

Franchises, Business Insurance, and Risk Management

Starting or advising a franchise comes with hidden pitfalls, and choosing the right business insurance can be just as complex. This course walks through the key legal and financial risks tied to franchise agreements and helps you understand how to evaluate business insurance coverage. Whether you work with small business clients directly or provide tax and financial planning support, you'll come away better equipped to spot red flags and guide clients toward smarter protection strategies.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the government agency that has nationwide regulatory powers over franchises.
- Recall the characteristics of various types of insurance coverage.

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Chapter 1: FRANCHISES: HOW NOT TO GET BURNED

Chapter Objective

After completing this chapter, you should be able to:

- Identify the government agency that has nationwide regulatory powers over franchises.

America's landscape is dotted with franchises: Take the first exit off any freeway, and you're likely to spot familiar ones offering fast food, gasoline, groceries, lodgings, and more. So, you might conclude, they must be making money, or they'd pack up and disappear. And why shouldn't you buy into an established chain to get a jump on the learning curve and tap into an existing customer base?

Not so fast. For most people hoping to own a small business, buying a franchise is a poor idea. Most of the franchises you see on the road—or on Main Street or at the mall—are just barely eking out a profit beyond the percentage they must pay to the franchise vendor (the “franchisor”). Worse yet, some of their owners would like to sell, but can't. Because of the legal and economic rules exerted by the franchisor, you might end up feeling more like an indentured servant than an entrepreneur. In our view, you'll be happier and farther ahead financially if you start a business from scratch or buy an existing one.

In this chapter, I'll explain how franchises work, and delve deeper into their pitfalls. Then I'll introduce you to the two most important legal documents that are involved in the purchase of a franchise: the Franchise Disclosure Document (FDD) and the franchise agreement.

Resource

For more information and insight into franchise ownership, visit The Association of Franchisees and Dealers (www.aafd.org). Also, the Federal Trade Commission (www.ftc.gov) has valuable information on franchising.

Think About It

Get professional advice before you plunge in. Don't wait until you find yourself trapped in a costly and frustrating relationship with a franchisor—at which time you might have little legal recourse. It's worth paying for some sound legal and financial advice before you get locked into a contract or pay the franchisor a cent.

WHAT IS A FRANCHISE?

The most convenient analysis and definition of a franchise come from the Federal Trade Commission (FTC)—the one government agency that has nationwide regulatory power in this field. The FTC recognizes two types of business relationships that qualify for regulation as franchises:

- **The package franchise.** The franchisor licenses you to do business under a business format it has established. The business is closely identified with the franchisor's trademark or trade name. Examples include car washes, fast food outlets, motels, transmission centers, tax preparation services, and quick copy shops.
- **The product franchise.** You distribute goods produced by the franchisor or under the franchisor's control or direction. The business or goods bear the franchisor's trademark or trade name. Examples include gasoline stations and car dealerships.

This chapter deals primarily with package franchises, which are more common.

The FTC definition is broad. It covers all of the businesses that you and I would ordinarily think of as franchises. Generally, the FTC (and many state agencies that regulate franchises) will classify your business relationship as a franchise if three conditions exist:

- You have the right to distribute goods or services that bear the franchisor's trademark, service mark, trade name, or logo.
- The franchisor significantly assists you in operating your business or significantly controls what you do. For example, your franchisor might assist in site selection, train you and your employees, or furnish you with a detailed instructional manual. A franchisor might exercise control by telling you where your business must be located and how your shop must be designed, or by dictating your hours, accounting and personnel practices, and advertising program.
- You pay a fee to the franchisor of more than \$500 for the first six months of operations. (In the real world, you're going to be paying a franchisor much more—probably anywhere from \$10,000 to \$1 million.)

All of this can add up to a complex and expensive relationship between you and the franchisor.

