Identifying and Managing Risk when Buying a Franchise

Risk exists but it can be managed

Franchising is a dynamic and sophisticated way of doing business. It presents a very real opportunity for growth and survival in the current challenging economic environment. Some see franchising as the ultimate business network and the best hope for independent business in a competitive environment. Others see it as simply taking an unnecessary risk!

Business format franchising can be a highly effective business model. There are many great success stories but sadly there are also tragedies at times. Far too many people, both franchisors and franchisees, rush into franchising without proper understanding and assessment of the risk of failure and disaster can strike.

Franchising does involve risk but so does all business. There are many variables that influence business risk, not the least being the economic environment, market conditions and competition. The real issue is whether the level of risk is acceptable and manageable. If franchising is carefully understood by both parties and the franchise system is properly developed and managed according to good quality franchise practice, then it can significantly reduce risk in business. It can be better than trying to survive alone. In fact, based on the synergy generated by many working together under good leadership, the quality of the support structure and the marketing thrust, it can potentially be very powerful and generate success for everyone.

There are several challenges to reducing the risk of franchise failure including determining whether one is suited to the risks and demands generally associated with operating a small business or to the controlling influence inherent in the franchise business model. Ultimately however, a prospective franchisee needs to discern the right franchise opportunity for them. All other factors being equal, good franchise systems that are profitability for both parties and are led by credible quality franchisors, should reduce the business and investment risk.

This article discusses just some of the risk factors and questions a prospective franchisee might consider when evaluating a franchise business opportunity. There are risks throughout the life of a franchise business but many of these can be significantly managed if one discerns at the outset, what they are getting into and with who.

Understand the nature of the business format franchise concept

Very few commercial contracts are called upon, as is a business format franchise contract, to accomplish so complex a task as to structure an entire ten to twenty year business relationship with all the future uncertainty that will prevail in the market over that period. The main purpose of the franchise contract is to state broad objectives or goals and set out a framework for decision-making in future.

It is highly desirable to educate one’s self about the nature and responsibilities of franchising before purchase. If your expectations do not match reality, then disappointment and conflict are more likely to arise. That can increase the risk of failure through lack of commitment or understanding. For example the franchisor may require performance expectations to be achieved or trade marks to be utilised in a certain way. Resistance can potentially lead to breach and termination.
The inexperienced franchisee gains the opportunity via the franchise contract, to use the franchise system and brand, usually only for a limited period and in a very controlled way. They enter the market relying on the experience of the franchisor and its support. If the system and brand are not controlled properly, then the integrity and quality of the system and the brand can be compromised. This can result in a detrimental effect to all who trade under it.

Furthermore, as the franchise develops as a marketing and distribution model, it needs to adjust to market and other conditions over the long term. The franchisor must have the right to adjust its system within the boundaries of what may be commercially and legally acceptable. This is significantly achieved by unilateral lawful changes to the franchise system as it evolves over time. That is reality and although it can lead to the risk of opportunism and exploitation on the part of the franchisor, it is best understood early and appropriate evaluation made.

Is the franchisor's reason for franchising credible?

A franchise model should be adopted for the right reasons. It is a marketing concept designed for business to effectively penetrate and compete in the market. It should not be used by a business simply to get out of financial difficulty. In the current economic conditions, prospective franchisees should be particularly alert to this dangerous possibility. Many undercapitalised businesses abound. Franchising is not the solution to that difficulty. Careful assessment and inquiry regarding the franchisor can reduce risk in this area.

The franchise model should not be used simply to enhance someone’s ego by rapidly expanding a brand and profile. It needs to expand for good reason. Is there opportunity for market growth with the particular goods and services involved or is the market saturated and possibly even in decline? It could be even worse if one is buying a new franchise opportunity when the existing franchise network itself has reached saturation point. A good understanding of exactly where the market is going is crucial and particularly if franchisee performance expectations are incorporated into the agreement.

Even more important is where the franchisor is going in that market and why. A good franchisor will ask a prospective franchisee for their business plan. That is highly desirable and it should be prepared. It is also reasonable to ask the franchisor for an outline of where they are going with the franchise system. If they don't know, then there is a risk that everyone may get lost and a whole network of franchises could collapse.

Is the business well established?

