<u>Test Period Agreements</u>**

Before leaving the topic of Alternative Structures, we should be made aware of the uses of Test Period Agreements.

In typical subfranchising situations, the prospective Subfranchisor may be reluctant to commit to the payment of a significant Regional Franchise Fee or a specific Development Schedule until he has some assurance that the proposed franchise is commercially viable in the target market. In addition, the Franchisor may have some questions regarding the suitability of the prospective Subfranchisor. Test Period Agreements allow the parties to enter into a limited relationship without the necessity of a major financial or legal commitment.

A Test Period Agreement would generally provide for the following, along with other terms:

(a) Permission to open one franchised unit in a specified area.

(b) Payment of a unit Franchise Fee.

(c) Execution of a Unit Franchise Agreement.

(d) Provisions for training, assistance, possible modification of operations to suit local market, etc.

(e) Discussion of mechanism for conversion to a Master Franchise Agreement covering the entire country.

(f) Undertaking by the Franchisor not to open other units or franchise in the country for a period of time (this may require payment of a separate fee.)

(g) Discussion of what happens if no Master Franchise Agreement is executed (continued status as franchised unit, mandatory or optional repurchase, de-branding, etc.)

AVOIDING FRANCHISE LAWSUITS IN THE U. S.

The Basic Problem:

Franchisees who are not successful will blame the Franchisor (and any available salespersons) for their failure. Given the chance to get their money back by filing a lawsuit, they'll do so in a heartbeat.

If the Franchisee doesn't succeed, at least up to the level of his own expectations, it's very difficult for him to blame himself. Even though the Franchisor delivers the same system to all of its Franchisees and most of them may do very well, the unsuccessful Franchisee will almost always blame the Franchisor, ignoring the reality that the most likely reason for his lack of success relates to his own abilities, motivation and degree of effort and that other Franchisees, who received the same system, support, etc., are successful. Psychologically, it's very difficult for many people to accept responsibility for their own lack of achievement and very easy to find someone else to blame. The Franchisor and any salesperson is the most likely target of this blame.

The Solution:

Structure your relationships and documents so that you:

(1) Give your Franchisees more than you promised them in terms of support, assistance, etc. Wake up every morning prepared to answer the question "What have you done for me lately?";

(2) Don't promise anything that you're not absolutely sure you can deliver;

(3) Sell your Franchises based on realistic presentations and not on the basis that buying a franchise automatically assures success;

(4) Treat your Franchisees like adults, involving them in decisions that affect their future (The Golden Rule probably applies here.); and

(5) Make sure that you're as thoroughly protected as possible from any claims against you.

(6) Most importantly from a legal standpoint, have state-of-the-art documents that have been successfully tested in Federal and state courts.

Note that this involves an interesting balance of attitudes and behavior toward Franchisees: On the one hand, you're as supportive as possible, seeing the Franchisee, in a very real sense, as your business partner, without whose success you will not be successful. On the other hand, the Franchisee may be suing you at some point in the future, through no fault of yours, and you need to have erected every possible legal barrier against such a suit.

Now let's discuss some of the possible lines of attack an unhappy Franchisee might take against you as a Franchisor and the best means of defending yourself against those attacks.

The Potential Lines of Attack:

1. ***This Deal Wasn't Registered With the State.***

Examples: Your "regular" deal was registered but the special deal you and the Franchisee developed was never registered.

Your registration lapsed for a few days during which you offered or sold the franchise.

2. ***Your UFOC Wasn't Up-to-Date and Had Material Misstatements and/or Omissions.***

Examples: That bankruptcy, litigation or settlement you left out of the UFOC because you thought it wasn't "material."

Adverse financial or other developments.

You had a major corporate deal pending (ceasing franchising, merging with another chain, etc.) and you never discussed it in the UFOC.

3. ***You Didn't Comply With the 10 Business Day Rule.***

4. ***You Didn't Comply With the 5 Business Day Rule.***

5. ***You Made Earnings Claims.***

6. ***You Never Told Me I Had to Work so Hard and Other Business Misunderstandings.***

7. ***Let's Have a Jury of My Peers Decide How Much You Owe Me <u>and</u> My Attorney.***

The Appropriate Defensive Strategies:

1. ***Registration.***

Particularly in California, don't do deals different from your franchise as registered with the state without registration or complying with the requirements on negotiated sales. Otherwise, you may have liability to the Franchisee you did the deal with <u>and</u> all those afterwards who will claim they never knew about the "special" deal.

