

What Do We Do With Franchise Brokers

North American Securities Administrators Association

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The easy question

Who is a broker?

The easy answer

- Any person, other than the franchisor who sells, offers for sale, or arranges for the sale of a franchise – FTC Rule
- Anyone who acts on behalf of one or more franchisors to further a franchise sale and receive a commission or other consideration if a sale is ultimately consummated – FTC staff advisory opinion



The practical implications

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Existing franchisees

- Franchisors pay franchisees a “reward” for participating in the selling process
 - There is no guidance as to when a “reward” becomes an inducement to sell and therefore a fee
 - Does it matter if it is not a cash reward?
- If the franchisee is a broker
 - Do they necessarily need to be disclosed?
 - What about the financial information they share about their own businesses to prospects?
 - Do franchisee brokers now create Item XIX issue?

One broker's approach

Statement signed by prospective franchisee

“I have come to (firm) for assistance in researching a number of franchise opportunities, with the possibility of finding one that matches my needs, goals and expectations.”

“I understand that the (firm) consultant does not sell any franchise. The (firm) consultant receives a placement fee from the franchisor upon a successful placement of a (firm) client.”

We are not brokers

“I acknowledge that my meetings and conversations with the (firm) consultant are to explore my options only and are not for the purpose of discussing the purchase of any franchise. The (firm) consultant is not prepared to discuss the purchase of any particular franchise opportunity. Those discussions can only take place with the representatives of each franchise company.”

“I have read and understand this acknowledgement.”

During broker's sales pitch

- “Success statistics
 - Yr 1-
 - franchises 96.2% still operating vs. independents 62%
 - Yr5
 - franchises 95% vs. independents 24%
 - Yr 10
 - franchises 90% vs. independents 18%”

During broker's sales pitch

- “Gallup Poll : Pre-Tax Income of \$124,290
 - Only an average... do you consider yourself average?”
- “Too Good to Be True
 - Thousands to choose from”
- “Your success is our only business”
- **“WE’RE NOT BROKERS”**

Brokerage sales training

- During face to face meeting –
 - “Present recommendations one at a time (slowly)”
 - “Tell why & how it will meet their goals”
 - “Note: Never refer to these (Qualification Form) as “Applications” or “The Application”
 - Personal history, Financial Status, Work Experience, Activities, References, Location

Brokerage sales training

- Follow up on the phone
 - “Have your Client tell you how tour/discussion went”
 - “Do not tell your client that you may have already spoken with the Franchisor”

The real world

- How the relationship is positioned
 - “We are your advisors”
 - “We are your consultants”
 - “We do not sell you anything”
 - “WE ARE NOT BROKERS”
 - Purchase by prospect irrelevant since broker positioned as independent advisor
 - Prospect signs an acknowledgement that the broker is only their advisor and not a broker
 - Prospect told “Thousands of franchisors to choose from”

The real world

- How the relationship functions
 - Prospect does not know which franchisors are represented by any particular broker – limited number
 - There is no disclosure if commissions vary dramatically or if there are spiffs or closed loop programs or other schemes existing
 - Face to face meetings are occurring
 - Weeks and often months of telephone and electronic sales are occurring

The real world

- How the relationship functions
 - Use of additional third parties to reinforce recommendations
 - Personality profiles – if used for selection of franchisors - may not be accurate even if used appropriately
 - Prospect does not receive a UFOC from their “Consultant” during this entire process
 - Broker may not be disclosed in franchisor’s UFOC as required

The real world

- The practical results
 - Broker positions themselves as the prospect's advisor
 - Broker positions themselves as an expert on franchising
 - Broker provides third party endorsement of franchisor since they are advising their "Client"
 - Broker assures prospect of the safety of investment
 - Broker provides information on average income they can expect during initial sales presentation

The real world

- The practical results
 - The rule did not contemplate the current electronic or telephone sales techniques during the many months before disclosure
- The good news is that these are not universal practices for all brokers - but neither are they limited
- The good news is that most franchisors seem to be complying with rules – but there is debate on what the rules mean

Updating the UFOC

- Amendments may be necessary when there are Material Changes
- There is a substantial likelihood that the changes will have an influence on the decisions of existing and prospective franchisees

What may be a material change

- It's often a judgment call
 - Litigation
 - Change in officers and directors – i.e. – CEO and majority of the board
 - Change in financial condition
 - Changes to franchise system
 - Changes in number of franchisees
 - Changes in franchise fee
 - Changes to investment

