

**MULTIPLE-UNIT FRANCHISING:
THE KEY TO RAPID SYSTEM GROWTH**

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Editor and Author

Published By

DLA Piper Rudnick Gray Cary US LLP
1775 Wiehle Avenue, Suite 400
Reston, Virginia 20190
703-773-4000

Distributed By

International Franchise Association
1501 K Street, NW, Suite 350
Washington, DC 20005
202-628-8000

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ACKNOWLEDGEMENTS

Multiple-Unit Franchising: The Key To Rapid System Growth is based upon and reprints, in part, a series of five articles first published in 1986 and 1987 in Franchise Legal Digest. The editor and author gratefully acknowledges the assistance of the following four attorneys, each of whom, as associates at Brownstein Zeidman and Schomer, co-authored with him one article in the original series: Mark A. Kirsch (re "Area Representation"), Andrew P. Loewinger (re "Subfranchising"), David W. Renz (re "Area Development"), and Frederick F. Simmons, Jr. (re "Franchise Brokerage").

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CHAPTER I

INTRODUCTION

A variety of terms have been used to describe the techniques in franchising known and described below as area development, subfranchising, area representation, and franchise brokerage. The most common of these terms are “multiple-unit franchising,” “multiple franchising,” “multi-tier franchising,” and “master franchising.” Close analysis of these terms indicates that perhaps the term “multiple-unit franchising” is the most appropriate to describe all of these techniques.

The term “multiple-unit franchising” recognizes the common goal of these techniques to establish relationships which provide for the opening of more than one unit. “Multiple franchising” does so as well, but is less precise as it does not specify the item to be multiplied. The term “multi-tier franchising” appears to provide an inadequate description because it fails to recognize the distinction between ordinary franchisee-franchisor relationships, which are two-tier in nature, and area development relationships (described below), which are also two-tier in nature. The term “master franchising” could be used to identify the techniques but may not be the best choice because it describes neither the common goal of the techniques to establish multiple-units, nor the structure of the relationships which are established. Thus, the term “multiple-unit franchising” will be used to refer to the group of techniques identified above.

A. Overview

The common goals of multiple-unit franchising are to establish many units with **speed**, to **leverage** both money and personnel by relying upon another person’s resources, and to obtain a **local presence**. These goals recognize the following potential **advantages** of multiple-unit franchising:

- Opportunity for extremely rapid development.
- Use of another person’s financial and human resources.
- Shared risk with another person.
- Opportunity to consult with another person who has certain shared interests.
- Added source of ideas.
- Potential for rapid cash flow from sale of multiple-unit franchise rights.
- Increased local credibility.
- Increased knowledge of local conditions.

- Added knowledge of local competition and ability to tailor programs to meet such competition.

Multiple-unit franchising also has its disadvantages, including the following:

- Loss of control to another – potentially large and powerful – person.
- Potentially more difficult to manage and lead the other person.
- “Giving it all away” – a significant portion of the revenue may no longer flow to the franchisor.
- Vicarious liability for acts by the other person.
- Potential limitations on the franchisor’s ability to enforce its franchise agreement, especially where the franchisor is not a party to the agreement.
- Complexity of the required agreements and the interrelationship of several required agreements.
- Complexity regarding the required content of disclosure documents and the procedures for registration.

As a matter of caution, it should be noted that, while multiple-unit franchising is a clear trend and a source of success for many franchisors, it is not recommended for all franchisors. The reasons for this may relate to one or more of the disadvantages listed above, to corporate goals or philosophies, to business exigencies, or to timing. Multiple-unit franchising may be appropriate for a franchisor at one point in its life cycle, but not at another point. For most franchisors, for instance, it is recommended at an early stage of development, in order to encourage initial growth at a rapid rate. A mature franchisor who has utilized multiple-unit franchising, often regrets having granted rights which the franchisor wishes it had retained. In such cases, in fact, franchisors sometimes attempt to repurchase previously granted rights. Franchisors often will utilize a combination of techniques, or a multiple-unit franchise technique in some territories but not in others.

