FDD Overview

The Franchise Disclosure Document (FDD) is a rather large document and can be very intimidating at first. Franchisors are required to provide you a copy, electronic or hard copy, early in the process. Your signature acknowledging receipt of the FDD is required.

I recommend that clients initially focus on specific sections in the FDD rather than becoming overwhelmed by the entire FDD document. Remember, if a brand makes it to the finish line, then an experienced franchise attorney can review the document in more detail for you. Early in the learning process, focus your time on these sections:

Item 2: Business Experience of Management
Item 3: Litigation (anything in the last 10 years or pending)
Item 7: Estimated Initial Investment
Item 19: Financial Performance Representations Related to Franchisees
Item 20: Franchise Unit Count by State for the Last 3 Years

FDDs are updated and resubmitted each year to both Federal and State agencies. All FDDs have 23 items plus a generic Franchise Agreement. Below is a brief description of the "23 Items" included in all FDDS.

Item 1 The franchise company

This is an overview of the history, ownership and corporate family of the franchisor, including the types of franchises offered. Watch out for: A company overview that isn't clear or readable. If you can't get an accurate picture of the organization here without a lot of effort, it is likely you will have issues deciphering the rest of the FDD.

Item 2 Business experience of franchise executives

Gaining knowledge of the franchisor's leadership is crucial, because it will help you decide whether you'll feel comfortable dealing with the people involved. Look for a solid group with experience in management and franchising. Watch out for: An executive team that is new to franchising or executives who have been involved in failures with other businesses.

Item 3 Litigation

This item lets you know about any litigation involving the company and its principals and directors. It notifies you of potential claims against the franchisor, as well as whether it has filed suits against entities infringing on its trademarks or against franchisees not in compliance with quality standards (which may be a good thing). Watch out for: Multiple lawsuits filed by franchisees alleging fraud or misrepresentation on the part of the franchisor. Is there a pending class action by franchisees or consumers that, if successful, could bankrupt the company?

Item 4 Bankruptcy

This item is rarely of great interest, because your due diligence should have indicated whether the franchisor is in bankruptcy. Any officer or director who has a personal bankruptcy, or was previously involved in a bankrupt franchisor, also must be listed.

Items 5, 6 and 7 Initial fees, other fees and initial investment

Item 5 is an overview of the initial fees required to open your franchise. Until the recession, most franchise fees were not negotiable; however, in the last three years, some franchisors have offered discounted fees that should be disclosed here. If you see initial fees listed as a range, ask if you qualify for a lower fee.

Item 6 is a chart of other fees, including royalty and advertising fees, which you will be required to pay on an ongoing basis. Be aware that not all fees are listed here, including the cost of products and inventory.

Item 7 lays out the fees and expenses required to open and operate your franchise for the first three months. Watch out for: Franchisees get into trouble when they are undercapitalized. Do not assume that the working capital listed in Item 7 is sufficient to sustain your business until you start making money. Ask other franchisees how long it took them to break even. Go over these items with an accountant before signing a franchise agreement.

Item 8 Restrictions on sources of products and services

The franchisor has a vested interest in knowing that the products and services you are utilizing or selling meet its standards. To ensure that, the company may sell you products itself or insist you use designated suppliers. Watch out for:

Franchisors who are getting large rebates from suppliers. Ask current franchisees if they feel the prices they pay for designated products are fair.

Item 9 Franchisee's obligations

This is the single best disclosure you will get: a list of your contractual obligations, with cross-references to the franchise agreement and the rest of the FDD. Item 9 allows you to see each obligation, then go back and read the language by which you will live and breathe. Watch out for: FDD descriptions that are not consistent with the franchise agreement.

Item 10 Financing

This tells you whether the franchisor offers a lending program, or whether the franchisor has deals with lenders who have agreed to help finance its franchisees. The item also discloses any financial relationship the outside lender has with the franchisor. Watch out for: Don't forget that borrowing from your franchisor is no different than borrowing from a bank, with the same credit terms. If you default, the franchisor can terminate your franchise agreement.

