

## FRANCHISE ALERT #: 24 FDDs Are Goldmines!

### WHAT IS A FRANCHISE DISCLOSURE DOCUMENT (FDD)?

It is a goldmine of information about a franchise. Each franchisor provides their own FDD to any potential franchisee during the discovery process.

**Background on FDDs:** The Federal Trade Commission (FTC) heavily regulates the franchise industry. One requirement is that each franchise provides specific information about itself to any potential franchisee. All franchises in the United States have an FDD which is updated annually.

Every year franchises must file their FDDs with each state it wants to operate in. There are 15 "registration" states that have a more involved process for FDDs to go through annually.

**Benefits of an FDD:** Since they have the same 23 sections, in the same order, it makes comparison among different franchises easier for potential franchisees. The formatting is the same to ensure there are no surprises throughout the long-term relationship between a franchisor and a franchisee.

Think of FDDs as the most valuable written tool you'll receive in your franchise discovery process.

The FDD has 23 sections (referred to as "Items"), as well as exhibits that provide a ton of supplemental information.

**FDD Outline:** Here's an overview of the information provided in FDDs.

#### Items 1-4: History

Item 1: A general review of the company, including any predecessors or affiliates, and the opportunity being offered. This key overview of the business is one of the sections you'll want to review first.

Item 2: Background data on key officers, directors, employees, and any others who have management responsibility related to the sale or operation of the franchise. It includes a summary of their work experience from the past five years and any other experience they have as officers and/or directors of other companies.

Items 3 and 4: These include disclosures of any past or current litigation or bankruptcy on the part of the company or its key people.





## Items 5-7: Fees and Costs

Item 5: Any and all initial fees you have to pay as you begin the franchise business.

Item 6: Any and all other fees that may be required in the subsequent operation of the franchised business, including royalty, advertising, renewal, and transfer fees.

Item 7: An outline of every component of the initial investment you'll be expected to make in the franchise operation, including an allowance for initial advertising and operating capital reserves. This section is extremely important, but the value of the information is limited by the fact that the franchise company is required to express the data in a tabular form involving ranges of potential costs. Review this section with existing franchisees and the franchisor to determine the most accurate estimate possible for your specific location and circumstances.

## Items 9, 11 and 15: Contractual Obligations of Franchisee and Franchisor

Item 9: Your obligations (as a franchisee), in a tabular format. The table lists major areas of responsibility in the business (for instance, obligations in relation to finding the real estate site for your business), then provides specific references to the exact sections of both the FDD and the actual franchise agreement contract that define the legal obligations you're assuming.

Even though it might seem tedious and burdensome to complete all the cross-referencing that is required by the format chosen for this section, it is essential to your investigation. You should read through the entire FDD and franchise agreement first (to develop a strong overall knowledge base) before coming back to Item 9 and carefully checking each cross-reference in the table.

Item 11: The contractual support obligations of the franchisor. This is usually the longest section of the FDD and is very important because it tells you what you'll receive in exchange for the fees you're paying. The section outlines pre-opening assistance as well as ongoing assistance. It also provides extensive detail about the franchisor's training programs and any required franchise systems, such as computer point of sale or advertising programs. Keep your highlighter handy in this section to make sure you note all important information as well as any questions you may have.

Item 15: Explanation of exactly what your personal obligations are in relation to the operation of the franchise business.

## Item 12: Territory

What you will receive in terms of a protected or exclusive territory. You'll find quite a variance in this provision from franchise to franchise.





Most prospective franchisees believe intuitively that the bigger the protected territory, the better for them. To the contrary, as a general rule, the most successful and well-known franchise systems typically offer territories that are either extremely limited or sometimes no protected territories at all. Discuss this at length with the franchisor to ensure you understand and agree with whatever philosophy it adheres to on this important matter.

### Item 17: Exit Strategies and Dispute Resolution Procedures

Any restrictions related to the renewal, termination or transfer of your Franchise Agreement as well as definitions of any required methodology for resolving disputes. You should consider any and all fees and restrictions you face in selling your business long before you get to the point of wanting to sell.

Dispute resolution provisions requiring negotiation and/or mediation before proceeding with legal action are quite common in franchising. It is also fairly common to see requirements for binding arbitration rather than lawsuits in state or federal courts, though this type of provision does not seem as prevalent as it was 20 years ago.

