

Franchise Brokers: Buyer Beware

By Peter R. Silverman

Franchisors face major challenges in finding the right sales personnel and being able to afford them, and in developing and funding the right marketing strategy. One tempting way to handle these challenges is to hire a sales broker to do it all.

My advice is to consider a sales broker but: Buyer beware.

Here's the big problem: The franchisor and broker have different incentives.

Brokers, for the most part, make money on commission. The broker's incentive is to sell fast; to sell any territory; and to sell to any prospect with enough money to get going. The franchisor's incentive is to select only those franchisees who are suitable for long-term, stable growth, and to grow at a pace that is sustainable in terms of servicing the franchisees and maintaining quality control.

So what's a franchisor to do?

STEP ONE

First of all, ask around in the industry for word-of-mouth referrals. The IFA and the ABA's Forum on Franchising are good starting points. However, recent requests for referrals on the Forum on Franchising's listserv have not turned up many suggestions, and the suggestions have generally been from lawyers who represent the broker the lawyer is recommending. Thus, be prepared to do some digging.

Once you've received solid referrals, do your homework. Plan to spend at least 8 hours of due diligence on each broker.

DUE DILIGENCE

Start by asking the broker, in writing, to provide the following information, in writing:

1) *A list of all its franchisor clients for the last 5 years, including those who are no longer with the broker.* Call some of the broker's current clients, and especially call the ones who have stopped using the broker's services.

2) *The resumes of its current sales representatives and a list of employees who have left in the last 3 years.* Look generally at the type of education and experience the sales representatives have. Ask which representative will represent you. Interview the person. Find out what happens if you're unhappy with the person or if the person leaves. How is your new representative selected and what role do you play in the selection process? Call some of the sales representatives who have left to determine if a systemic problem led to their leaving.

3) *A list of all of the broker's litigation, all litigation its franchisor clients have been in related to sales noncompliance, and any regulatory inquiry to, investigation of, or action taken against it.* Focus on issues that suggest systemic problems, like good faith or compliance, rather than the types of everyday commercial disputes that can arise in good faith relationships. Call the parties who have litigated against the broker in the "systemic" cases.

4) *A syllabus of and a sampling from its compliance training program.* Is it comprehensive? Is it boilerplate and in legalese, or is it written so that the sales representatives can understand it? Does it impress upon the representative the serious regulatory, litigation, and financial consequences that can result from noncompliance?

5) *Its liability policy for professional errors in selling.* Does the policy cover compliance errors in selling? Is it in an amount sufficient to provide coverage

for indemnity in a significant franchisee-franchisor suit based on sales noncompliance?

6) *The steps the broker takes to preserve the confidence of the franchisor's sales strategy and proprietary information.* Sales representatives should not share information among the broker's other franchisor clients, and representatives should be bound by confidentiality when they leave. Absent the franchisor's consent, brokers should be prohibited from discussing the franchisor with third parties other than prospects.

7) *A list of third parties used by the broker to generate leads or sales, and copies of all its contracts with those third parties.* Ask whether the broker considers the third parties to be sub-brokers and discloses them as such to its franchisor clients for the purpose of UFOC Items 2 and 3 disclosure. Check some of the UFOCs from the broker's franchisor clients to see how the franchisor clients handle broker disclosure in Items 2 and 3. Is the disclosure complete and consistent among the franchisors?

ECONOMIC ALIGNMENT

Once the franchisor finds a trustworthy broker, the next step is to see whether the broker is willing to structure its compensation so that the broker benefits by serving the franchisor's goals of long-term, stable growth with high-quality franchisees. This will likely mean a combination of commissions and fee for service.

This is not a cookie-cutter negotiation. The first key is that the franchisor should develop its sales strategy before starting to negotiate; it may be a good idea to hire a consultant to help devise the strategy. Prior to negotiations,

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sound out the broker on different fee structures available. Compare the fee structures among all the brokers who were recommended to you. Try running a best/most likely/worst-case analysis to see what the net revenue and cash flow results would be based on different fee structures. Then negotiations can be meaningfully aimed at aligning incentives.

Another economic issue to explore is whether the broker sells for a number of concepts. Explore with the broker how it generates leads and whether the leads are concept-specific or general. If they're general, which concept does the broker steer the prospective franchisee to? Is the broker willing to give concept exclusivity to the franchisor — that is, will the broker represent, for example, only one steakhouse concept?

A related issue to check is whether the broker has a financial interest in any of the concepts it represents. If so, how does the franchisor safeguard against the broker favoring its equity concepts over its non-equity concepts? Similarly, does the broker have bonuses, or like mechanisms, built into its

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contracts with certain franchisors that give the broker the incentive to favor that franchisor?

THE CONTRACT

Once the franchisor has done all this, then it's time to negotiate the contract. Here are a few items to consider.

- Be very clear who does what. This should include, among other things, advertising, UFOC disclosure, the application process, due diligence on prospects, initial discussions of territory, and whether the broker may or should be present at the initial visit with the franchisor.
- Negotiate for the right to terminate at will. If the economic interests are aligned properly and the broker has the confidence that it will perform well and ethically, the broker should be open to this.
- Retain the right to approve franchisees without any limitation such as "which approval shall not be unreasonably withheld." This is the franchisor's ultimate decision, and the franchisor should not leave itself vulnerable to challenge from the broker on any such decision.
- The broker should indemnify the franchisor for any errors in compliance caused by the broker, irrespective of negligence.
- Beware of the integration clause. If the broker wants one, the franchisor should carve out the written information the broker provided. Attach

it as an exhibit so everyone is clear about what is being relied on.

- Negotiate whether the broker is entitled to compensation if, instead of a prospect choosing to become a franchisee or area developer, the prospect chooses to become a master franchisor for a territory or a regional director or an investor. The franchisor's position should be that the broker earns compensation only on the sale of franchise agreements or area development agreements.

POST-CONTRACT

If a franchisor does use a broker, the franchisor's disclosure checklist to the franchisee should, as a general matter, make clear that the franchisee's "I did not rely on" checklist explicitly applies to the broker's (and sub-broker's) actions and representations as well as those of the franchisor.

Franchise counsel should circulate a questionnaire to the broker (and sub-brokers) every year in connection with updating the UFOC.

CONCLUSION

Yogi Berra is quoted as saying "You've got to be very careful if you don't know where you're going, because you might not get there." Don't let that happen with your franchise sales. Know where you're going, understand the options, and proceed with care.

