

The 10 COMMANDMENTS of Franchise Sales

Everyone in the franchisor's organization must understand the legal "do's" and "don'ts" of franchise development.

By Brian Schnell



Every successful franchise system has built its foundation with several key components. One of the essential building blocks is a franchise development program that effectively finds and then convinces high-quality franchisees to join the system

in a manner that meets the company's growth objectives without violating the franchise sales laws.

Very few successful franchisors blame the franchise laws for any failure to meet their franchise sales goals. Understanding what you can and can't say from a legal perspective simply is one part of the franchise sales process. The franchisor and franchise development professionals who know the legal aspects of franchise sales are much better positioned to get the job done with remarkable results.

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Those franchisors or development personnel who don't understand or disregard the franchise laws are headed for tough times. Even if they meet their development goals, their foundation is cracked and likely will crumble at some point with potentially devastating consequences.

This article briefly addresses several of the important legal issues that commonly arise in the franchise sales process. We refer to them as the 10 Commandments of Franchise Sales. If you under-

stand them, embrace them and live by them, you will improve your chances for building a successful franchise system.

1. Thou shalt deliver an offering circular at the earliest of the first personal meeting or 10 business days prior to signing an agreement or receiving consideration.

The Federal Trade Commission Rule defines a personal meeting as one between a franchisor and a prospective franchisee which is held for the purpose of discussing the possible sale of a franchise. The purpose of the meeting can be determined by considering the following factors: who initiates the meeting; are fees and initial investment expenses discussed; is any earnings claim made to the prospect. Telephone, mail or e-mail communications do not qualify as a personal meeting.

Franchisors often wonder if they need to disclose people they meet at a trade show. No one hands out an offering circular to each person who stops at their booth for the typical introductory conversation. However, if you arrange for a follow-up meeting over a cup of coffee or a more in-depth presentation in a separate meeting room, then you should treat this as a personal meeting and deliver an offering circular. Also, a franchisor's tradeshow booth or promotional hand-outs must not include any type of earnings claim, as the FTC Rule defines that as a triggering event for disclosure.

Notably, the proposed revisions to the FTC Rule would eliminate the first personal meeting requirement and simply require delivery of an offering circular at least 14 days before signing an agreement or receiving consideration.

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2. Thou shalt not offer or sell a franchise in a registration state without being registered.

Many franchisors want to jump the gun on responding to inquiries by sending out promotional materials or an offering circular to any prospect regardless of whether the franchisor is registered in the state where the prospect resides or wants to locate the franchised business. A franchisor must work with its franchise counsel to understand which of the 14 registration states may be off-limits because the franchisor has not registered with the state. The franchisor also must know if an isolated sale exemption is available because certain states will allow an isolated offer or sale prior to registration with the state. Further, because state laws are triggered with an offer, not just the sale, the franchisor's Web site should include disclaimer language that explains that communications on the Web site are not directed to residents of any states where the franchisor is not registered.

3. Thou shalt not make any statements contrary to information disclosed in the offering circular.

This commandment sounds simple. Yet it is the easiest one to violate if a franchisor does not insist that its personnel know and understand the information disclosed in the offering circular. In order to accomplish this objective, the franchisor must coordinate regular meetings of its personnel to discuss the offering circular and its contents, to discuss how to respond to prospects' frequently asked questions, and to insist that individuals talk only about what they are qualified to discuss—you don't want your marketing representative discussing product distribution/supplier issues during a Discovery Day.

4. Thou shalt not make any earnings claim that is not contained in the offering circular.

Illegal earnings claims probably are alleged in franchisee lawsuits more than any other allegation. In order to avoid these allegations, the franchisor and all of its personnel and agents must understand that an earnings claim is defined as any information given to a prospect from which a specific level or range of actual

or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained. In effect, if you don't make an Item 19 earnings claim, you can't provide any financial information to a prospect. Those franchisors who do not make an earnings claim generally encourage prospects to talk to existing franchisees. If this is the franchisor's practice, then it is absolutely critical that the franchisor's personnel understand they can't assist or review a prospect's pro forma and they can't refer prospects to any company publication that contains an earnings claim.

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Most industry statistics indicate that approximately 30 percent of franchisors include an Item 19 earnings claim in their offering circular. Although no franchisor should make an earnings claim believing that it will eliminate legal liability, each franchisor should carefully consider, with assistance from legal counsel, whether an earnings claim would assist them in the franchise sales process.

In many instances an earnings claim provides credibility with prospects, it responds to one of the most important questions a prospect will ask during the sales process and it can assist the prospect with its pro forma and financing due diligence. Also, each franchisor should understand that its earnings claim can be customized to fit their business. Some claims include average sales only; others will be based on sales and certain key expenses. Some claims will be based on franchised units; others will include company and franchised units. The key is that there is no single format, provided the franchisor discloses all factual bases, material assumptions and otherwise complies with the Item 19 requirements.

5. Thou shalt not seek to limit or restrict the current or former franchisees with whom a prospect consults.

This commandment has become more complicated in recent years due to the rigorous franchisee validation process

that many franchisors use. We simply used to say that a franchisor should not direct a prospect to its top performing franchisees as a way to avoid making an earnings claim and lead the prospect to believe that the top performers were representative of the franchise system overall.

