

How do you spot a franchise scam?

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Back before California started the move to regulate the offering of franchises during the 1960s, and long before the Federal Trade Commission published its franchise rule at the end of the 1970's buying a franchise could be as risky as putting your 401K into Enron or Talk Magazine. Before disclosure, the franchise industry suffered from companies that had lots of hype, little substance and an absence of management talent. What they did have were great salespeople.

Some of the franchise offerings back in the 50's, 60's and 70's were for companies that had never opened a single unit before selling franchises. Some had management that had never been in the business being offered but did have experience in bankruptcies, litigation and problems with regulators. Some of the companies were so weak financially that they needed the proceeds from franchise sales to meet payroll or to pay for the franchise ads the prospects responded to. There were even stories of franchisors whose furniture was being repossessed in one room while the prospective franchisee was in the other. Just because the government regulates something though doesn't mean things are always better. While not common, there are still franchise offerings today that are such poor opportunities that they would have fit in nicely with the other bandits back then.

How is that possible? Part has to do with the ease of developing a franchise system, part is due to the lack of consistency in franchise regulations; and, part is due to how franchises are sold. But, the primary reason that franchise scams still exist today is due to the individuals who do not do their homework and invest in these "opportunities". They allow the bad opportunities to remain in business.

There's no single indicator of a franchise scam and you need to weight all of the indicators in making your assessment. Just remember, there are hundreds of superior franchise opportunities available today and there is absolutely no reason to settle for less than the best opportunity in your investment range. There is little you can do about the ease of development or the inconsistency of regulations but you can protect yourself by doing your homework.

The disclosure document is a wonderful tool for prospective franchisees to have. At your first personal meeting with a franchisor they are required to provide you with one. Some franchisors will even mail you a disclosure document and others post them on their web sites.

Even before you get to the point of contacting a franchisor you can get a sense of whether their opportunity is for real. Go on line and research news stories about the

company and the industry. If the company is public, look at the information available from their SEC filings. Visit their web site and get information about their consumer offering as well as their franchise offering. Learn what you can about their management and thoroughly research their background. Compare the company to its competition – both franchised and non-franchised. Locate some of their stores and speak to existing franchisees. Then, when you are satisfied, contact the company.

When you first contact the company ask them about the process they use in selecting franchisees. If you get the sense that they don't select franchisees but are in the business of selling franchises, that's the first indication you should have that the franchise is risky.

Remember, a franchise system is only as strong as its brand and that brand rests to a great extent on how well the other franchisees in the system perform. If the franchisor lets anyone who has money in the system and does not have selection criteria then in all likelihood your investment is going to be at risk.

If the company is willing to "sell" you a franchise and does not require you to visit with them at their company headquarters so that you can perform a thorough evaluation of them and they can perform a thorough evaluation of you, that's another indication of a poor franchise system. If on top of that the salesman you are talking with is not an employee but an outside sales broker that's even a stronger indication. Remember, unless you buy, the franchise the brokers doesn't earn any money. And, since he is not an employee of the franchise system, he doesn't risk much more than the chance to earn a future commission check if he introduces into the franchise system individuals destined for failure. Franchise brokers just move on to the next franchisor looking to sell franchises.

When you visit the franchisor's headquarters meet as many of the franchise support people as you can. Assess whether they have the experience to do their jobs. You need to be certain that they can and are required to provide you with the level of support that you are anticipating getting. Take a look at the condition of their offices. Do you get the feeling of success or impending doom? Do all of the company's resources seem to go into marble and brass or does it seem that the company is investing in computers, personnel, training programs and other components of support.

Once you get the disclosure document be prepared to analyze it thoroughly. If this is an opportunity that still interest you after you read the company's information you should engage a qualified franchise attorney, consultant or accountant to help you in conducting your due diligence. The franchise salesperson or broker works for the franchisor. No matter how friendly or professional they may be, they should not be a source of advice that you rely upon.