B. Area Development

Area development is a technique whereby the franchisor grants to an entity (the “area developer”) the right, and the area developer undertakes the obligation, to establish and operate more than one unit within a specified territory. The area developer may pay a development fee for the right to have territory set aside for its development and, generally, must adhere to a schedule for development. Individual franchise agreements ordinarily will have to be entered into for each unit to be developed, and a portion of the development fee may be credited toward the initial franchise fee payable under each

franchise agreement.

Under this technique, the area developer must have the financial and managerial capability to develop multiple units itself. Ordinarily, subfranchising, as that term is used below, is not permitted. The area development arrangement may be structured, however, so that the area developer has the right, for example, to have the individual units owned and financed by limited partnerships in which the area developer is the sole general partner.

Area development has potential for rapid growth with shared risk. The pace of growth may not be quite as rapid as the subfranchising and area representation techniques described below, however, and will depend upon the financial and managerial resources of the developer. If structured properly, area development can increase a franchisor's revenues through both initial development fees and increased franchise fees and royalties.

On the downside, area development has the potential to create large and powerful counterparts who may demand concessions of both an economic and business nature. A franchisor also risks "freezing" an area by misjudging the potential number of franchises which can be established in that area. The required agreements can be complex, and the disclosure implications significant.

C. Subfranchising

Subfranchising is a technique whereby a franchisor grants to another person (the "subfranchisor") the right, in a specific territory, to exercise powers normally reserved to the franchisor. The subfranchisor may be an existing franchisee or, in some systems, a person unrelated to the system. Some franchisors will require their subfranchisors to operate at least one unit, while other franchisors will prohibit the subfranchisor from engaging in such activities. The subfranchisor ordinarily has the right to offer and sell franchises (sometimes subject to a schedule or quota), to sublicense the use of the franchisor's trademark, to collect franchise fees, and to provide certain services to franchisees. Generally, the subfranchisor undertakes services of a regional or local nature, while the franchisor assumes broader responsibilities such as national advertising and annual conventions.

The subfranchisor signs a subfranchise agreement with the franchisor. The subfranchisor also enters into franchise agreements with franchisees. The form of franchise agreement is generally provided or approved by the franchisor, although in some cases the subfranchisor has wide latitude as to the form of franchise agreement which is used. The franchise agreements also may be signed by the franchisor, or the franchisor may be a named third party beneficiary in such agreements.

A subfranchise agreement will delineate the portion of fees which will be retained by the subfranchisor and the portion which will be paid to the franchisor. In some cases, the subfranchisor may retain a majority of the fees. Also, in some cases, subfranchisors are granted rights to purchase individual franchises – often at reduced fees.

Subfranchising has the potential for extremely rapid expansion. It also benefits from most of the advantages listed above. It is in disfavor among many franchisors, however, because it also suffers from most of the disadvantages listed above, especially those related to loss of control (primarily due to the insertion of an additional and independent entity between the franchisor and franchisee) and to registration and disclosure complexities.

D. Area Representation

Recognizing some of the disadvantages of subfranchising, the concept of area representation has developed. In an area representative arrangement, the so-called “area rep” is given the right to solicit prospective franchisees, and to provide certain services to existing franchisees, in a stated territory. Unlike the case in subfranchising, however, the area rep has no right to contract with franchisees. All franchise agreements are entered into directly between the franchisor and the franchisee. In this fashion, the franchisor assumes all responsibilities to the franchisee, but delegates some of those responsibilities to the area rep. For example, the area rep, in addition to soliciting for prospective franchisees (which is, ordinarily, subject to a schedule or quota), might have responsibilities for training franchisees, periodic inspections, local or regional advertising, and periodic consultation.

As the franchise agreements are entered into directly between the franchisor and the franchisee, the initial franchise fees and royalties are paid directly to the franchisor. The franchisor might charge the area rep for the right to solicit and service within the territory. In turn, the franchisor will pay the area rep a portion of the initial franchise fees as compensation for soliciting prospective franchisees, and a portion of the royalties as compensation for servicing franchisees.