Also, think carefully before you allow changes to your agreements. If the change makes sense, why not do it for all your Franchisees? On the other hand, if you're being asked to make a special concession just to close this sale, you're selling from weakness and will have a difficult time explaining to your other Franchisees why they didn't get the same deal. Are you really willing to stand up at the next convention and explain why Mr. Jones got a better deal than Ms. Smith?

<u>Always check with franchise counsel before undertaking **any** marketing, sales or other activities in or to any particular state so that counsel may advise you of current regulations and new interpretations.</u> Also, note that exemptions from business opportunity or similar laws in various states depend on satisfying exemption conditions.

2. *UFOC Up-dating Requirements.*

Almost by definition, if you don't want to put a particular development in your UFOC because of its negative effect on franchise sales, it's material and should be in there as something a reasonable Franchisee would want to know about before they invest in the business. When in doubt as to the materiality of a change in your business, contact your franchise counsel.

3. *You Didn't Comply With the 10 Business Day Rule.*

Understand how the rule works, track your calendar and have written proof (the "Statement of Prospective Franchisee" is excellent for this) that you followed the requirements.

4. *You Didn't Comply With the 5 Business Day Rule.*

See above.

5. *You Made Earnings Claims.*

First of all, don't make them, unless you use a formal Item 19 Earnings Claim Document. There's no way any of us can predict how much a new Franchisee will make and "back-of-the-napkin" claims generate lawsuits and lead to the idea that success is somehow assured. In fact, the business reality is that you probably can't give any assurances as to how a new company-owned unit will do, and you <u>certainly</u> can't project how a franchised unit will perform. So … don't allow yourself to be put in the position of predicting results you can't control!

Second, make sure that you have proof that no such claims were made or relied on. Again, the "Statement of Prospective Franchisee" is excellent for this.

Third, beware of the ways in which inadvertent earnings claims can be generated, including preparation of loan documents for the Franchisee, working out business plans, "running the numbers" on the Franchisee's laptop, working with his/her accountant, etc. You may have earnings claims-type liability even for numbers you present to the Franchisee after the sale.

Fourth, consider using a formal Item 19 Earnings Claim Document. That's probably the best way of defeating a claim that "the salesman told me I'd make $200,000 net my first year!"

6. ***You Never Told Me I Had to Work So Hard and Other Business Misunderstandings.***

Let's be realistic: Generally in life, people are successful in business to the degree that they work hard, are intelligent and behave with maturity toward their customers and employees. A good location and a valid business concept are also vital and even then there's no assurance of success.

There's nothing wrong with telling prospective Franchisees those simple facts of life. If we sell them on the basis that if they just buy the franchise and open the doors they'll be successful, we'll lose credibility and generate lawsuits.

Use a Pre-Acceptance Interview form to verify that no significant business misunderstandings exist before the sale is concluded (e.g. no financing contingencies, no misunderstandings regarding support or advertising, etc.)

Use a Site Selection Acknowledgment for site-specific franchises. This document has the Franchisee confirm that the location has been chosen by him/her and is the Franchisee's sole responsibility, not that of the Franchisor.

7. ***Let's Have a Jury of My Peers Decide How Much You Owe Me and My Attorney.***

As a Franchisor, the last thing you want to do is end up in front of a jury of retired postal clerks and housewives. The result will not be a happy one! To avoid this, make sure your franchise documents are state-of-the-art, have clauses which been successfully tested in Federal and State courts and provide, at a minimum, as follows:

- Mandatory mediation and binding arbitration clause.
- Waiver of jury trial.
- Waiver of punitive damages.
- All disputes to be resolved at the Franchisor's headquarters
- No attorney's fees clauses.
- Clause regarding no claims against Franchisor without opportunity to cure alleged problems.
- Shortened (6 mo./1 year) statute of limitations.

- Merger and integration clause.

- Choice of laws - important to maximize enforcement of non-competes in some jurisdictions.

- Non-retention of funds by Franchisee in a dispute.

- Repeated defaults by Franchisee result in termination even if cured.

- Performance standards.

- The “Friendly Divorce” Clause/Exit Strategy.

- Releases of all claims by the Franchisee.

Also, be sure that the "Statement of Prospective Franchisee" is appropriately completed before any sale is finalized. Be sure that the dates inserted match legal requirements. In addition, all fill-ins, including dates, initials and "NONE". should be done by the prospective Franchisee in his/her own handwriting.

Have a solid paper trail in your files. This can demonstrate such things as the Franchisee’s satisfaction level with initial training, his/her non-attendance at on-going training, customer complaints, operational non-compliance, audits turning up financial and other violations, your efforts to help him/her resolve problems, your compliance with disclosure requirements, etc.