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BUSINESS STARTUP—SHOULD YOU BE A "FRANCHISE PLAYER"?

Launching a business is a little like walking a tightrope, with any long-term rewards coming only after overcoming some risk. Being well-informed and realistic from the outset is essential. One of the first considerations is the legal form that the business should take. An option that has the potential for achieving a good balance between risk and reward is the franchise.

A franchise is a relationship between the owner of a trademark or trade name (franchisor) and an individual or entity (franchisee) who contracts to use that legally protected identification in a business. The details of the relationship are controlled by a franchise agreement, but most franchises share some common characteristics. Typically, the franchisee sells goods or services that are either supplied by the franchisor or at least must meet standards set by the franchisor. In simple terms, the franchisor provides the ingredients that come from the proven experience of an established line of businesses, while the franchisee provides the elbow grease and all of the other intangibles that are needed if a fledgling business is to get off the ground and prosper.

There are two types of franchises. The simpler version, known as a "product/trade name franchise," is the sale of the right to use a business name or trademark. In the more complex form, called a "business format franchise," the fates of the parties are tied together more closely and for a longer period of time. In this format, the franchisee trades some of its independence in exchange for various forms of assistance from the franchisor.

Money Matters

One benefit of a franchise is that the prospects for a healthy bottom line are enhanced, since the risks of the investment are reduced by being associated with an established company and its good name. But that boost is not without cost. A would-be franchisee should always be aware of the financial commitment involved, but not be too quickly scared away by the reality that here, as in most business matters, “you have to spend money to make money.”

It is only prudent to consider carefully a number of likely expenses. There is the initial franchise fee, sometimes nonrefundable and usually at least a few thousand dollars. Costs to rent or build an outlet and to purchase the initial inventory will be significant. The full range of expenses depends on the type of business, but some of the other typical expenses include fees for licenses and insurance, ongoing royalty payments to the franchisor based on income and for the right to use the franchisor's name, and payments into the franchisor's advertising fund.

Who's in Charge Here?

It is the nature of a franchise that, in exchange for getting to hitch its wagon to the franchisor, the franchisee agrees to give up some of the control over how the business will operate. There still should be room for putting a personal stamp on the business, but the franchise business model is not for someone who would have difficulty giving up the decision-making power that comes with starting a business. Owners of a “Mom and Pop” do not need permission for their store's color schemes, but the franchisee probably will.

As set out in the franchise agreement, the franchisor will usually have the final say about the specific goods and services that may be sold, site approval for the business location, design or appearance standards, as well as authority over an array of operational matters such as hours of operation, signs, employee uniforms, and even bookkeeping procedures. On the larger scale, the franchisor also may limit the franchisee's business to a specific territory.

Parting Company

A franchisee's breach of the franchise agreement, such as by failure to make payments or to comply with performance standards, could result in termination of the franchise and loss of the franchisee's investment. Even without a breach, a franchisee must foresee that franchise agreements generally run for a finite period, such as 15 or 20 years. Of course, if both sides so desire, the agreement can be renewed under the same terms or perhaps even terms more favorable to the now-proven franchise. But the franchisor could decide not to renew, and it usually reserves the right to do so for its own reasons. If there is a renewal, the parties must agree again to all of the terms and conditions. The franchisor may take that opportunity to make changes in the deal to its benefit. In that event, the franchisee would be wise to give a fresh look at whether owning a franchise still makes business sense.

Anyone seriously considering buying and running a franchise needs to do the homework first, and the Federal Government has made that process more organized. The Federal Trade Commission (www.ftc.gov) requires franchisors to prepare a disclosure document, sometimes called a Franchise Offering Circular, that puts in one place a wealth of information about the franchisor, current and former franchisees, and what the franchisee is agreeing to when the franchise agreement is signed. Reading and understanding the disclosure document, not to mention the franchise agreement itself, is essential. One should always seek independent professional advice before making a commitment to a franchise arrangement.

