

## **Examining the Risks and Benefits of Using Franchise Brokers**

By: Michael H. Seid, founder and managing director, Michael H. Seid & Associates - MSA

Used intelligently and with care, brokers can provide value. They can be a source for new franchise prospects, and while they add a significant cost to the sales effort, one can argue that they earn their compensation only when someone closes on a deal. Brokers also can bring franchisors franchise candidates that for some reason were not attracted to the franchisor's advertisements or other marketing efforts.

However, in these days of the Internet, with the abundance of lead generation sites and other techniques, not only can a well-structured and professional in-house franchisee sales force do as well for franchisors as brokers can, but it likely will do better at a lower cost and certainly at a significantly lower risk. Putting that debate off to another day, brokers can be a crutch for a weak inside salesperson who requires a presold candidate before he or she even can contemplate closing a sale. Equally, brokers can be a source of candidates to help a franchisor fill in a particular market.

### **Risks of Using a Broker**

There are certain risks associated with using a broker. The risk most often mentioned is the possibility that commissioned brokers will improperly share unit financial information with a prospective franchisee and make an illegal earnings claim. That risk, however, is not unique to third-party sales agents alone and can just as easily occur with in-house salespeople.

The rules governing the disclosure and registration of outside sales agents are reasonably clear and not new to franchising. The two main requirements are that:

- Brokers must be disclosed in Item 2 and, if necessary, Items 3 and 4 of the UFOC and,
- In certain states, brokers must be registered.

Many brokers and some of the franchisors that use them do not follow the rules. Part of the problem likely stems from the nomenclature used today in the industry. Few brokers refer to themselves as such any longer. They refer to themselves as coaches, advisers, sales consultants, lead generators, referral networks and the like. Indeed, a major brokerage firm's web site proclaims in capital letters to prospective franchisees that it is not a broker.

Neither the regulations nor the regulators share that position. In an informal staff advisory opinion in November 1999, the FTC said, "there was no question" that a major consultancy that had asked for an opinion qualified as a broker under the rule. According to the FTC's Guide to the FTC Franchise Rule "A 'franchise broker' is defined as any person who 'sells, offers for sale, or arranges for the sale' of a covered franchise (Part 436.2(j)), and includes not only independent sales agents, but also subfranchisors that grant subfranchises (44 FR 49963).'"

Based on my firm's discussions, some franchisors that use brokers often disclose only the brokerage firm and not the individual brokers. Others are unaware that relevant litigation and bankruptcies by brokers are subject to disclosure. Many franchisors are unaware of the requirement to include information about the brokers on their state cover pages and on the receipt to the UFOC, and several brokers are neither registered where appropriate nor have they registered a consent to service of process, where required.

The rationale for not abiding by the rule varies. Some franchisors believe that since the brokers do not hold face-to-face meetings and therefore are not required to provide prospects with a UFOC, they merely are providing leads and are not subject to

disclosure. Others feel that including a long list of brokers in their UFOCs, especially when they may periodically change during the year, is a burden, and so listing only the brokerage firm should be sufficient. Still others are concerned that the change in the cadre of brokers might be considered a material change and thus might necessitate the suspension of franchise sales for a period of time in some states.

## **Conflicts of Interest**

The reason that disclosure and, where necessary, broker registration is required is to protect both the franchisor and franchisees. Regulatory burden aside, the rules regarding disclosure of brokers and whether these lead generation firms are brokers and subject to disclosure and, where required, registration are no longer subjects of significant debate.

Using brokers raises other issues clearly less rooted in the law but possibly more important, since they are based on integrity, ethical practices and fairness. The problem is how some brokers practice their craft.

It is important to point out that not all brokers practice their craft the same way, which highlights the fact that obfuscation is not an essential element of franchise sales. Each of the major broker networks, while disclosing that it is paid by the franchisor, in one form or another represents that it provides no-cost, beneficial services to prospective franchisees. On some of the web sites, though, a prospective franchisee is led to believe that the broker is its coach, adviser or consultant. Indeed, some brokers describe prospective franchisee as their clients, even though they are paid and are agents for the franchisor. An assertion that the prospective franchisee is the client when the broker is a paid agent of the franchisor is totally unsupportable. The conflict of interest and the unfairness to a potential franchisee are apparent.

Brokers' sites include promises to inexperienced prospective franchisees that their recommendations are unbiased and that their role is to help the prospect find the

perfect franchise. Some claim that they are not trying to sell the prospect anything and that they have no reason to recommend any particular franchise or a more expensive franchise. They include claims of doing the necessary research on the franchisor that minimize the prospective franchisee's risks.

Add to that the fact that many brokers are not disclosed in the franchisor's UFOC, might not be registered where required, may have a conflict of interest and may pressure the prospect to make a rapid decision, and the risk to prospective franchisees is clear.