Example

Lila loves the idea of selling doughnuts and buys a franchise from Munchin Donuts International. She pays Munchin Donuts \$50,000 as a franchise fee plus an additional \$5,000 for training for herself and an assistant. Lila and her assistant must travel to the Munchin Donuts headquarters in another state for the training. Munchin Donuts helps her find a suitable location for a doughnut shop, then prescribes the store layout and décor. Lila makes the necessary improvements, but can't use her favorite contractor—she must use one on Munchin Donuts' approved list. She buys the doughnut-making equipment and shop furnishings directly from Munchin Donuts, as required by her franchise contract. Munchin Donuts provides Lila with a 500-page operating manual called *Making Donuts the Munchin Way*. Lila is also given the right to use the Munchin Donuts logo in her signage and advertising. Lila must buy all of the doughnut mixes directly from Munchin Donuts, and each month she must pay Munchin 8% of her gross sales, plus a hefty fee for participation in Munchin's co-op advertising program. She must keep the shop open from 7 a.m. to 9 p.m., six days a week, as required by the Munchin Donuts operating manual.

THE DOWNSIDES OF FRANCHISE OWNERSHIP

During your negotiations to buy a franchise, while everyone is still smiling, the franchisor is likely to assure you that you won't be in business all by yourself, but will be part of a team selling a recognized product or service. Franchisors typically also tout three other supposed benefits:

- **A proven plan for running the business.** The franchisor will furnish an operations manual that can serve as a road map to get you started.
- **Help from the franchisor if you run into problems.** The franchisor promises to make people available who are experienced in real estate, personnel policies, accounting, and day-to-day operations.
- **A national or regional marketing program to attract customers.** The franchisor promises to advertise in print and on radio and TV so that the brand will become famous and customers will flock to your door.

Even if the franchisor makes good on all of these commitments—and many won't—the price you'll pay to get these benefits might be backbreakingly high. Do you really need to pay a company month after month, year after year, in order to master the fundamentals of making pizza or cleaning houses? As for business help from the franchisor, can't you simply hire advisers on an as-needed basis to help you with real estate, marketing, or accounting issues? (As a matter of fact, you can probably learn the basic management skills you'll need by taking a course or two at a nearby

community college.) And will the franchisor really invest enough money to build the kind of brand recognition that translates into huge profits for you? It's highly unlikely.

It's true that some small business owners have signed on for a franchise and found prosperity and happiness, but many more have lost their shirts and feel bitter about their franchise experiences. So before you're seduced by the glitter of the franchisor's glib promises, take a hard look at the downsides of investing in a franchise.

Tip

It takes money to make money. Some franchises might have a high profit potential— but the better ones tend to be well beyond the reach of the small operator. National hotel and motel groups might offer fine franchise opportunities, because they provide a real service through their 800 phone numbers and reservation booking services. The same goes for auto rental franchises because they, too, offer something of value. And franchises with famous and respected brands such as McDonald's and Pizza Hut might be worth the high cost. But these blue-chip opportunities are expensive to buy into. If you're an ordinary entrepreneur with possibly \$50,000 or \$75,000 to invest, you'll probably be looking at lesser-known franchises for which the prospects are not nearly so bright.

Let's look at some reasons why franchises are usually a worse option than starting your own business or buying an existing one.

The Franchisor Gets a Huge Piece of the Pie

The franchisor will almost certainly insist on getting a thick slice of your financial action—often the lion's share. Franchisors have figured out many ways to make money on your business, including:

- **Franchise fees.** You must always pay up front for the right to be a franchisee. These buy-in fees can verge on the astronomical, especially for a successful, nationally established franchise.
- **Royalties.** Commonly, the franchisor gets a percentage of the income your franchise earns. Income usually means gross sales, not profits. If your franchise takes in \$200,000 from gross sales and your contract calls for a 10% royalty, the franchisor will be entitled to receive \$20,000 whether or not your business earns a profit. Other operating expenses can easily eat up the remaining \$180,000 of gross income, leaving nothing—or even less.
- **Markups on equipment, goods, and supplies.** The franchisor might add dollars to the cost of equipment, goods, and supplies that the franchisor furnishes. Many franchise agreements require you to buy certain items from the franchisor rather than from outside suppliers; others let you buy through outside sources if the items meet the franchisor's

specifications. If, for example, you're required to purchase cooking equipment from the franchisor, you might pay a bundle more than you'd pay a restaurant supply store.