### Item 19: Financial Performance Information (FPI)

Franchisors' representations about the financial performance of their units. This is often the first Item prospective franchisees read to determine the answer to the most commonly asked question in franchising: "How much money can I make in this business?"

**But Item 19 will never give you the answer to this question. In fact, the disclaimers of every Item 19 representation you'll ever see will make this point in the clearest and most emphatic language possible. Every franchisee is different, every site is different, and it's simply impossible to predict in advance what future financial performance results you might achieve. What Item 19 can provide--and it is extremely valuable--is helpful clues you can use in your own research to answer the question of how much money you might make.**

The typical Item 19 disclosure consists of three types of information:

- 1) numerical presentations of revenue and/or expense data,
- 2) notes and explanations outlining the assumptions used in preparing these numerical presentations, and
- 3) disclaimers that carefully explain the limitations of the usefulness of the data presented.



It's essential to carefully review and analyze the clues you receive from each of the three types of information. If, for example, this Item states that all units used in calculating the numerical presentation were at least two years old at the time the data was gathered, it should be obvious that the presentation won't be relevant in determining what your performance might be like in the first year of the operation of your business.

Item 19 can be one of the most important sources of information you'll receive in the entire FDD. **The secret is to be very careful to use the information only within the scope of what it's meant to convey and then to verify this data in your conversations with existing franchisees.**

### Item 20: Existing Unit Data

Information, in tabular form, about the number and location of the existing units in the franchise system. By requiring franchisors to disclose numbers on the units that have transferred ownership or closed, you get information that may assist you in forming an opinion about growth and success rates for the system.

### Items 21 and 22: Financial Statements and Contracts

Item 21: The franchise's audited financial statements for the previous three years. Examine these financial statements to determine the financial strength and stability of the franchisor because you won't receive any future assistance if they go out of business. If this isn't a subject you know well, get assistance from your accountant or someone else familiar with financial statement analysis to help you perform this review and form this opinion.

Item 22: All contracts you may be required to execute in conjunction with becoming a franchisee, including the actual Franchise Agreement contract and other contracts covering personal guarantees, real estate assignments, advertising, co-op rules and conditions, and territorial development schedules.

### Other Rules, Restrictions, and Information

Items 8, 10, 13, 14, 16, 18, and 23 all contain important information pertaining to the franchise. Some of these sections relate to rules, such as where you can buy your supplies, what products or services you can offer, and what your obligations are as far as personal participation. Others contain information about any financing programs available through the franchise, any public figures involved in promoting the business and the status of all trademarks, patents, and copyrights.



In addition, there are standard exhibits in every FDD with required listing of state-specific information and other "housekeeping" matters.

### Tips For Understanding FDDs:

By using a careful, systematic approach to assimilating the important information that's available to you via the FDD, you'll go a long way toward solving the riddle of whether a particular franchise is right for you.

About 30% of franchise companies include a Financial Performance Representation (FPR) in Item 19. Though they are not required to do so, this can be a real time saver for you if it is included. **Even if it is included in the FDD, it is still imperative that you discuss this subject with franchisees during your fact-finding calls.**

I recommend that you go through the FDD and put a Post-It note or highlight any areas you have questions on and discuss those with your franchise representative. As a business person, you want to make sure you can live with the terms and commitments of the agreement.

Later, you may want to have a franchise attorney do a legal review. Because franchise law is specialized, it's been my experience that the people who hire an attorney outside of that practice end up with higher legal bills and usually don't get the expert advice they wanted. At the appropriate time in the process, I can refer you to franchise attorneys.

Your franchise rep will gladly address any questions you have about the FDD. That's an important part of the role they have in helping you understand what their franchise offers.





Next Step:

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It's my pleasure to help you understand what an [FDD is and the goldmine of information](#) one provides to you about a specific franchise!



Anna Wilds, CFE  
Certified Franchise Executive  
Franchise Economist and Franchise Wealth Advisor

# Learn. Launch. Live Your Dreams.



[anna@selectfranchises.com](mailto:anna@selectfranchises.com)



706-736-0579



[www.howtoselectfranchises.com](http://www.howtoselectfranchises.com)



@annawilds