Recently, more franchisors are scheduling validation conference calls where prospects can talk to existing franchisees about the franchisor, the franchise system and the franchise opportunity. The purposes for this process can be legitimate, but franchisors must exercise care in the mechanics and should discuss the relevant pressure points with its franchise counsel. For example, a franchisor should not arm prospects with a list of questions to ask during the call and then provide the existing franchisees with the responses to the questions. Further, the franchisor should not participate in or facilitate any earnings claim discussions during the call.

6. Thou shalt use smart communications during the sales process.

We spend considerable time with franchisors on the importance of understanding and utilizing smart communications. A poorly-written letter or a failure to communicate clearly or effectively is at the core of many franchise disputes. Smart writing does not come naturally. Franchisors, therefore, are encouraged to emphasize and train their personnel on smart communication techniques.

A principle that at times is easier to state than implement is that every individual should communicate what they mean and mean what they communicate. The clarity of writings is critical, whether it is formal correspondence or notes from an internal meeting or phone calls. All writings will be analyzed carefully in any lawsuit. For example, if the franchise operations representative sends an e-mail that blames marketing for a franchisee's poor operating performance or sends an internal memo that the franchisee should never have been awarded a franchise, the statements seemingly may protect the operations representative, however, they can be damaging to the franchisor in any lawsuit. Also, individuals must under-

stand that not every communication needs to be in writing. Simply put, all franchisors should take a hard look on how they address smart communication issues in their organization.

7. Thou shalt not make any representation that the franchisor's site survey constitutes any assurance of success.

The franchisor's offering circular and franchise agreement should squarely address this issue with statements that any franchisor survey or franchisor's approval of a site or location does not suggest or guarantee success. This statement, however, potentially can be compromised out in the field when the franchisor representative is spending hours with the prospect looking at potential sites. A prospect surely is going to ask for the representative's input on how site A compares to site B or what types of locations generate the highest sales in the system. An experienced representative who understands the legal pressure points will respond with answers that focus on whether or not a site generally meets the franchisor's current criteria and underscore that, while location is important, the overall success of the business depends on the franchisee and the decisions they make in the operation of the business.

8. Thou shalt not make any representation that the franchisor will not allow the future development at a location that may have a negative impact on an existing franchisee.

This commandment focuses on impact/encroachment issues as franchisors build their brand and increase market share in a particular market. Every franchisee wants the franchisor to build the brand and add units, just not in their backyard. These issues are a higher priority with franchisors that license site-only locations with no or little protected area. Similar to the site survey commandment, a franchisor's offering circular and franchise agreement should address impact/encroachment related issues. Franchisor representatives will be asked direct questions on these points and they need to understand that their response may need to be that, "Yes, we can put a new location anywhere we want at any

time." A statement like "Well, I'm not aware of any instance where we've opened another unit within two miles of a location for a least two years" not only violates this Commandment 8, but also Commandments 3 and 6.

9. Thou shalt use some form of questionnaire to confirm no statements or representations were made during the sales process that contradicted the offering circular or franchise agreement.

Few franchisor practices in the franchise sales process evoke more passionate debate among franchise lawyers than a franchisor's use of a questionnaire or closing checklist. This is a document where the franchisor asks the prospect to answer key questions regarding the franchise sales process. The questions will focus on offering circular delivery, a prospect's review and understanding of the franchise documents, confirmation that no earnings claim was made by the franchisor (other than any in Item 19), and the like.

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Franchisee advocates argue that use of this questionnaire/checklist is the franchisor's attempt to whitewash any unlawful statements or practices. For example, their position is that even if a franchisor makes an unlawful earnings claim, the franchisor will refuse to award the prospect a franchise unless the prospect acknowledges that they did not receive any earnings claim information.

Advocating for use of the questionnaire, our position focuses on what it means to go through the franchise sales process and then have two parties voluntarily agree to enter into a long-term franchise agreement. The prospect and the franchisor are each investing considerable time, effort and money in the relationship. It is critical that a "meeting of the minds" exists at the time the agreement is signed. The terms and conditions of the relationship are reflected in the franchise agreement. From the franchisor's perspective, this meeting of

the minds is critical. If the franchisee is basing its decision on something outside the franchise agreement, then the franchisor has every right to know that fact at the time they sign the franchise agreement, not two years down the road. For example, if the franchise agreement explains that the license is for a site-only location with no protected area, but the franchisor's sales representative has made statements that suggested something else, it is critical for both the franchisor and franchisee to discuss and resolve that issue at the time they sign the franchise agreement, not when the franchisor decides to open a new unit in proximity to the franchisee's location.

The bottom line is that the use of this questionnaire or checklist is one of the most valuable best practices that every franchisor should adopt.

10. Thou shalt seek guidance and advice from franchisor's senior management and/or counsel if there is any doubt whether a particular act or course of action is legal.

Each franchisor establishes the culture for its entire organization. The stakes are high with franchise sales compliance issues, so franchisors should encourage their team to seek guidance and advice if any questions exist on whether a statement, an act or course of action is legal. Don't let anyone believe they are better off by hoping that an issue simply might go away. This approach rarely works.

Understand the "Do's and Don'ts"

Many people believe that the lawyer is a necessary evil in the franchise development process. Clearly, at times franchise counsel must step in and say "No" to a practice. However, the lawyer's primary role in development is to get the job done in a manner that helps the franchisor meet its sales goals and minimizes potential legal liability. In order to do so, everyone in the franchisor's organization must understand the legal "do's" and "don'ts" of franchise development.

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