

Franchise Brokers – Is integrity in the franchise sales process really that much of a burden?

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Brokers in franchising are nothing new and while I have never been a proponent for third party sales in franchising, there is nothing inherently wrong with outside sales agents.

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

In these days of the Internet though, with the abundance of lead generation sites and other techniques, a well-structured and professional in-house franchisee sales force can not only do as well for franchisors as brokers but likely 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 sales person who requires a pre-sold candidate before they could even contemplate closing a sale and equally they can be a source of candidates to help a franchisor fill in a particular market. Used intelligently and with care, brokers can provide value.

There are though certain risks associate with using a broker. The risk most often spoken about is the possibility that commissioned brokers will improperly share unit financial information with a prospective franchisee and make an illegal earnings claim. I am not so naive to believe that the back of the napkin disclosure does not still take place, but quite frankly that risk is not unique to third party sales agents alone and can just as easily occur with in-house salespeople.

There are rules that govern the disclosure and registration of outside sales agents and they are reasonably clear and certainly nothing new. 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

Unfortunately, many brokers and some of the franchisors that use them are not following the rules.

Part of the problem likely stems from the nomenclature used today in the industry. Few brokers refer to themselves as brokers any longer. They refer to themselves as coaches, advisors, sales consultants, lead generators, referral

networks and anything but brokers. Indeed, one of the major brokerage firms in capitalized letters on their web site proclaims to prospective franchisees that they are NOT BROKERS.

Unfortunately neither the regulations nor the regulators share that position. In an informal staff advisory opinion in November 1999, the FTC stated, "there was no question" that they qualify as a broker under the Rule when asked by one of the major brokerages for an opinion.

In our discussions we found that some franchisors that use brokers often only disclose the brokerage firm and not the individual brokers. Others were unaware that relevant litigation and bankruptcies by brokers was subject to disclosure. Many franchisors were unaware of the requirement to include information about the brokers on their state cover pages and on the receipt to the UFOC and several of the brokers are not 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 believe that since 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 felt that including a long list of brokers in their UFOC, especially when they may periodically change during the year is a burden and therefore listing only the brokerage firm should be sufficient. Others are concerned that the change in the cadre of brokers might be considered a material change and therefore might necessitate the suspension of franchise sales for a period of time in some states.

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 rooted in integrity, ethical practices and fairness. The problem is how some brokers practice their craft.

It is important to point out that not all of the brokers practice their craft in the same way, which only highlights that obfuscation is not an essential element of making money in franchise sales. For example, if you review the web site of the brokerage firm that asked the FTC for their opinion, you will find an absence of many of the significant issues that you find on other sites.

Each of the major broker networks, in one form or another represents that they are providing beneficial services to the prospective franchisee. On some of the web sites though the prospective franchisee is led to believe that the broker is their coach, advisor or consultant and that they are the broker's client. Indeed, some brokers describe the prospective franchisee as their client, even though they are paid agents of 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 clear.

The prospective franchisee, usually inexperienced in investing in a franchise are being told by the brokers:

- “We provide all our clients with the most comprehensive, objective, unbiased and meaningful advice available anywhere”
- “Our experienced franchise consultants will help you find the perfect franchise.”
- “We’re coaches, NOT BROKERS. We’re not trying to sell you anything”
 - Coaches help their clients ...
 - Coaches ask their clients...
 - Coaches focus their clients...
 - Coaches provide their clients...
- “We have no reason to suggest that you buy a more expensive franchise, or any franchise in particular!“
- “We’re here to help minimize the risk”
- “We’ve done the homework for you. “

(emphasis added)

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

Broker sites do disclose that they are paid by a franchisor. However, the overwhelming language of the site is usually geared to give the impression that the service to the prospective franchisee is beneficial, risk free, cost free and that they – the prospective franchisee – are the broker’s client and that the broker has an obligation to help them succeed. In fact, brokers are agents for their paying clients and not for the prospective franchisee.

Most prospective franchisees likely have only worked with one type of broker in their lives – a real estate broker. In those situations the majority of the houses in a market are listed. However, 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 broker represents. While some 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 only the best franchisors are selected. The perception that is being created is that the broker is selecting from hundreds of leading opportunities when in fact their selection may be limited to a handful of lesser opportunities.

The conflict of interest does not end there. On none of the web sites we reviewed is it disclosed that the commission and fees paid by franchisors upon the sale of a franchise may not be uniform. The truth is that fees often vary and

contrary to the written assurances brokers do have an interest in which franchise is selected by a prospect.

