Offering Franchises
A Primer

By Stuart M. Bordman

Fast Facts:

To offer franchises in Michigan, one must comply with the Federal Trade Commission Rule (FTC Rule) and the Michigan Franchise Investment Law.

Franchisors must comply with the FTC Rule in all states.

Registration states have statutes with which franchisor counsel must be familiar.

At the beginning of the day, you check your calendar and see that your secretary has scheduled a meeting with a long-time client. You have no idea why the client wishes to see you and, accordingly, you cannot prepare for the meeting. The client appears and informs you that he has a great idea for a new franchise. He wants you to prepare a franchise agreement and any other documents that are necessary to offer franchises throughout the U.S. He also wants to know how long it will be before he can offer franchises. While you are an experienced business attorney and have drafted and reviewed many types of agreements, you have never drafted a franchise agreement, and you have had very little exposure to the Michigan Franchise Investment Law (MFIL).[1] This article will outline the steps you must take between the initial meeting with the client and the delivery of a disclosure document to the client.

There is more to being a franchise attorney than knowledge of the MFIL. One must be familiar with the MFIL, the Revised Federal Trade Commission Rule (FTC Rule),[2] the FTC Compliance Guide,[3] the FTC FAQs (frequently asked questions),[4] the North American Securities Administrators Association (NASAA) Registration and Disclosure Guidelines,[5] contract law, antitrust law, bankruptcy law, and the franchise statutes and rules of all the "registration" and "notice" states. These terms will be defined later.

The Franchise Team

In addition to a franchise attorney, the franchisor must retain an intellectual property attorney and a certified public accountant (CPA). The franchise attorney will organize the entity that will serve as the franchisor, draft the franchise agreement and disclosure document, and provide advice and consultation throughout the offering process.

The intellectual property attorney will check the availability of and will register the franchisor's trademark or service mark (collectively, the "marks") with the United States Patent and Trademark Office. Early in the process, the franchisor should be certain that its proposed name and marks are available and their use will not infringe on those of any other party. It would be unfortunate to invest time and money only to learn that another company is using the same or similar marks.

The franchisor must be certain that the CPA will prepare the audited financial statements that are part of the disclosure document. Because of liability issues, not all CPAs issue audited financial statements.

Formation of an Entity

The franchisor and the CPA must decide whether to form a corporation or a limited liability company. To make preparation of the audited financial statements as easy as possible, a new entity that sells only franchises is ordinarily organized. The assets of such an entity are generally cash, computer equipment, and accounts receivable from franchisees.

Notice and Registration States

Michigan and a number of other states are referred to as "notice" states. In Michigan, a notice and payment of $250 must be forwarded to the Department of Attorney General before a franchise can be offered. The notice is a one-page document stating that the franchisor will offer franchises in Michigan. In some states, once the notice is filed it is effective forever. Other states, like Michigan, require annual filing.

Several states ("registration" states) require the disclosure document to be reviewed and approved by a state agency on an annual basis *before* a franchise can be offered to prospective franchisees in that state. Michigan does not review the disclosure document.

The first time a franchisor's disclosure document is submitted for pre-offering review, the examiner will likely come back with numerous changes that must be made before the disclosure document is accepted and the franchisor can offer in a particular state. As the examiner becomes more familiar with the franchisor's disclosure document, there will likely be fewer or no changes. An examiner is not precluded from raising issues that were not raised in prior reviews. This fact makes it difficult to use the same disclosure document and franchise agreement in all states. Addendums to the disclosure document and franchise agreement are used to address state-specific issues. Each registration state sets its own fee for review of the disclosure document.

Franchise Agreement

The franchise agreement is a contract between the franchisor and franchisee that sets forth the rights and obligations of each party. A sample table of contents to a franchise agreement is shown on the following page. The complexity of the business will control the franchise agreement. For example, a hotel franchise with its reservation system, promotions that partner with airlines and auto rental companies, rewards programs, and heavy capital investment will be more complex than a hair salon franchise.

The franchise agreement is unique in a number of respects. State laws prohibit certain provisions in a franchise agreement or deem certain provisions unenforceable. (See, for example, Section 27 of the MFIL.[6]) State law may prohibit arbitration outside of the state in which the franchised business is located. One state prohibits supplier rebates to franchisors on the basis of purchases of franchisees. The attorney must know the law of the state in which the franchised business is located, and modify the franchise agreement accordingly.

Early in the process, the franchisor should be certain that its proposed name and marks are available and their use will not infringe on those of any other party. It would be unfortunate to invest time and money only to learn that another company is using the same or similar marks.

FRANCHISE AGREEMENT
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The franchisor has the power to unilaterally make extensive changes to the franchisee's business operations and the franchise system during the term of the agreement. The franchisor will deliver manuals to the franchisee, such as operations, construction, and marketing manuals.[7] The franchisor can make changes to the manuals, and the franchisee must operate its business in accordance with the manuals. The changes may require the franchisee to spend thousands of dollars and make significant changes to its business. The franchisee has no voice in making such changes.[8] For example, in a restaurant setting, the franchisor will retain the power to add, delete, and modify menu items; require the franchisee to change the décor and trade dress of the restaurant; require the franchisee to purchase new furniture, fixtures, kitchen equipment, computer equipment, etc.; and require the franchisee to contribute to an advertising fund and change hours of business operation. Without the power to make changes, the

franchise system would not be able to change with consumer preferences, technology, or business practices.