A soundly based business of value should exist around which the franchise system is later developed. The franchise model should not be used to enthusiastically take some great idea to market as a result of some cerebral exercise without first establishing a proven and credible business around that idea. That approach can put others at risk and is simply exploitation. If a solid, profitable and sustainable business is not first established, then franchising the business can generate fundamental problems. A person running their own business may take calculated risks themselves but they should not as a novice franchisor unduly put others at risk and mess up the life of the franchisee and their family by taking an unproven business to market. This is particularly pertinent when it is the franchisee’s capital (and possibly their home) at risk.
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**Is the franchise system credible?**

A credible and trustworthy franchise system should be proven. When expansion through franchising is being considered, a successful pilot test franchise should usually be established first. Undertaking the business of franchising is hugely distinct from running the business upon which it is based. Success in one direction does not necessarily mean success in the other. There are many additional factors to consider when engaged in the business of franchising such as providing training, proper support to franchisees and developing a culture of franchise system compliance. Many businesses make the transition well but some don’t. Inquiries of existing franchisees can often reveal how successful the franchisor has been.

The right structure for the franchise should be carefully considered and clearly demonstrate an acceptable profit potential for everyone. Many franchise operations run into difficulty simply because not enough prior thoughtful consideration has been given to the structure, the impact of growth and new cost centres that will arise as a result of franchising. There should be an adequate return to both franchisor and franchisee in the short and long term.

The characteristics of a quality franchise should be evident from the beginning. This includes comprehensively documented and up to date systems and procedures. A robust franchise agreement should exist. There is good reason for this including to protect the integrity of the brand and the system for the benefit of everyone. It should be tailored to the particular business but it should also be fair to both parties. It is a working relationship of mutual trust that is created and the agreement should fairly reflect the mutual interests of the parties. An experienced franchise lawyer can usually determine what is fair and what is not. The important intellectual property base of the system should be well protected and diligently enforced otherwise everyone is at risk. Sound communication and information gathering systems should also exist and actually function. An effective and enforced franchise system compliance regime should be operating. One rebellious non compliant franchisee is all it takes to tarnish the brand and create a liability problem.

Good dispute resolution policies and procedures should be evident so that relationships can endure. Conflict will inevitably come in such a close working relationship. It needs to be both anticipated and carefully managed through appropriate dispute resolution process so that the relationship can hopefully survive the conflict. The brand value can be delicate and easily damaged by the conduct of just one franchisee. When that happens, everyone is affected. Inquiries should be made into the level of disputation and conflict and talking to other franchisees can assist.

**Is the franchise sale process carefully managed?**

The process of selling franchises is a potentially dangerous liability risk area for both franchisor and franchisee. Franchisors are entrepreneurial and are usually very good at selling their own franchise opportunities. It is a warning of danger however, if they are enthusiastically over selling a franchise at the pre-contract stage. If they increase the franchisee’s expectations beyond reality, then the gap between the two is where the seeds for conflict, legal liability and later business failure are often sown.

One needs to be wary of misrepresentations. If franchisors or their representatives, talk and negotiate cautiously with realistic expectations and challenge a prospective franchisee to do their own independent homework as well as develop their own business plan, then that can be a very good early indicator of a prudent franchisor at work.

A representation can take many forms including oral or even silence in certain circumstances. It can be a fact, or an opinion like; “We sell the best product in NZ.” If
statements are wrong or misleading however, then they become misrepresentations and can infringe the Fair Trading Act. Section 9 states that “no person shall in trade engage in conduct that is misleading or deceptive or likely to mislead or deceive”. In the business context, if an opinion is expressed which is not honestly held or there is no reasonable basis for holding it, then it may be held to be misleading or deceptive.

Particular areas of misrepresentation sometimes encountered in the sale of franchises can relate to; profitability forecasts especially when an operating business does not exist to start with, site suitability, training and support expectations, assurances of ownership or protection of intellectual property. It only takes one successful claim against a franchisor by one franchisee in a network, to seriously damage or even destroy a franchisor. That then affects everyone in the network.