The franchisor that is the “best fit” may simply be the best fit because the franchisor pays a higher commission or has a track record of closing franchise sales quicker. Should the perfect franchise system not be a client of the broker it is unlikely that the prospective franchisee will learn about that franchisor from the broker – although the broker promised to find them the “perfect” franchise. If the perfect franchise pays a very low fee but another client pays a substantial fee, you would need to make 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 essential to remember that the prospective franchisee is at all times being led to believe that the broker is their coach or their advisor and that the broker is looking out for their best interests. It is also important to remember that since many of the brokers do not meet face to face with the prospect they are not required to provide the prospect with a disclosure document. I can't imagine that the rules ever contemplated outside salesperson, with all of these conflicts, having weeks and maybe longer to pressure the prospect to buy without the prospect having a copy of the UFOC. The proposed change to the rules that eliminate the first personal meeting requirement will only exacerbate this concern.

On some sites the prospective franchisee is taken back to a time when unsupportable claims about franchising's success were widely touted. Several of the brokers quote statistics on their web sites about success that The International Franchise Association long ago recommended that franchisors no longer use.

- “What's more, after 10 years, franchises have a 90 percent survival rate. Compare that to just an 18 percent survival rate for other forms of independent businesses”
- “If that were true, why have over 90 percent of franchises succeeded?”
- “A U.S. Department of Commerce study conducted from 1971 to 1987 showed that during that time less than 5% franchise businesses were closed each year.”
- “Compare that to a U.S. Small Business Administration study conducted from 1978 to 1988, which found that 62% of non franchised businesses closed within the first 6 years of their existence due to failure, bankruptcy, etc.”

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 at best could be misleading.

At the same time some of the brokers make claims about their franchisor selection criteria:

- We have carefully pre-screened hundreds of franchise companies.
- We only refer clients to franchises that meet the exacting standards we have set
- We examine the record of the franchisor relating to return on investment, litigation, failures and many other factors.

Most of the largest and most attractive franchisors do not use brokers. However, claims by the broker that franchisors were selected based upon their return on investment and failure rate implies that these are the best of the best and that the prospective franchisee will have little financial risk. Indeed on one of the web sites is a promise that they “minimize the risk”. Some of the regulators and attorneys we have spoken with felt that these claims when taken together with information in the UFOC might constitute an illegal earnings claim. For franchisors who use these brokers, that could be a problem.

Others felt that while an improper earnings claim was possible, more likely the prospective franchisee had relied upon an actionable promise made on behalf of the franchisor by their agent. This would equally be 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 their broker be an inadvertent franchisor and in violation of the Rule.

What should franchisors do when working with a broker? MSA recommends to our clients that they:

1. Disclose the individual franchise brokers in Item 2, 3 and 4 of the UFOC including all of the required personal and historic information as well as required on the state cover page and receipt. The individual brokers can be listed in an addendum to the UFOC.
2. That they keep their legal counsels informed about changes in the broker network, as those changes, depending on their materiality, may require changes in the UFOC.
3. Require the brokers to notify them immediately upon any changes to the broker’s network or individual brokers that would impact the franchisor or its disclosure requirement.
4. Require that each franchise broker in the network complete a Uniform Salesperson Disclosure Form as required by state statutes and also completes a registration application as well as a consent to service of process in the appropriate states. Further the broker should provide copies of all of the applications and approval documents to the franchisor.
5. Require the brokerage firm to certify that they have conducted a thorough and independent due diligence on each broker in their

network and verified the information in the registration application. The brokerage network should also 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.

6. Since brokers are agents for the franchisor we strongly recommend that franchisors require both the brokerage firm as well as the individual franchise brokers to indemnify them for their activities.
7. It is essential that franchisors obtain an Errors and Omissions and Broad Liability insurance coverage from the brokers on which the franchisor is listed as an additional insured.
8. Require the broker to notify them 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.
9. The franchisor should provide to the broker network any standards they have set for conducting the sale of franchises and require the brokerage to abide by those standards and certify in writing prior to closing on a franchise sale that they have done so.
10. Require the broker to provide to them a list of their other clients and update that list on a regular basis.

Requiring brokers to follow the rules, to provide additional assurances to franchisors and to eliminate objectionable language from their web sites and selling practices is only sensible. As an "industry" we have worked hard to create a reality of fairness when we offer franchises and it is one of the reasons that I am proud to be affiliated with the IFA. We cannot afford to allow the type of caveat emptor approach to franchise sales being employed by some brokers to be part of franchising. Integrity is never too high a burden.