How to Read a Franchise Disclosure Document (FDD)

The purpose of this outline is to assist you in identifying red flags or warning signs associated with the FDD. There are 3 reasons why you need to read the FDD before purchasing a particular franchise:

1. To know what you are buying
2. Identify if the franchise is stable or in trouble
3. Identify the financial ability of the franchise you are purchasing

Here, we will list possible warning signs for each section. The sections are broken-up into the same order as the FDD for ease of comprehension.

The Summary Page

This identifies what the total investment is of the franchise and the services or products it sells.

- Check to see if the total sum of money paid to the franchisor is high for items you could buy for less on your own. A typical franchise fee is between $35,000 to $50,000.
- Red Flag: Look at the range of the estimated start-up expense, if it is a large range (more than $100,000 between the lowest and highest estimated start-up costs) this may be a red flag. Some franchisors will put a large range in to cover their possible liability within this section. Also, they may not know the actual range, but they should. If this is the case for the franchise you are investigating, ask the franchisor why the range is so high, there should be logical reasons for a significant range in start-up costs. For example, it may offer two different types of facilities; industrial versus retail or home based versus retail.

Item 1 – THE FRANCHISOR AND ANY PARENTS, PREDECESSORS, AND AFFILIATES

- Do the executives of the company operate the same type of business or location? This tells you if they are qualified to teach, train and advise you on the business.
- Look to understand who the franchisor is. You want to know who would be responsible if something goes wrong.
- Red Flag: Sometimes franchises are undercapitalized, meaning they don't have many assets. If you have a dispute with an undercapitalized franchise, you would be going up against a shell company with little or no ability of indemnification.
- Has there been a recent reorganization? If so, why?
- Have they suffered financial issues recently?
- It is fine to see many entities that are affiliates of the franchise, but be sure to check them. A good way to investigate the affiliates is to Google them, be sure to do a search that includes the affiliates' names and "rip off," this will give you an idea if there are a large number of complaints against them.
- How long have they been operating this business?
- Look to see how many different programs they are selling. Some start-ups may have more programs than they can handle successfully while retaining the quality of all of the programs.

- Look for industry-specific regulations. Make sure the laws of your state allow the franchisee to conduct the business activities the franchisor offers. This is especially important for healthcare franchises.

Item 2 – BUSINESS EXPEREINCE

- How long have the executives been with the franchise?
- Are there corporate locations, do the President and key members own locations?
- This section will tell you whether or not they have an active location to test products, services and new developments. It also shows you the commitment level of the affiliates, because if they own stores as well, then they clearly believe in the investment.

Item 3 - LITIGATION

- The litigation section is critical. How many lawsuits, if any, have they brought forward? This must be a minimal number.
- Look for any cases of fraud or other felonies.
- Is there a pattern to the types of lawsuits?
- This is an indicator of how the franchisor handles situations. Red Flag: If there is a lot of litigation that may imply the franchisor is not willing to resolve disputes amicably.

Item 4 - BANKRUPTCY

- The franchisor should not have any bankruptcies.

Item 5 – INITIAL FEES

- In the initial fees section, compare the fees to ensure they are reasonable.
- In the situation of an Area Developer, do they require all of the money upfront before a site is opened or do they allow each fee to be paid at the time the territory or location opens?
- The franchise fee is to cover the cost incurred by the franchisor to prepare a franchisee for training, support and opening for business.

Item 6 – OTHER FEES

- When checking the other fees assigned by the franchisor, you need to verify fees are also reasonable.
- Do the fees make sense economically? Are the fees so high that it would be difficult to be profitable?
- Look for unusual fees like liquidated damages for early termination.
- Some franchisors make their money by taking a lot from their franchisees, which makes it hard for the franchisees to make money. Other franchisors are there to have happy franchisees that are making a lot of money for themselves. You want to be part of the latter system.

Item 7 – YOUR ESTIMATED INITIAL INVESTMENT

- Look at this chart carefully and understand the various details.
- This section should include 3 months of operating expenses, as a minimum
- Do the numbers make sense?

- Be sure to include real estate related expenses; they can be a significant expense.
- Is the franchisor receiving rebates for directing you to certain vendors?
- Read the notes carefully. Look to see what exactly the fees represent.

Item 8 – RESTRICTIONS ON SOURCES OF PRODUCTS AND SERVICES

- Does the franchisor overcharge the franchisee for products they are required to purchase through them or the franchisor's approved vendors?

Item 9 – FRANCHISEE'S OBLIGATIONS

- This is a directory of where to find the franchisor's different obligations throughout the FDD.