- **Training fees.** Often you must pay the franchisor to train you and your employees—whether or not you need the training.
- **Co-op ad fees.** These fees cover advertising for the entire group of franchises or a regional group. For example, you might have to contribute to a fund for national advertising or for advertising for all the franchisees in your metropolitan area—whether or not any of your customers are likely to see the ads.
- **Interest on financing.** You might have to pay for deferring payment of a portion of the franchise fee, the cost of improving your business premises, or buying equipment.
- **Leases.** Your franchisor might charge you rent on real estate or equipment. Typically, the franchisor does not lease real estate or equipment to you at the franchisor's cost but adds on a profit factor. But because relatively few franchisors own the premises where their franchisees do business, real estate lease charges are relatively uncommon.

If it appears that we're painting a grim picture, we are. After you've made all the required payments to the franchisor, very little might be left for you.

Law From the Real World

Going It Alone

Parker, a real estate broker, wanted to open his own shop. He first considered going it alone, but then decided he might do better by purchasing a franchise from one of the national organizations. He contacted several and was amazed to find that he couldn't buy a one-office franchise directly from them. Instead he was told that in his region a "master" franchise had already been sold and that he would have to contact this company to purchase a subfranchise.

When he did, he learned that his region had been divided into hundreds of subregions or territories, each of which was for sale through a local real estate office. All training, quality control, and recruiting was done by the master franchise holder, not the national organization.

Eventually, Parker decided not to purchase any of the local franchises he was offered, concluding that the territories had been divided too narrowly. In the meantime, he has opened his own office and is doing fairly well. He might still affiliate with a franchise organization, but only if he can find one that sells good-sized territories at a reasonable price.

The Franchisor Can Tell You What to Do

If you're like many entrepreneurs, part of the attraction of owning a business is that you're free to make your own business decisions, test new ideas, and change and improve the products and

services you offer. Unfortunately, when you're a franchisee, you give up a great deal of that freedom. The franchisor typically prescribes a formula for running the business and, for the most part, you're locked into using it. Don't be surprised if you soon become frustrated and bored.

But the consequences of signing on as a franchisee can go much farther than just stifled creativity. There's a real chance that your bottom line will be affected. Small businesses normally enjoy a huge advantage over multistate giants: They're nimble enough to respond quickly to local conditions.

By contrast, large organizations can't react nearly as fast, meaning that opportunities for adding profits— or avoiding losses—can be missed. For example, if you own a pizza franchise and notice that everyone in town is going crazy for fresh shiitake mushrooms, you could wait years before your franchisor lets you put any mushroom atop your pizza that isn't straight from a can. You're just a cog in a huge machine.

The Franchise Contract Will Favor the Franchisor

When you buy a franchise, you'll need to sign a contract with the franchisor. Contracts aren't bad in and of themselves—they're useful tools for spelling out all the terms and conditions of the relationship. However, the contract that you'll be handed will have been drafted by a team of skilled lawyers hired by the franchisor and will most likely contain dozens of clauses aimed at giving the franchisor every conceivable advantage. And you'll probably be told to "take it or leave it," with no opportunity to negotiate any of the contract terms.

To give you an idea of how one-sided these contracts can be, here are some clauses you're likely to find in the typical franchise contract:

- **Competition.** The franchisor will usually protect its freedom to grant additional franchises without restriction. This means that if your operation is successful, the franchisor might decide to sell a franchise to someone else right down the street, cutting into your market share. By contrast, you'll be required to agree that after the franchise relationship ends, you won't compete with the franchisor—either directly or indirectly. This stops you from working or investing in a similar business. Although it's reasonable for the franchisor to want to protect its trademarks and trade secrets, the franchisor already has plenty of legal protection in this area. The franchisor has no solid justification for interfering with your ability to earn a living doing similar work after you've stopped being a franchisee—but it has superior bargaining power. It can usually force even unreasonable restrictions on you as part of the price of buying the franchise.
- **Selling your franchise.** When you own your own business, you're free to sell it to whomever you wish. Not so with a franchise. Typically, you can't sell your franchise unless the franchisor approves of the buyer. This means that if you want to retire or move to another state or shift to a different line of work, you're at the mercy of the franchisor. If the franchisor is picky, you might be left with few—if any—prospective buyers, and you