Item 11 Franchisor's assistance, advertising, computer systems and training

This item outlines the content and scope of the franchisor's support services. It should include disclosures about cash registers and related information involving the use of extremely sensitive franchisee data to which the franchisor has access. Watch out for: Subtle qualifying words, such as "at our discretion" or "as needed," and know that you cannot count on receiving those services. Look carefully to see how much of your required advertising fees actually get spent on advertising and how much can be siphoned off into uses that mainly benefit the franchisor. Also note that if franchisees are not involved in managing the national marketing fund and program, it can be a major red flag for investors.

Item 12 Territory

Whether you need a protected territory depends on the nature of the business. The franchisee of a retail outlet wants to know that another unit cannot open within a certain radius; a service business might require five to 10 franchisees in a geographic area. Be aware that any territorial protection lasts only for the duration of your franchise agreement; the franchisor has the flexibility to change it when you renew your contract. Watch out for: Retail franchises that provide no geographic protection.

Items 13 and 14 Trademarks and patents, copyrights and proprietary information

These straightforward items list the trademark and copyright registrations the franchisor has obtained. Watch out for: A trademark that is not registered.

Item 15 Obligation to participate in the actual operation of the franchise business

Franchisors want to be sure franchisees are devoting full time and effort to running each location. Some franchises require franchisees to run the business themselves; others allow them to be passive owners and hire someone else to manage day-to-day operations. Watch out for: Restrictions placed on managers. For example, do they need to own a share of the business?

Item 16 Restrictions on what the franchisee may sell

This item lets you know that you can sell only what the franchisor allows. Watch out for: Franchisors whose product offerings are too limited.

Item 17 Renewal, termination, transfer and dispute resolution

This chart provides a summary of the franchise relationship to the franchisee, with cross-references to the franchise agreement, showing terms of termination and renewal and stating where and how disputes will be resolved. Watch out for: In franchising, you don’t have a right to renew, only a right of first refusal on a new contract, which may contain higher royalties and other charges. When signing your first contract, try to perpetuate as many financial conditions into the renewal contract as you can. Most disputes must be settled in the hometown of the franchisor, which puts the franchisee at a disadvantage.

Item 18 Public figures

This is relevant only if you are buying into the less than 1 percent of franchise systems that use public figures in their advertising.

Item 19 Financial performance representations

Although this is one of the most important pieces of the FDD, only 30 to 40 percent of franchisors provide information on how much their current franchisees are earning; the others must state that they choose not to make such a claim. Watch out for: Earnings claims based on corporate stores, because they pay no royalties and may have different labor, rent, product and shipping costs than you will experience. Also, look out for earnings based on franchises that have been open for five to 10 years, which may pay lower rents.

Item 20 Outlets and franchise information

These charts show the number of franchises opened, transferred and closed in the last three years, which lets you see whether the system is growing or shrinking. The most important part of the FDD is the list of current and former franchisees. You would be completely remiss not to contact as many as possible to get an independent perspective on the health of the system. Watch out for: A large number of closures, which could mean the business model is trending out of favor.

Item 21 Financial statements

These audited financial statements let you know if the franchisor is stable. Look at the profit-and-loss statement first, then the balance sheet. You may need an accountant to figure out whether the current ratio of assets to liabilities is favorable and how the franchisor accounts for deferred revenue. Be sure to read the footnotes. Watch out for: Franchisors who earn most of their money from franchise sales. Good franchisors sustain themselves on royalty payments.

Items 22 and 23 Contracts and receipts

These items include the contracts you will be required to sign and the receipt you must sign when you receive the FDD. It is critical that you read and understand the contracts and keep copies of all documents (including the receipt); you'll need them if you ever wish to bring an action against the franchisor.

document is strictly prohibited. For more information, browse our web site at https://InsiderFranchiseInvesting.com/

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No hype, no fees, no BS… just accurate & valuable information.