Nowhere on any of the brokers' web sites is the prospective franchisee informed that the broker represents a limited number of franchisors or even which franchisors the brokers represent. While some brokers claim to have evaluated hundreds of franchisors, they do not disclose who their clients are, although the impression given is that the list is extensive and that only the best franchisors are selected. The perception created is that the brokers are selecting from hundreds of leading opportunities, when in fact their selection may be limited to only a handful of lesser opportunities.

The conflict of interest does not end there. None of the web sites that my firm reviewed disclosed that the commission and fees paid by franchisors on the sale of a franchise may not be uniform. The truth is that fees often vary, and, contrary to written assurances, brokers do have an interest in which franchise is selected by a prospect. A franchisor may be the "best fit" simply because the franchisor pays a higher commission or has a track record of closing franchise sales more quickly. If the "perfect" franchise pays a low fee but another client pays a substantial fee, it would need an Olympic leap of faith to believe that the prospect will be introduced to the franchisor paying the lower fee or no fee. It is important to remember that most of the largest and most attractive franchisors do not even use brokers. The proposed change to the FTC rule eliminating the first personal meeting requirement will only exacerbate this concern.

## **Broker Claims**

On some sites, the prospective franchisee is taken back to a time when unsupported claims about franchising's success were widely touted. Several brokers quote statistics on their web sites that have long been discredited, such as "[A]fter 10 years, franchises have a 90 percent survival rate. Compare that to just an 18 percent survival rate for other forms of independent businesses."

Few franchisors today include these claims in their promotional literature. The reason is that the validity of the methodology used in reaching some of these statistics has long been under a cloud, and since there are no recent studies supporting those claims, they are misleading at best.

Brokers include claims on their web sites that they carefully select the franchisors to which they refer prospects, and some claim that those franchisors must meet the brokerages' exacting standards, including "return on investment, litigation, failures and other factors." However, these types of claims imply that these franchisors are the best of the best and that the prospective franchisee will have little financial risk. Indeed, one of the brokers promises to "minimize the risk." Some of the regulators and attorneys with whom my company has spoken felt that these claims, when taken together with information in the UFOC, might constitute an illegal earnings claim. For franchisors that use these brokers, this could be a problem.

Others felt that while an improper earnings claim was possible, it was more likely that the prospective franchisee had relied on an actionable promise made on behalf of the franchisor by its agent. This would be equally problematic to those franchisors.

Finally, of the major brokerage firms, one is a franchisor, while the others are not. However, there is a question concerning the impact on a franchisor should its broker be an inadvertent franchisor and in violation of the rule.

## **Recommendations**

What should a franchisor do when working with a broker? Here are some recommendations:

- Disclose the individual franchise brokers in Items 2, 3 and 4 of the UFOC, including all the required personal and historic information, as well as that required on the state cover page and receipt. The individual brokers can be listed in an addendum to the UFOC.
- Keep its legal counsel informed about changes in the broker network, as those changes, depending on their materiality, may require changes in the UFOC.
- Require the broker to notify it immediately of any changes to the broker's network or of any individual broker who would affect the franchisor or its disclosure requirement.
- Require that each franchise broker in the network complete a Uniform Salesperson Disclosure Form as required by state statutes and also complete a registration application, as well as a consent to service of process in the appropriate states. Further, the broker should provide copies of all the applications and approval documents to the franchisor.
- Require the brokerage firm to certify that it has conducted a thorough and independent due diligence on each broker in its network and has verified the information in the registration application. The brokerage network also should indemnify the franchisor if it is found that information that should have been disclosed in the franchisor's UFOC is not provided to the franchisor. Since brokers are agents for the franchisor, I strongly recommend that franchisors require both the brokerage firm and the individual franchise brokers to indemnify them for their activities.

- Require brokers to obtain errors and omissions and broad liability insurance coverage from the broker, listing the franchisor as an additional insured.
- Require a broker to notify it immediately if there is any pending or threatened litigation or regulatory action taken against any of the broker's other clients (current and former) or any broker in the network (current and former) as it relates to the sale and offering of franchises.
- Provide to the broker network any standards it has set for conducting the sale of franchises, require the brokerage to abide by those standards and certify in writing prior to closing on a franchise sale that it has done so.
- Require the broker to provide it with a list of its other clients and update that list on a regular basis.

Requiring brokers to follow the existing rules and also providing additional disclosures and assurances to both franchisors and prospective franchisees are small prices for preserving the reputation that franchising has fought so hard to earn and keep. Insisting that future franchisees be treated fairly and also that trust, truth, honesty and integrity be required of outside sales agents is the only sensible course.