VETERANS' BENEFITS IMPROVEMENT ACT

A new federal law has enhanced the rights of members of the armed services during active duty and on their return to the civilian workforce. The Veterans' Benefits Improvement Act makes two significant additions to the Uniformed Services Employment and Reemployment Rights Act (USERRA). USERRA is intended to encourage non-career uniformed service by balancing the needs of individuals in those services with the needs of civilian employers who also depend on those same individuals.

Notice Requirement

The first provision requires that civilian employers inform employees of their rights and obligations under USERRA annually. The notice requirement may be met by posting a notice where employers customarily place notices for employees. This part of the new law became effective on March 10, 2005.

Extension of Benefits

The second change is an extension of employer-sponsored health care from 18 to 24 months, beginning with the person's absence from employment because of duty in the armed services. USERRA gives the individual the right to elect to continue coverage under the employer's health plan, even though the coverage otherwise would end because of the individual's absence. A “health plan” encompasses an employer's health, dental, vision, and prescription drug plans, as well as health reimbursement arrangements and flexible spending accounts. The employee, not the employer, pays for the coverage during the employee's absence. This health-care provision went into effect on December 10, 2004.

USERRA, the comprehensive legislation that was changed only in part by the Veterans' Benefits Improvement Act, is far-reaching in its impact, as it applies to private and public employers alike, regardless of size. It is subject to various conditions and exceptions that make a full reading of the law, not to mention professional guidance, advisable. USERRA affects the following areas:

* Reemployment—Employers must grant military leave for employees called to active duty or National Guard or Reserve training. On their return, the employees must get their jobs back or jobs with comparable seniority, status, and pay.
* Payroll—USERRA does not require an employer to continue to pay employees who are away on military duty (though some state laws do).
* Time Off—Employers cannot force employees to use vacation and sick days during military service, but neither do employers have to let vacation and sick days continue to accrue during the employee's absence. If the employer awards vacation days based on length of employment, the returning employee must receive vacation time that would have been given but for the military service.
* Promotions—Returning employees “step back on the escalator,” whether it is going up or down. That is, they assume the place in the employer's tenure and seniority scheme that they would have had if their employment had not been interrupted.

ENVIRONMENTAL LAW UPDATE

Wetlands Inspection

Paul owned waterfront property that included some tidal wetlands that were subject to state regulation. When he decided to extend his existing dock and add another boat lift, he submitted the necessary application to the state, but he refused to consent to a land-based inspection of the premises. Nevertheless, following the usual procedure, an inspector went to the property to make sure that plans submitted with the application accurately reflected existing conditions and to evaluate the possible impact of the project on the wetlands.

When the inspector arrived and no one answered the door, she passed through a gate with a "No Trespassing" sign on it to get into the backyard that led to the dock area. With a video camera rolling, Paul confronted the inspector, who identified herself and explained the reason for her visit. Paul told the inspector that she was trespassing, threatened to have her arrested if she did not leave immediately, and then escorted her off the property. The whole encounter took about three minutes.

Paul sued the state inspector for violation of his right not to be subjected to unreasonable searches or seizures. It is true as a general rule that an inspection of a private dwelling by a local or state officer, without either a warrant or the consent of the owner, is unreasonable absent certain exceptional circumstances. Unfortunately for Paul, his case fell within one of those exceptions, causing his lawsuit to fail. Under the "special needs" doctrine applied by the court, a weighing of several factors can justify a warrantless administrative inspection undertaken as part of a regulatory scheme.

In Paul's case, he had a diminished expectation of privacy since the outside areas around his home could be viewed by the public. Paul's privacy interest was also weakened by his having submitted the application that prompted the inspection in the first place. The intrusion by the inspector was minimal and was hardly different from the kind of observation of the property that anyone could have accomplished from the water behind Paul's house. The court emphasized that each case would turn on its particular facts, but in Paul's case the state's interest in regulating construction on tidal wetlands overrode any expectation of privacy.

No Help for Toxic Waste Cleanup

A company bought an aircraft engine maintenance business and operated the business for a few years. It then discovered that the property on which the business was located was contaminated with toxic waste, both because of the company's activities and the activities of the previous owner. The company reported itself to a state environmental agency, which told the company that it was in violation of state laws and directed that the site be cleaned up. However, neither the state agency nor its federal counterpart, the Environmental Protection Agency, ever brought a proceeding to force the cleanup.