The primary advantage of the area representative approach is that the franchisor retains direct control over franchisees by contracting directly with them. While the franchisor retains responsibility for servicing franchisees if the area rep can no longer (for whatever reason) do so, this increased responsibility, when compared to subfranchising, generally is viewed as a small price to pay for increased control. Another advantage of the area representative approach is that, because the area rep is not contracting directly with franchisees, less disclosure may be required concerning the area rep in the offering circular furnished to prospective franchisees than would be the case with the subfranchise approach discussed above. Also, depending upon whether the area rep pays for the acquisition of area representative rights, the area rep may or may not be acquiring a “franchise,” as that term is defined under the FTC Rule and state franchise laws, for which registration is necessary and disclosure must be furnished.

Despite these advantages of the area representative approach, as compared to subfranchising, the area representative approach is not without its costs. Some of the disadvantages discussed above are common to the area representative approach, including the potential to give away a significant portion of the revenue, vicarious

liability concerns, the complexity of agreements, and the complexity of registration/disclosure issues. Thus, franchisors should not undertake the area representative approach without adequate thought, analysis, and guidance.

E. Franchise Brokerage

Franchise brokerage is a technique in which the franchisor retains a third party (the “franchise broker”) to solicit prospective franchisees on behalf of the franchisor. A number of franchisors rely upon outside franchise brokers, wholly or partially, for the sale of franchises. In addition, a subfranchisor and an area rep are likely to be franchise brokers under both federal and state franchise laws.

Franchise brokerage can relieve a franchisor from many of the burdens of the franchise sales process and increase the pace of franchise sales. However, franchise brokerage also can result in loss of control over one of the most vital aspects of the franchise relationship – the sales process. This is a point at which the franchisor’s potential liability is high and at which the franchisor needs to exercise discretion over prospective franchisees in order to assure the quality of its system. While these types of concerns can be addressed in a franchise brokerage agreement, such an agreement must, of necessity, be carefully drafted and complex. Disclosure also can be complex, and must be considered carefully in the franchise brokerage context. While a number of franchisors do utilize franchise brokers, others have weighed the issues and opted for reliance only upon employed franchise salespersons (whether on a salary, commission, or both).

CHAPTER II

AREA DEVELOPMENT

A. Introduction

Area development is a technique whereby a franchisor grants to an entity, the “area developer,” the right, and the area developer undertakes the obligation, to establish and operate more than one franchised unit within a specified territory. Under this technique, the area developer must have the financial and managerial capability to develop multiple units itself. Ordinarily, subfranchising is not permitted, although the agreement may be structured to permit ownership of the individual units by separate legal entities under the common control of the area developer.

Area development benefits from a number of the advantages, and is subject to some of the disadvantages, which are generally applicable to multiple-unit arrangements. These advantages and disadvantages are examined first. This chapter then considers some of the principal issues which must be addressed in an area development agreement, including the grant of territorial rights and exclusivity, the schedule for exercising the development rights, transfer of area development rights, and termination of the relationship. Finally, this chapter discusses the application to the area development approach of federal and state laws which require registration and/or disclosure in connection with the offer and sale of franchises.

B. Advantages and Disadvantages of the Area Development Technique

1. Advantages

One of the principal advantages of the area development approach is that it permits a more rapid development of the franchise system than would single unit sales. Although the pace of development may be less rapid than with other forms of multiple-unit development (where the franchisor may use third-parties to assist in soliciting and selling franchises), area development provides the franchisor with more control over the pace of development because all sales activity is conducted by the franchisor. By maintaining control over the pace of development, the franchisor can limit the risk of over-extending its financial and administrative resources. Moreover, by handling the soliciting and selling of franchises, the franchisor avoids the potential increased liability which exists when third-parties undertake these activities for the franchisor.