One source of potential friction between a franchisor and its franchisees is the extent to which the franchisor has the power to make system-wide changes through its manuals. There is ongoing litigation between International Dairy Queen and its franchisees. The franchisor is attempting to force the franchisees to convert their stores to DQ Grill and Chill or DQ/Orange Julius concepts. The franchisees have filed suit in the U.S. District Court for the Western District of Michigan, requesting the court to enjoin Dairy Queen from such action. The franchisees allege the cost of converting to the franchisor-mandated concepts would be between $275,000 and $450,000.

The Disclosure Document

After the franchise agreement is drafted, the attorney must prepare a disclosure document that meets the requirements of the FTC Rule.[9] The franchisor must comply with the FTC Rule in notice states, registration states, and states that have no applicable statute. In the registration states, the franchisor must also comply with the NASAA Registration and Disclosure Guidelines.

A table of contents for the disclosure document is shown on the right. The franchisor must follow the format and disclose all information requested.

The FTC Rule requires the disclosure document, together with the franchise agreement and any other agreements that the prospective franchisee is required to sign, to be delivered at least 14 calendar days before the franchisee signs any binding agreement or delivers any consideration to the franchisor.[10] Such "other agreements" include, for example, leases with the franchisor or agreements to purchase equipment either from the franchisor or an affiliate of the franchisor.

Many of the items in the disclosure document will be relatively easy to complete because a new franchise system has little history. For example, "the franchisor, and any parents, predecessors, and affiliates" can be summarized in one or two paragraphs for a small and relatively new system. The same topic can take several pages in the disclosure document of a hotel system that has gone through a number of very complicated acquisitions and reorganizations.

DISCLOSURE DOCUMENT TABLE OF CONTENTS

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Exhibits:

A: State Addenda to Disclosure Document
B: State Administrators
C: Agent for Service of Process
D: Financial Statements
E: Franchise Agreement
F: Multiple Unit Agreement
G: Standard Lease Rider
H: List of Franchisees
I: List of Former Franchisees
J: Receipt

One source of potential friction between a franchisor and its franchisees is the extent to which the franchisor has the power to make system-wide changes through its manuals.

The FTC Rule encourages items such as "other fees" and "estimated initial investment" to be set forth in tabular form. References in the disclosure document to particular sections in the franchise agreement are required to assist the prospective franchisee in reviewing the disclosure document.

The franchisor has the option of disclosing a table of contents for its manuals or, in the alternative, allowing the prospective franchisee to review the manuals before the franchise agreement is signed.

Under "financial performance representations," a franchisor is not obligated to make a financial performance representation, but if it does so, a prescribed format must be followed.

"Outlets and franchise information" is sometimes referred to as the "turnover schedule." The goal is to inform the prospective franchisee of the number of outlets that, within the last three years, have opened for business, transferred to new owners, or terminated or ceased operations. A healthy system will have few units that ceased operations. A system in turmoil will have a significant turnover and a large number of units that ceased operations. Contact information is included in the disclosure document so a prospective franchisee can call former franchisees and learn about the franchise system.

Once the disclosure documents and audited financial statements, franchise agreement, and related documents are attached and the manuals are ready, the franchisor is ready to offer franchises.[11]

As its name implies, the disclosure document's goals are to inform a prospective franchisee of (1) his or her rights and obligations under the franchise agreement and related documents, (2) the franchisor's history and the business experience of its principals, (3) the amount of capital the franchisee will need to start the business, and (4) information regarding the franchise system as a whole. The franchise agreement, audited financial statements, and any other agreements the prospective franchisee must sign are attached as exhibits to the disclosure document. Notwithstanding the efforts of the FTC, the registration states, and franchisor counsel, few prospective franchisees review the disclosure document or retain counsel to do so. While a prospective franchisee will mortgage his or her home to pay a franchise fee and start a business and guaranty obligations under the franchise agreement and a lease, few will spend $2,000 to $3,000 to have an experienced franchise attorney review the disclosure document and franchise agreement.

Conclusion

This article sets forth some very basic information regarding the steps necessary to offer a franchise. Knowledge of a variety of statutes and areas of the law is necessary to draft the franchise agreement and disclosure document. The ability to visualize and address all the potential issues that could arise between the franchisor and its franchisees in the course of a long-term relationship during which there will be changes in consumer preferences, marketing techniques, and technology is an attribute that must be possessed by a franchise attorney. ■

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FOOTNOTES

1. MCL 445.1501 *et seq.*
2. Federal Trade Commission, Franchise and Business Opportunities Rule, available at <http://www.ftc.gov/bcp/franchise/netfran.shtm> (accessed August 7, 2008). All websites cited in this article were accessed August 7, 2008.
3. Federal Trade Commission, Compliance Guide, available at <http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf>.
4. Federal Trade Commission, Franchise and Business Opportunity FAQ's <http://www.ftc.gov/bcp/franchise/faq1.shtm>.
5. North American Securities Franchise Administrators Association, Registration and Disclosure Guidelines <http://www.nasaa.org/industry___regulatory_resources/uniform_forms/3697.cfm>.
6. MCL 445.1527.
7. The manuals are generally drafted by the franchisor.
8. Some franchisors will work with a franchisee's council or association regarding extensive changes, but the franchisor has final decision-making power.
9. The disclosure document was previously called the "Offering Circular" or "UFOC" (Uniform Franchise Offering Circular).
10. The rule for delivery is different in certain of the registration states.
11. Approval to offer must be obtained from the state if the prospective franchisee is in a registration state.

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