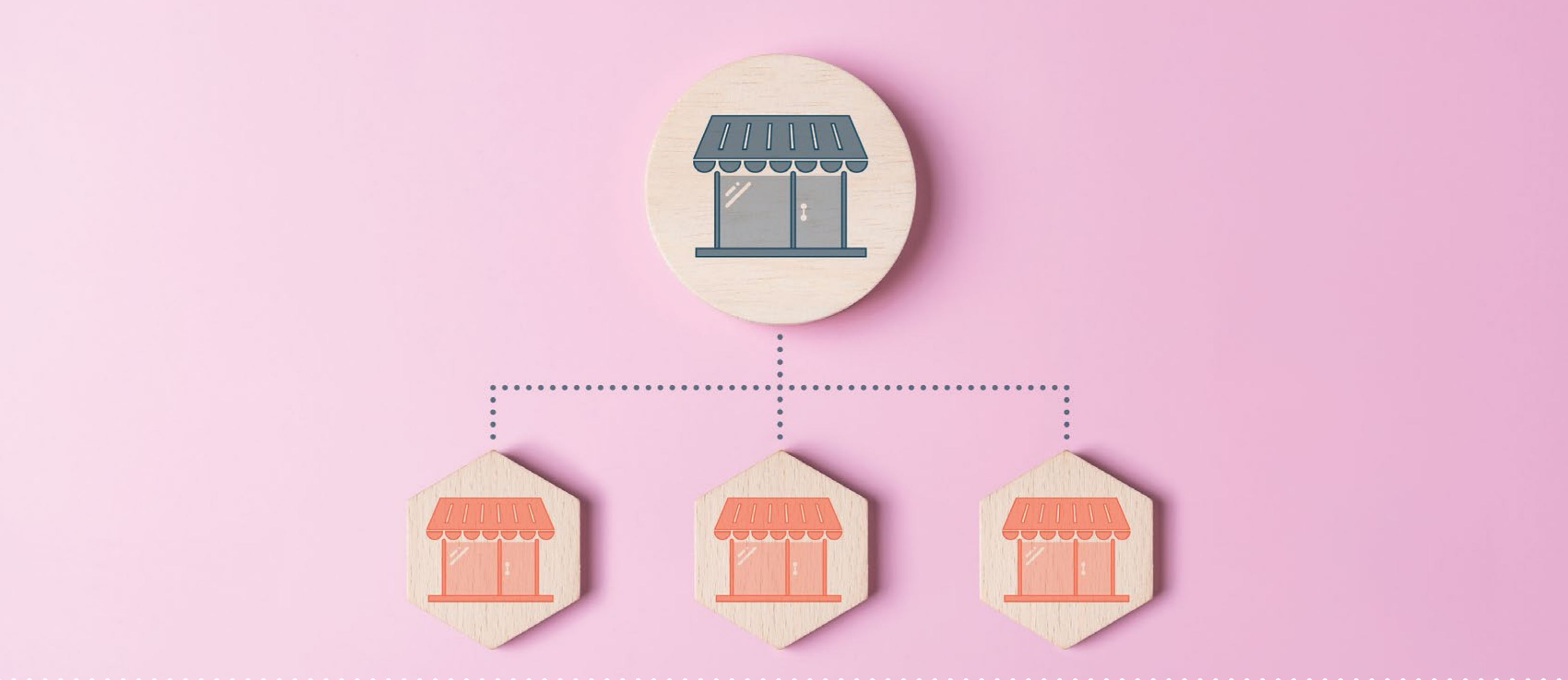

Stay Informed with Updated FDDs

by Justin Klein

Franchisors are required to update their Franchise Disclosure Document (FDD) annually within 120 days of the franchisor's fiscal year-end at a minimum. Indeed, certain instances may require a franchisor to update its FDD more frequently, such as in connection with state filings or registrations or upon the occurrence of a "material change."

Material change has many meanings. That is, the Federal Trade Commission, the legal body that governs the sale of a franchise under federal law, generally considers any change to the franchisor or within the franchise system that may have a significant impact on, or which is likely to influence the decision-making process of a franchisee or prospective franchisee, to be material. Moreover, certain states, such as New York, Maryland and Illinois, have also codified when a material change has occurred thus requiring an update to an FDD.

Some examples of a material change that may require a more frequent update to an FDD would include: the change in corporate structuring of a franchisor; the firing or hiring of certain system-related employees such as the CEO or chief development officer; a change in the franchise fees charged by the franchisor; or certain litigation against the company such as lawsuits challenging the franchisor's right to use its trademark or litigation that may otherwise cause substantial financial hardship on the franchisor; and a massive closure of units in a short period of time.

Why is this relevant? Being aware of changes to the government-required disclosures can give franchisees critical knowledge in making operational or growth decisions in how they run their business. And, because franchisors are required to keep the FDD updated with all material changes, neglecting to recognize and digest those changes could put a franchisee in an unnecessarily compromised position when making such decisions. Below provides a breakdown of several of the items included within the FDD that franchisees should pay careful attention to not only when they are a prospective franchisee (prior to signing a franchise agreement), but throughout their franchise operations year over year or as frequently as more information may be provided.