Some of the indicators of scams include the following:

- Does the company have experience in the business being offered?

We're not talking about a related business but the exact business. If the company has successfully been operating 4,000 square foot stores but the franchise opportunity is only for 1,000 square foot stores, it's not the same business no matter what they say. The same works in reverse – bigger is not always better. If you will be opening your franchises in Boston but the only experience the company has is in Texas its not necessarily the same either. Have they done the necessary research to determine if the concept will work in Boston or are you going to be their cold weather guinea pig?

- Does management have a history of success?

Now, success as franchisors is wonderful but what about in the industry in which you will be operating. Does management of the franchise system know how to operate your business successfully? If not, what type of support are you likely to get? How frequently have they changed jobs? How well are their former companies doing? If they seem to move just before the sheriff or process server arrives, that is not a great indicator. If they have been with other franchisors call franchisees of those systems and find out how well this management did in the past. A mix of executives with experience in the business and as sucesul franchisors is a great benefit to franchisees.

- What is the financial condition of the company?

Your investment is likely to be significant. In some franchises between debt and equity your investment may be more than seven figures. What about the franchisor, will you have more skin in the game then they do? Do they have a history of profitability? Are they earning their revenue from royalties and other continuing sources of revenue or are they relying on the sale of the next franchise to make payroll. Even new franchisors need to have financial resources to meet their commitments.

- Are you getting value for your money?

Sure if it's a well known established brand and the franchisees in the system are doing well, expect to pay a sizeable franchise fee. But, if it's a new franchise system and your training lasts only a few days are you paying more than it is worth. Paying \$25,000 or more for a franchise fee when you are only getting one week of training from a new franchisor with limited experience, simply because they have a great brochure and a spectacular franchise sale program doesn't seem to be value for your money. Ask the other franchisees in the system if they got value for their money. Remember though that franchisees new to the system may not even know yet.

- What's the franchisor's litigation or regulatory history?

Franchisors must disclose relevant litigation. Sometimes litigation is good. Any franchisor that enforces system standards will occasionally need to sue its franchisees. If they are able to still maintain a good relationship with their other franchisees than that type of litigation is an indication of a strong and responsible franchisor.

However, if there are pages upon pages of lawsuits from franchisees in the disclosure documents, that is not a good sign. You need to understand the basis for the lawsuits and make a decision based upon the facts. Your attorney can help you analyze the franchise litigation.

- Is the franchise offered only in the non-registration states?

There are only twelve states in the United States that review franchise documents and require franchisors to register their offering before getting permission to offer franchises in their state. In the rest of the United States no regulator ever sees the franchise offering. Sometime companies don't offer franchises in the registration states because those states do not fit into their geographic strategy. But, if a franchisor is offering franchises all over the United States, except for the registration states, that may be an indication that their franchise would not meet the requirements of the registration states. You need to be very careful when you come upon opportunities that go out of their way to avoid the registration states. Your attorney can give you a list of the franchise registration states or you can contact the International Franchise Association at (202) 628-8000 and their government relations department can provide you with a list.

One final point that I think is worth making. I have to admit some bias toward membership in the International Franchise Association since I am on the Association's Board of Directors; was chairman of the professional arm of the association, the Supplier Forum; and have been active in the organization for over fifteen years. Active membership in the IFA by a franchisor, while not a guarantee that the franchisor is a worthwhile investment, is a strong indicator of a responsible franchise system. Active members have available to them training programs, networking opportunities and meetings in which they can exchange best practices with other franchisors. I can't imagine investing in a franchise system that was not an active member of the IFA.

These are just a few of the questions you will need to assess in determining whether the franchise is a scam. Your outside advisors will be able to help you put aside your entrepreneurial burn to get into the game and assist you in conducting a proper due diligence on the opportunity. Don't get into a franchise unless you have the assistance of a qualified expert. The franchise salesman that has befriended has the advantage of having been through the selling process hundreds of times. This is likely to be your first experience.