

Franchisee Lawyer Mario Herman Talks to The Real Deal



Mario Herman has been defending franchisees for over 16 years. His views on franchise law and franchisees' rights have been published in *Franchise Times* and other industry publications. He specializes in representing franchisees in negotiation, mediation, arbitration, and litigation with their franchisors. He also advises franchisees on the right franchise opportunity for them. He's based near Frederick, MD, not far from Washington, D.C., *RealDeal on Franchising* interviewed him in April 2005.

RealDeal: You were quoted saying that you think 1/3 of franchisees are making money, 1/3 are marginal, and 1/3 are losing their shirts. Why do you think 2/3 are not making a good profit on their investment?

Mario Herman: I've talked to CEOs of major franchises who told me those numbers. There's a difference between being marginally successful and being very successful. If you add up the marginally successful and the out-and-out failures, you'll get a significant number, leaving only around 1/3 or even less who are making a significant return on their investment.

Marginally successful means people who are buying themselves a job, and it's a 24x7 job, so on an hourly basis their income is often a lot less than if they were in a regular job working for someone else. For example I've represented a lot of pharmacists who can make a six-figure income working for a large chain, but working for certain franchises they are making less than that and risking a great deal of their own capital.

The experience has been that between those who end up transferring their franchise [i.e. selling to a new franchisee at a loss] and losing their shirts, and those who are marginal, in other words they're not losing money but they've bought themselves a job and a relatively low-paying job at that, that adds up to a very considerable number.

RealDeal: Do you think the situation is getting better or worse?

It's hard to say. After 9/11 and the economic downturn, there was a large attrition rate and a failure rate among the franchisors themselves. I don't think the number of successful franchises has improved.

In the 1990s, there were some very questionable statistics that said that 94% of franchisees were successful. But a lot of those statistics were based on including people who considered themselves "marginally successful." The true statistic was much smaller.

Timothy Bates at the Bureau of the Census published some statistics which showed that 34% of startup franchises were failing compared to only 28% of independent retailers. That turned the popular folklore on its head, and said that your chances of success were better as an independent than as a franchisee. That was due to a couple of factors: first, franchisees are highly leveraged, they are encouraged to borrow money by the SBA among others; secondly, the franchise fees themselves, which typically can approach 40% to 50% of their net proceeds. The royalty fee might only be 5% [of revenue], so on annual revenue of \$500,000, that's \$25,000. But if your push-through [net profit] is in the 18%-20% range, then on \$500,000 revenue, it's \$100,000, so you're giving 25% of your net proceeds up in royalty payments. A lot of times when franchisees get into this, they think 5% isn't so bad, but on very thin margins, it really is a huge chunk you're paying out to the franchisor.

An independent doesn't pay out those royalties, but then on the other hand, he doesn't get all the support of a franchise, the brand name, the advertising, etc. But they don't always get the support they're promised or thought they would get. And they are often not told that it might take years before their franchise becomes profitable. It can take two, three, or four years for the business to make money and five to ten years before it is really successful, and how many franchisees can go even three years without breaking even?

RealDeal: What are some of the issues where franchisees get abused by franchisors? On your website, you talk about fraud, breach of contract, encroachment, and so on.

It depends on the type of franchise. If the franchise is well-established, you have encroachment issues. If you have a three-mile area, then the franchisor might put another store at 3.1 miles. As a mature franchise system, McDonald's experiences encroachment issues every day.

Then, with up-and-coming franchises, advertising is a big issue. Franchisees want to see advertising to get the name recognition out there. Then even if there is advertising, there are issues over the placement and the payment for advertising.

Despite all the rules, earnings claims by franchisors [regarding the future profits of a franchise] still happen all the time, and that leads to fraud in the inducement issues. For people who want to go independent and face a non-compete, that's a big issue. The franchises say: "we taught you everything you've learned about how to operate this business," and often the franchisees' response is "I never had the support I was promised." And there are issues of ongoing support. You're trying to make your franchise work and the franchisor is too busy signing up new franchisees to give you support or just doesn't have the resources to support their franchisees.

RealDeal: Can you give me some examples of interesting cases you have won?

There was a water-ices franchise who misrepresented the costs and potential profitability of the franchises. We won a case in arbitration and essentially closed down the entire franchise. I have helped numerous franchisees who wanted to terminate and exit the business. I am on a target list with some franchisors so I would rather not name specific names.

RealDeal: What sort of franchises tend to be more successful?

The low-end franchises like janitorial services or web design services have severe problems. The dot-coms are very problematic. Setting up web pages is a difficult business to make money in. Restaurants can do very well, depending on location. They can do well if they're positioned properly. I don't tend to see the ones who are doing wonderful. I see the ones with problems.

I would say a business format franchise that has a good concept and doesn't require a huge amount of investment. It's not a get-rich-quick scheme, unless people have something novel, for example a franchise for the removal of tattoos, taking advantage of cutting edge technology, then they can potentially do very well.

My concern is people who go into franchising who believe it's a cookie-cutter, a surefire thing, and believe the SBA will guarantee their loan.

I reviewed a franchise whose Franchise Offering Circular showed he had close to a 20% attrition rate. You start to question it at that level. I think a healthy franchise will have 10% and under. But franchises with 25% to 50% attrition are, frankly, scams. Often a franchisor will cover it up as transfers.

RealDeal: How much should a franchisee figure to spend on a lawyer before signing a franchise agreement?

I do a review for \$1250, compared to my normal rate of \$395 an hour. I put five hours into the review, just to look at the offering agreement and the Circular. Setting up the company and lease

review, that's all separate. You want to go to a franchise attorney. They [franchisors] always tell you the agreement is non-negotiable, but many will do addendums. They won't change the fundamentals but they will change other things.

So for \$1000 to \$2000 you can buy yourself some pretty decent services, but you want a competent franchise attorney. There are about 800 of us in the ABA Forum on Franchising, but no more than a couple dozen of us who are franchisee attorneys on a full-time basis.

RealDeal: What do you think is the single most unjust thing in franchise law today?

The fact that we don't have a national franchise statute. We have plenty of regulations of securities for passive investments (i.e. in the stock or bond markets) that frequently involve less money than what a franchisee spends on his franchise. I'm appalled we don't have any federal legislation. But the franchise lobby is very strong in Washington and I don't think we'll ever see it. It's the old rule of power, they get away with it because they can. We need a countervailing force to get in their face. There was a huge effort in the 1990s to educate the Congress. But the IFA says "we can regulate ourselves," and to some extent they are trying. But frankly, there's a scam invented every minute. Fraud is as prevalent today as it's ever been. The FTC is overworked and don't have the ability to go after people. The state Attorneys-General are too busy with what they consider "real crime" to go after white-collar crime. But there have been suicides, divorces, and lives shattered as a result of bad franchises, and the franchisor is always happy to take their money and go onto the next one. There's an old saying among franchisors: we don't want a franchisee who's too rich because then they'll have money left afterwards to back and sue us with.

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