Risk Factors

In certain instances, a franchisor may be required to disclose certain risk factors that a prospect should consider when acquiring a franchise. However, it is equally important for an existing franchisee when reviewing updated FDDs to look for and consider the disclosed risk factors. For example, franchisors may be required to disclose as a special risk factor information about the financial health (or more likely the lack thereof). Or the franchisor may be required to disclose other risk factors that would be unattractive to a purchaser of your franchise. So, knowing those before you begin negotiating a sale may also be helpful.

ITEM 1

Who is the Franchisor?

Item 1 provides information about the franchisor and any parent companies, predecessors and affiliates as well as information like how long the franchise has been in business. It also includes information relating to the market the franchise operates within and who competitors may be.

Item 1 also includes specific industry regulations that may change over time, so reviewing this information year over year in the FDD can be helpful in ensuring you are complying with all laws. Likewise, if the franchisor went through a corporate restructuring, or was acquired by private equity or a competitor, you may want to be aware as the franchisor could make changes to the system depending on ownership needs, goals and desires.

Further, Item 1 may provide new details concerning the franchisor's affiliates, which may include vendors that franchisees may now be required to purchase products and services from.

ITEM 2 Who Works Here?

This section will be important to review so that you are aware of any company changes of directors, principal officers and other key executives. Surely, you will want to be aware of these changes so you can not only know who is responsible for certain aspects of the business but also so you can see the experience and background of those making the decisions. One thing is certain, there is a high likelihood that individuals required to be identified in Item 2 will change throughout your franchise agreement term.

ITEM 3 Is There Litigation Against the Company?

This section will be important to review to learn if there is any litigation in which the franchisor is involved. Reviewing this information could be helpful to learn not only if there are lawsuits, but the types of lawsuits. For example, it is important to be aware if there is a "bet the company" litigation that is pending or an action challenging the use of the franchisor's trademarks in a particular way. This, for example, may be especially important if you are contemplating a remodel or refresh to your location that could be impacted by how the litigation is resolved.

ITEMS 5,6&7 What's Its Cost and What're the Fees?

Perhaps the most important information to consider year over year is what the franchisor discloses new location costs to build out and what are new franchisees being charged in terms of fees. It would not be uncommon for the cost to build a location to increase over time as the franchise locations get larger, more equipment is required or technology is enhanced. This would also be particularly essential for franchisees who have committed to developing multiple locations because the cost of entry (and the fees) can change drastically from the first agreement to future agreements.

If a franchisee is required to sign the current franchise agreement for future locations and has not secured a cap on increase of fees from the initial agreement, the investment could look considerably different. Indeed, PF® has increased its fees considerably from legacy franchisees to today. Likewise, the cost of building has also increased significantly.

ITEM 19 How Much Money Can I Make?

Presuming the franchisor includes an Item 19 disclosure in its FDD, this too can be a significant piece of information available to an existing operator. If a franchisor chooses to provide financial performance representations to prospects, they must be accurate and reasonable based on market circumstances. As an existing operator, it may be important to see what financial information the franchisor is providing to prospects for many reasons. Considering franchisors typically include ranges of revenues in the Item 19 disclosure, an existing operator may find it useful to compare their financials to those in Item 19 to see where on the spectrum their sales compare to others in the system. It can also be helpful to have a handle on the ranges year over year to see if they are increasing or decreasing. And if the franchisee is considering a sale or a renewal, this information can be valuable

Continued on page 62

Updated FDDs

Continued from page 61

during negotiations with a potential purchaser or the franchisor, whatever the case may be.

ITEM 20

Who Joined? Who Left? Who Hasn't Opened?

Item 20 can be a gateway of information for both prospects and existing operators. As an initial matter, existing operators can learn how many locations are opening year over year and where. This may be an indication that the system is growing and healthy. And it can give insight into where the franchisor is focused on expanding or where franchisees are opening locations.

As an existing operator this may offer you insight into your market and provide information that may be useful in making expansion decisions. Similarly, seeing the development pipeline may also provide an understanding about how many franchisees are soon joining the system. Also, having a grasp of how long they have been in the system and are not yet open may be an indicator of development backlogs that an existing operator may also want to explore if they are considering adding locations.

Finally, knowing how many franchisees left the system or transferred may also be an indicator of potential problems in the system. Item 20 gives you access to each past franchisee's contact information, which can allow an existing operator to gain more information about the details of those terminations and/or transfers.

The Franchise Agreement – How Has the Deal Changed?

The franchise agreement is the contract between a franchisee and a franchisor. Undoubtedly, the form franchise agreement in an FDD will evolve over time, often becoming less favorable to a franchisee. This could mean increased or additional fees, new operational obligations or stricter dispute resolution provisions. All existing franchisees would be wise to not only review the contents of updated FDDs but to also pay careful consideration to the updates to the franchise agreement. What are the changes and how may they affect a sale or transfer? Or have there been changes that are more favorable than terms in your existing agreement? If so, you might want to address these things with your franchisor to ensure you have the best terms available as compared to others in the system.

Franchise Disclosure Documents contain a wealth of information about a franchise investment opportunity. This is true whether it is someone already in the system, a prospect or an investor. As a business owner, it is beneficial to always have as much information as possible to make decisions that lead to the success of your business. Reviewing the updated information in the FDD provided by your franchisor each year can add the cutting edge that may help you achieve all your investment goals.

Justin M. Klein *is a franchise and business attorney and a partner with the nationally recognized franchise law firm of Marks & Klein, which represents Planet Fitness® franchise operators throughout the United States and internationally. You can contact Klein at justin@marksklein.com.*