

# Pitfalls People May Face When Buying a Franchise

*Wall Street Journal Center for Entrepreneurs: WSJ.com Startup Journal* By JULIE BENNETT

The book "Annual Franchise and Distribution Law Developments, 25<sup>th</sup> Edition" could be considered by some the "Bleak House" of franchising. But while Dickens's novel was about one case, the American Bar Association casebook lists hundreds of disputes between franchisees and their franchisers. Many likely may have been avoided had prospective franchisees been more careful when they went shopping for a franchise.

Here's a rundown of common pitfalls people fall into when buying a franchise, and tips that could help you avoid a listing in a future ABA casebook.

## **Pitfall No. 1: Assuming a great product also means a great franchise system.**

Snap-on Inc., in Kenosha, Wis., makes top-line automotive aftermarket tools that Snap-on Tools franchisees sell from their own trucks to a specified call list of 200 to 225 auto-repair shops.

Matt Setser of Tampa bought a Snap-on franchise in 2003 because, he says, "I owned some of their tools and knew they had a good product." Within a few weeks, Mr. Setser says, he concluded he'd made a mistake. "I never had enough customers to make a profit," he says. He closed his franchise in September 2004 and joined other franchisees in a class-action arbitration against the company. In the complaint, Mr. Setser and the other franchisees claim they were sold territories that Snap-on knew were too small to provide a profit. According to U.S. Securities and Exchange Commission filings by the franchiser, more than 600 other franchisees have dropped out of the Snap-on system since 2003.

Justin Klein, partner of the law firm Marks & Klein in Red Bank, N.J., who represents Snap-on franchisees in actions pending before the American Arbitration Association in New York, says his clients feel they were exploited and they claim the franchiser misrepresented the value of the business. "But they all still feel that Snap-on makes the best tools on the market," he says.

A Snap-on spokesman says the vast majority of its 3,400 U.S. dealers are pleased with their routes. "There is no incentive for Snap-on to have dealers leave the system," he says. The company provides lists of customers to prospective franchisees and encourages prospects to visit them before signing franchise agreements, he adds.

**Tip:** Don't focus solely on the quality of the product. Question current franchisees about their business. Are they making a profit? Have they added new customers and new product lines every year? How helpful has the franchisor been? Check to see if litigation is pending against the franchiser.

**Pitfall No. 2: Assuming that franchises in a fast-growing system are always profitable.**

Quiznos Sub, the sandwich franchise based in Denver, has 4,400 units worldwide and is known for its rapid growth, opening about 1,000 units a year since 2003. But some franchisees claim that when new stores opened near their existing units, they stopped turning a profit. Glenn Keane, a franchisee in Derby, Conn., is among them. "When Quiznos allowed a second franchisee to open here last summer, my sales dropped from \$15,000 a week to \$8,000. Instead of taking money out of the franchise, I'm now putting my own money in, just to keep going," he says. Two Quiznos franchisee associations, both with hundreds of members, cite similar complaints and another group of franchisees filed an encroachment lawsuit against the system in 2005. A federal district court judge in Denver dismissed the suit, rejecting the argument that oral promises of exclusive territories the franchisees claimed to have received would modify the written franchise contract.

A Quiznos spokeswoman didn't return calls for comment on this article. Rick Schaden, chief executive officer of Quiznos, had told Franchise Times in its February 2006 issue that he, too, had heard criticisms about stores being built too close together. He told the trade publication: "Encroachment is a big challenge in our business. We're a convenience item and we're putting restaurants where consumers can grab a quick lunch. In the country that may be four miles apart, but in the city it may be every five blocks. When you look at the overall numbers, we have a lot fewer restaurants in any market than Subway, McDonald's or Burger King."

**Tip:** Seek out franchises that offer protected territories -- exclusive rights to operate within a geographic area. If territories are not protected (they aren't with Quiznos), talk to existing franchisees about the impact on their business when another unit opens nearby.

### **Pitfall No. 3: Signing with a system before it works out the kinks in its business model.**

According to FRANdata, a franchise-research firm in Arlington, Va., 346 new franchise concepts registered to do business in the U.S. in 2005, including franchises that kill mosquitoes, sell gloves and scoop up pet droppings. Often franchise buyers hope to get on the ground floor before a concept catches fire, for several reasons. Among them: potential to buy at a lower price; the opportunity to acquire more units than they might otherwise be able to; being among the first to benefit from growing customer interest; being a leader in the franchise system and helping to shape it going forward. Franchise-industry insiders call this strategy "the next McDonald's" syndrome.

Yet, many newcomers franchises won't grow beyond a handful of units before they fade away, says Darrell Johnson, FRANdata's president. Most of those that do stay around will tweak their business models several times, requiring franchisees to adjust.

Velocity Sports Performance of Alpharetta, Ga., for example, began franchising in 2002, with a program designed to improve the athletic ability of boys and girls, ages eight to 20 and to provide training facilities for professional and semi-professional athletes. The first 56 franchisees invested \$450,000 to \$650,000 to build large gyms and equipment, according to the company's 2005 UFOC. But their expensive new gyms went empty during the day, when kids were in school. Franchisees in other parts of the country didn't attract adult athletes like those that worked out in the franchiser's original facility near Atlanta, according to franchisees. Of the initial franchisees, 13 closed down, and a 57<sup>th</sup> franchisee scheduled to open didn't, according to company documents and a Velocity Sports spokeswoman.

Lee Kallman, Velocity Sports's vice president of marketing, acknowledges the concept required tweaking and says that last year the company expanded its business model to include daytime adult-fitness programs. Within four to six months, the new initiatives made an impact, he says. "Our services were designed for student audiences," he says, "and we knew going into it that they were not available during the day. The new adult programs are not a shift in strategy. What we didn't want to do from the get-go was to grow lots of different programs all at one time. We've been more strategic growing out."

Dale Deatsch, a Velocity Sports franchisee in Willowbrook, Ill., says that the new program drives some business, but he developed his own daytime programs after he opened in 2005.

Examples of franchise concepts with untested business models include a service to help small businesses go online that faltered when Internet access became so simple that business owners had no reason to pay for it, and a retail concept selling cell phones and wireless business connections that ran into problems when discounters offered similar products at lower prices. In the first case, when going online became easier in the U.S., the company focused on expansion overseas. In the second case, the company went out of business.

**Tip: Before rushing to join a system, consider waiting until the initial franchisees are breaking even and can show you how it's possible to make a profit.**

*-- Ms. Bennett is a free-lance journalist based in Northbrook, Ill.*