What happens today when franchisors amend

- Revisions to UFOC
- May require re-disclosure to prospective franchisees
- Registration States
 - Suspension of franchise offering pending approval
- Non-Registration States
 - May offer franchises as soon as amended documents available

Current Requirements for Brokers

- Must be disclosed in Item 2 and 3 of the UFOC
- Item 4 - Bankruptcy included in proposed FTC Rule change
- Sales representative disclosure form filed in most of the registration states
- Updates to brokers personnel – may need to be disclosed – depending on materiality franchisors may be required to amend

Practical implications

- Franchisors are not uniformly disclosing their use of brokers in their UFOC
 - Some broker's claims that they are not brokers but really coaches and consultants to prospects since some also charge a nominal fee to prospect
 - Rules too burdensome as listing every broker in each network make UFOC potentially into a telephone book
 - Franchisor can't do a due diligence on each broker in each network they work with
 - Believe that brokers are not meeting with prospect and are merely a lead generator

Practical implications

- Franchisors are reluctant to amend UFOC due to:
 - Personnel changes in the brokers network
 - Litigation – including other franchise systems using the same broker
 - Changes in relationship with brokerage relationship during year
 - Cost of compliance
 - Legal and regulatory
 - Suspension of franchise sales while they comply
 - No guidance on materiality
 - Any of the other trigger issues

Practical implications

- Some brokers today providing complete disclosure material to franchisors for their UFOC
- General assessment is that current disclosure requirements concerning brokers are unreasonably burdensome to be practical
- Prospective franchisees are now at risk because relevant information is not universally provided since the rules do not fit reality of current marketplace

Practical implications

- The sales practices of some brokers (not all) need to be scrutinized – including their own pre-sale period
- The rule changes regarding first personal meeting and electronic disclosure may have unintended consequences
 - The effectively shortened disclosure period will create opportunities for bad practices
 - Potential registration issues due to broker's physical location
- Most franchisors in compliance but requirements for compliance still being actively debated

Proposed solution

- Broker's discontinue
 - Use of any safety, unit sales and other generalized claims targeted to prospects but not directly relevant or included in their client's disclosure documents
 - Use of potentially misleading titles i.e. coaches, advisors, consultants or lead generators
 - Referring to prospect as their client unless there is no fee paid by franchisor related to sale of franchise

Proposed solution

- Franchisors disclose only the broker network information in their UFOC
 - No requirement to amend due to broker issues
 - If amendment required – reasonable materiality standards identified
- Brokers prepare monthly disclosure
 - List of brokers
 - Litigation – including any required because of relationship with franchisor clients
 - Bankruptcy as proposed in FTC Rule change

Proposed solution

- Brokers include additional and relevant information in monthly disclosure – not currently required
 - List of franchisors available to prospect through broker
 - Existence of any variable broker fees or spiffs paid by franchisors for enhanced placement
 - Existence of any closed loop relationships or other enhancement schemes

Proposed solution

- Broker's file disclosure quarterly with regulators
- Broker provides monthly update to franchisor for their review
- Broker provide monthly update to prospective franchisees
- Prospects signs a receipt for broker's disclosure and broker keeps copy on file
- Prospect presents copy of dated receipt to franchisor at the time they are disclosed by franchisor – safe harbor

Proposed solution

- Franchisor relieved of obligation to amend due to broker related issues
- Responsibility placed at source of information – the brokerage firm
- Prospective franchisee better protected
 - Appropriate information uniformly available
 - Current information provided
 - Franchisors kept alert to potential broker issues that could impact their system

MSA's current client recommendations

- Provide the broker network any standards set by the franchisor for conducting sales of franchises and require the brokerage to abide by those standards
- Require notification upon any changes to the broker's network/brokers that could impact the franchisor or its disclosure requirement
- Require completion of Uniform Salesperson Disclosure Form, registration application, consent to service of process as and where required

MSA's current client recommendations

- Require certification that brokerage has conducted appropriate due diligence on brokers in their network
- Request indemnification for sales activities of the brokerage
- Request Errors and Omissions and Broad Liability insurance coverage listing the franchisor as an additional insured
- Require the broker to notify if there is any pending or threatened litigation or regulatory action taken against any of the broker's other clients that may impact the franchisor

MSA's current client recommendations

- Prior to closing on a franchise sale, a written statement that the broker has not violated any of the offering rules and that they have followed the policies of the franchisor as they relate to the offering of franchises
- Review brokerage's web site to ensure that it does not include any claims or statements that would impact franchisor
- Do not compensate existing franchisees for actively participating in selling process – passive participation does not create issue



Questions

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