Item 10 - FINANCING

- Details of whether the franchisor offers financing directly or with a third party

Item 11 – FRANCHISOR'S ASSISTANCE, ADVERTISING, COMPUTER SYSTEMS, AND TRAINING

- This is a very important part of the disclosure. These are the obligations the franchisor is agreeing to prior to opening their location.
- There is a training chart that shows the training program and type of training you will receive.
- Look for a robust training program. Are the items listed generic or well developed?
- It is good to see on-site support when your location opens, this will be invaluable to you.
- Next, review and understand the obligations and support after you open. More support is always better. Regularly scheduled meetings is ideal
- Check to ensure the computer costs coincide with what is stated in Item 7.

Item 12 - TERRITORY

- Are description and protection of your territory well defined?
- The territory should be defined and agreed upon BEFORE signing the franchise agreement.
- In most industries, you should expect a protected territory to avoid falling prey to oversaturation.
- Is the franchisor is using alternative channels of trade. This means they can sell the same product for a lower price in a grocery store, catalog, on the internet, etc. This can be challenging for a franchisee if you are sharing customer information with the franchisor. You don't want them selling the same product for less to the customers you earned.

Item 13 - TRADEMARKS

- See that they have a registered trademark.
- Who owns the trademark?
- Is there a license agreement for use of the mark and, if so, how will it be handled if the license agreement is terminated?
- Look at this carefully.
- You must have federal protections of the mark to ensure brand value. A good resource for information and checking the trademark is www.uspto.gov.

Item 14 – PATENTS, COPYRIGHTS, AND PROPRIETARY INFORMATION

- Are there patents? A patent only lasts for 17 years.
- Check to see how many years are left on the patent.

Item 15 – OBLIGATION TO PARTICIPATE IN THE ACTUAL OPERATION OF THE FRANCHISE BUSINESS

- This section is important if you would like to eventually run your franchise passively. The obligations as to the level of your participation are in this section.

Item 16 – RESTRICTIONS ON WHAT THE FRANCHISEE MAY SELL

- What restrictions do you have on advertising, soliciting and selling?
- Are there any restrictions on what you can sell?

Item 17 – RENEWAL, TERMINATION, TRANSFER AND DISPUTE RESOLUTION

- Renewals should be available so the franchise can operate for 20+ years. Renewals in perpetuity are ideal.
- Check for low renewal fees. The franchisor is not incurring significant additional costs when you renew, so the fees should be minimal.
- Check for low transfer fees. If a new franchisee is taking over your location, that franchisee will be paying a whole new set of fees so the fee here should also be minimal.
- What termination provisions are in the document? You should have the opportunity to cure if the violation is an immaterial violation.

Item 18 – PUBLIC FIGURES

- States any public figures involved in the promotion of the franchise.

Item 19 – FINANCIAL PERFORMANCE REPRESENTATIONS

- This section contains the past earnings of franchise locations. This section should be studied carefully by you and your accountant.
- What can you earn from the franchise? Is it reasonable? Is it in-line with your goals?
- Make sure to look at the footnotes.

Item 20 – OUTLETS AND FRANCHISEE INFORMATION

- This is the chart with all of the franchise outlets.
- How many new franchisees are they selling?
- Look to see how many have left the system. How or why did they leave?
- Was it a termination or did they decide to cease to operate? If there are many terminations that is a red flag.

Item 21 – FINANCIAL STATEMENTS

- These are the franchisor's financial statements. This is a very important section because you can see the solvency of the franchise system. **Please have an accountant review these statements**.
- Look for the following items to see how they change from year to year.

- How much cash do they have on hand?
- Are they increasing in business revenue from year to year?
- Are they increasing in savings?
- Do they have good spending habits?
- How much debt do they have?
- Is the debt going up or down?
- What money is owed to them?
- Are royalty's receivable going up or down?
- Are officers paying in money to the company?
- What did their expenses do in the last year?
- What did net earnings do?

Item 22 - CONTRACTS

- This shows all of the contracts you must sign to become a franchisee.

Item 23 - RECEIPTS

- This is the receipt that must be signed, dated and returned to the franchisor 14 calendar days before any transaction is allowed to take place. Franchisors need this document to stay compliant with the FTC from all candidates they send their FDD to.

Validation Calls

- Call multiple current and past franchisees to get their take on training, support, their business in particular and the industry in general
- Accept franchisee input with open eyes; be wary of the overly enthusiastic and the overly negative
- At their discretion, individual franchisees can discuss precise financial metrics such as sales and profit