Franchise agreements often include very strong provisions intended to place all responsibility for selecting the franchise upon the franchisee and include a clause disclaiming any liability for representations or statements not included in the actual franchise agreement (called an “entire agreement” clause). Generally courts have not allowed misrepresentations of the nature of misleading and deceptive conduct under the Fair Trading Act, to be ousted by exclusion or disclaimer clauses in contracts. However, it needs to be appreciated that courts in NZ are now recognising that where a franchisee, or any purchaser of a business, has taken independent professional advice and had the opportunity to complete due diligence, they may be less likely to interfere with contractual terms that have been explained and accepted. Issues associated with the degree of reliance and the particular circumstances of each case will still heavily determine matters but franchisees need to be very aware that there is an increasing responsibility upon them to rely on their own judgement and not that of the franchisor.

The whole area of misrepresentation liability risk needs to be carefully managed and of course, franchisors need to avoid being involved in misrepresentations or misleading conduct. If a franchisor is observed to have good processes and policies in place for managing that liability risk, then that in turn assists the franchisee to manage its own risk of getting caught up in a very unfortunate and potentially destructive dispute. A prospective franchisee can help minimise their risk exposure by evaluating such sale processes carefully in conjunction with their own lawyer.

A franchisee should also identify what representations are being relied upon with regard to their decision making, communicate them to the franchisor and then seek verification and disclosure of supporting information. If the franchisor agrees, they could be incorporated into the documentation through special conditions or by a separate document recording agreed upon representations. In that case however, it is most important to record all representations and not just some.

Undertake thorough Due Diligence

A franchisee should as a matter of necessity, undertake in conjunction with professional advisors, their own thorough due diligence inquiry. It is a critical step and even more so now with the trend of courts mentioned above. It involves an investigation into many areas of the business opportunity including financial, tax, legal, IT, intellectual property, labour, and the market/commercial situation. Only some of these have been briefly touched on in this article.

Careful assessment of the financial viability of the business opportunity should be undertaken by an independent accountant experienced in franchising. The financial forecasts, if any, supplied by the franchisor need to be reviewed. Often there will only be a template provided with variables as there are no existing business financials to analyse. The prospective franchisee is to create the new business. In that case risk increases and all the
more reason to utilise an accountant with franchising experience who may have a better understanding of the dynamics behind the particular franchise. The assumptions upon which profitability predictions and forecasts rest also need to be identified and evaluated carefully as part of the assessment.

As an integral part of due diligence, a careful review of the franchisor’s pre-contract disclosure document should also assist to reduce risk. It is usually considered information supplied by the franchisor at the time documents are presented for review. (There is no specific law that requires this in NZ but members of FANZ are required to provide such documents.) It generally provides, amongst other things, a background and overview of the franchise opportunity as well as further detail of the franchise opportunity and financial detail of what will be involved in the franchise commitment. The document can also help both the franchisor and franchisee to manage their respective risks in the area of representations by carefully recording the representations and statements which are to be relied upon. However, it is still important that the disclosure document is completely consistent with everything that is stated in the franchise agreement as that is the fundamental overriding legal agreement of commitment.

**Is the Franchisor committed to the importance of the franchise relationship?**

It has been said many times that franchising is like a marriage. Building trust, transparency and integrity in the relationship are vital. Managing the risk associated with a franchise purchase involves being satisfied that the franchisor is seriously committed to an on going attitude of win/win for each party (the franchisee should commit to the value of this as well) and aspire to best franchise practice. If they don’t know what that means, then a franchisor should be prepared to get educated. There are many opportunities for such education including from FANZ. Franchisees need to be teachable but sometimes franchisors need to be as well.

The franchisor’s success and return on their investment should generally be entwined with that of the franchisee’s business and revenue expectation. There should be a demonstrated recognition of the importance of the shared economic interest that each party has in the relationship. A well established franchisee support structure will reflect this. Good franchising is not about a franchisor making money up front by simply carving up New Zealand and selling off territories.

**Seek experienced and wise advice**

If risks associated with the purchase of a franchise opportunity are to be managed, then it is imperative to do your home work thoroughly first. In the commercial world where many voices are to be heard, determining the credibility of the message and the messenger is vital. With a franchise opportunity, this includes assessing the credibility of the franchise system and the franchisor but also the credibility of advisors who seek to advise people in this area.

It is of enormous value for legal and financial advice to be immersed in a thorough understanding of both the commercial and legal realities and risks of franchising. The right questions need to be asked if the right answers are to be obtained. Advisors experienced within the franchise sector can assist to facilitate finding those answers and guide a franchisee toward business success with reduced risk.

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