Under the state's supervision, the company cleaned up the property (incurring costs in the millions of dollars) and unsuccessfully sued the previous owner that had contributed to the contamination, in hopes of getting a contribution to the cleanup costs as well. This case is a study in how a few words in a statute can control the outcome in a dispute where large sums of money are at stake.

The claim for a contribution to the cleanup costs rested on a part of the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). That statute states that any person "may" seek contribution from any other person who is or may be liable under CERCLA, "during or following any civil action" under CERCLA. The U.S. Supreme Court interpreted the statutory language as meaning that the company could not seek contribution from the previous owner (and fellow polluter) because no proceeding under CERCLA was ever instituted against the company that cleaned up the toxic waste.

The use of "may" by Congress meant that an action for contribution was authorized *only* if the conditions that followed were present, including a civil action under CERCLA. Appeals by the company based on the underlying purposes of CERCLA fell on deaf ears before the Court. As the Court put it, "It is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed."

NEW TAX DEPOSIT RULES FOR SMALL BUSINESSES

As of January 1, 2005, the IRS increased the minimum threshold for Federal Unemployment Tax Act (FUTA) deposits. Under the previous rule, employers were required to make a quarterly deposit for unemployment taxes if the accumulated tax exceeded $100. Now the threshold is $500.

The IRS estimates that this change will lighten the load for more than 4 million small businesses. Assuming an employer makes timely state unemployment tax payments, the most that the IRS will collect from employers per employee is $56 per year. Before the threshold was increased, most employers with two or more employees had to make at least one federal tax deposit a year. Now employers with eight employees or fewer will be freed from the requirement of making as many as four FUTA deposits per year.

FAMILY LIMITED PARTNERSHIPS DRAW IRS SCRUTINY

A family limited partnership (FLP), like other limited partnerships, is a form of business consisting of one general partner and one or more limited partners. In an FLP, however, the individuals involved usually are members of different generations of the same family. One of the advantages of a well-executed FLP is a reduction in federal estate and gift taxes. Instead of transferring assets directly to beneficiaries, an individual may transfer interests in a limited partnership. Since interest in an FLP is not marketable and since a limited partner does not control management of the enterprise, the value of interests in an FLP usually can be discounted by anywhere from 25% to 50%, with a corresponding reduction in tax liability.

As with many transactions among family members, the IRS has a history of casting a skeptical eye on FLPs. Essentially, the IRS is intent on assuring that the tax advantages of any particular FLP are not the be-all and end-all for its existence. If the FLP is deemed to be a sham, the IRS may challenge the valuation discount and perhaps even the very existence of the partnership.

In one recent case, a federal appeals court found an FLP to be legitimate despite some circumstances that had aroused IRS suspicion. A 96-year-old woman put about $2.5 million into an FLP, keeping $450,000 for her personal expenses. She died two months later. The fact that the transfer included interests requiring active management and that no personal assets, such as a house or car, were involved weighed in favor of the FLP. Also, the person making the transfer into the FLP did not manage the FLP. Perhaps most importantly, oil and gas operations provided an essential legitimate business purpose for the FLP.

In another case that was similar in many respects, including the age of the individual transferring the assets to the FLP, the assets were found to be subject to the estate tax because the FLP had not been formed for a valid business purpose. Transactions made by the FLP never went outside the family circle and amounted to financing the needs of individual family members.

Emerging from the cases are a few rules of thumb for setting up and running an FLP so as to realize its tax benefits without attracting the attention of the IRS:

* Articulate real business reasons for the FLP that can be substantiated by persons outside the FLP;
* Do not let the person transferring assets into the FLP transfer all of his or her assets or use the FLP to pay personal expenses;
* Assign control over the FLP to a general partner who is not the same person who funded the FLP. Often the general partner is an entity, such as a limited liability company;
* Have some "actively" managed assets in the FLP; and
* Follow the formalities for setting up and operating the FLP, including separate accounts and scrupulous adherence to formal accounting practices.