

Testing a New Franchise Concept

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One of the toughest challenges an aspiring franchisor may face is selling its first franchise. Who would take the risk of buying a franchise from a franchise company that has no franchisees?

For a few successful business owners, the idea of franchising may come from one or more customers who love the business concept and initiate the idea of buying a franchise even before the owner has taken the first step to prepare a franchise offering. But this rarely happens.

Here's another suggestion: If the aspiring franchisor has a successful business unit (a store or a restaurant, for example) that is operated well by a trusted manager, that manager might be a good candidate to buy the business at that location and become the company's first franchisee. The manager will already know the business inside out, having successfully managed the business as an employee. The transaction would entail the sale of the existing business at a single location in which the buyer undertakes to continue operating as a franchisee of the seller. The buyer's newly-formed company would sign a franchise agreement as part of the purchase of the business.

To enhance the appeal of the transaction, the franchisor may extend credit for a portion of the purchase price or may waive the payment of any initial fee and give a grace period on the payment of any ongoing royalty or marketing fee. The idea is to maximize the fledgling franchisee's chances of success. The franchisee's success is crucial. This franchisee will be the first validator of the system for subsequent franchise buyers. With only one franchisee, the franchisor is unlikely to include financial performance representations in Item 19 of its franchise disclosure document (FDD). And without providing numbers in Item 19, the franchisor may not discuss numbers orally. Only an existing franchisee can do that.

But what about the legal requirements of franchise registration and disclosure, which may include the requirement to prepare and disclose audited financial statements and much more? Is there a way that the aspiring franchisor can avoid the cost, the time and effort of preparing a detailed FDD and possibly registering it with the state? This answer is yes. There are ways to start small and test the concept before the franchisor is ready to prepare a disclosure document and to register the offering.

The Federal Trade Commission's trade regulation rule on franchising (the FTC Rule) excludes from the definition of a franchise the grant of the right to use a trademark where the license is the only one of its general nature and type to be granted by the licensor. So a single license should not trigger the federal requirement to prepare a disclosure document. State laws will usually not be a concern if the outlet is located in a nonregistration state, although the business opportunity laws may pose an issue.

What if the outlet is located in a registration state? A few states (Indiana, Minnesota, New York and Washington) exempt the isolated sale of a franchise.

New York's single sale exemption calls for some explanation. The exemption applies when (i) the franchisor makes an offer to no more than two persons, (ii) the franchisor does not grant the franchisee the right to offer subfranchises, (iii) no commission or other remuneration is paid for soliciting the prospective franchisee, and (iv) the franchisor is domiciled in the state or has filed with the NY Department of Law its consent to service of process. (N.Y. Gen. Bus. Law §684(3)(c).)

The single sale exemption in New York only applies by its terms to the state's registration requirement. What about the disclosure requirement? Does this exemption save the franchisor from the time and expense of preparing a detailed FDD? Fortunately, the exemption does apply to both the registration and disclosure requirements. A franchisor's obligation to provide disclosure arises under New York law when the franchise is subject to registration. Section 683(8) of the NY General Business Law states that "[a] franchise **which is subject to registration** under this article shall not be sold without first providing to the prospective franchisee, a copy of the offering prospectus, together with a copy of all proposed agreements relating to the sale of the franchise"

This exemption will not extend beyond the first franchise sale in New York or any other state. Unless another exemption applies, the franchisor will be required to prepare a franchise disclosure document and possibly register the offering before selling its second franchise. That would be the time to form a new franchisor entity, open a bank account in the name of the franchisor entity and prepare an audit of the franchisor's opening balance sheet. The licensor of the test franchise might be the operating company that owns the trademark. The test franchise agreement should allow the franchisor to assign the agreement to its affiliates so that the brand owner may assign the agreement to the newly-formed franchisor. In any event, the contact information for the first franchised business should be listed in the first FDD.

Another approach that works for some companies in nonregistration states is to use the minimal payment exemption under the FTC Rule. A franchise sale is exempt from the FTC Rule if less than \$570 is paid to the franchisor or an affiliate at any time before the franchisee's business has been in operation for six months.

Another exemption under the FTC Rule that can facilitate the first franchise sale without the need for an FDD is the insider exemption. In order to benefit from the insider exemption under the FTC Rule, one of the owners of the franchisor company must become a franchisee. This exemption applies when, within 60 days of the sale, the purchaser (or a person who owns at least 50% of the purchaser) has been for at least two years, an owner of at least a 25% interest in the franchisor. A few states also exempt insider sales (California, Rhode Island, South Dakota and Washington).

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