Area development also may attract larger, more sophisticated investors. Over time, such developers may require less support from the franchisor as they draw on the experience gained in opening the initial franchised units. Larger developers often are

able to contribute ideas and improvements that provide substantial benefit to the entire franchise system. Area development also can encourage more coordinated development of natural markets by limiting the number of participants in each market.

Area development also may benefit the franchisor financially. Generally, a separate fee is charged for the right to the area or territory, and this fee is often substantial. (The franchisor may not be permitted to recognize the entire development fee as income, however, at the time it is received. *See* Section C.4.a., below.) In addition, the accelerated development of individual franchise units can mean that royalty revenue from franchisees will grow more quickly, thus improving the franchisor's cash flow.

2. Disadvantages

Area development suffers from two principal weaknesses. First, area developers have more power over the franchisor, because they control a proportionally larger number of units in the system and are often as financially strong as the franchisor. The loss of a major area developer may have a significant financial impact on the franchisor, both directly, due to the loss of royalty income, and indirectly, through the loss of a significant presence in an important market. Also, the franchisor's ability to control the area developer through litigation, or the threat of litigation, often is diminished due to the financial strength of the area developer.

Second, under some circumstances, area development actually may hinder rapid development, by "freezing" development in large or significant territories. For example, the market may be capable of absorbing new franchise units more quickly than the parties anticipated. Generally, the franchisor cannot require the area developer to accelerate the pace of development required by the development schedule. Another problem arises when the area developer retains exclusive rights to the territory after completing the development schedule, and declines to develop further units to meet additional demand. This issue should be dealt with in the development agreement. (*See* Section C.2., below.) Finally, development of a territory may be delayed by the default of an area developer, especially where the area developer fails to meet even the initial requirements of the development schedule. The time required to obtain a new area developer, and the additional lead time required for the first unit, will further delay development of the territory. These delays will be particularly costly if, in the interim, competitors obtain the best locations in the territory.

Area development is not subject to a number of the disadvantages common to the other types of multiple-unit franchising. Because there is a direct relationship between the franchisor and the area developer, with no intermediate party, all of the revenue from initial fees, royalties, and advertising charges will flow to the franchisor. The risk of vicarious liability for representations by others is limited, because the franchisor, or its employees, negotiate directly with the area developer. The franchisor is a party to the franchise agreements executed pursuant to the development agreement, and therefore retains all rights to enforce those agreements. Finally, the

development agreement can be readily incorporated into the disclosure document used in connection with the individual franchise agreement, thus minimizing the effort required to comply with state and federal laws applicable to franchise offers and sales.

C. Significant Elements of the Area Development Agreement

1. The Grant of Development Rights

A typical development agreement will grant the franchisee the right to develop a certain number of franchise units within a specified territory, and within a given period of time. Usually the franchisor agrees not to grant to another franchisee the right to develop franchise units within the territory while the development agreement remains in force. This grant of exclusivity is the most important obligation of the franchisor under the development agreement. For its part, the area developer agrees to have in operation increasing numbers of franchise units at different dates in accordance with a development schedule specified in the development agreement.

a. Ownership of Franchise Units

Some area developers will syndicate the development of individual units. One common approach to development is for the area developer to form separate limited partnerships or corporations for each franchise unit, with the area developer acting as general partner of each partnership, or principal shareholder of each corporation. (This type of syndication is likely to be a form of subfranchising and subject to subfranchising's limitations, including the often difficult-to-comply-with registration and disclosure obligations. The subfranchising approach to multiple-unit development will be explored in Chapter III.) Franchisors should consider whether such syndication is to be permitted, and if so, what restrictions should be placed on the area developer's interest in each entity formed. In addition, the solicitation by the area developer of limited partners or shareholder/investors may invoke federal and state securities laws. To assure that the franchisor's role in such offerings is not misrepresented, the development agreement should provide the franchisor with an opportunity to review and approve any prospectus or other materials prior to their filing with any agency, if required, or prior to delivery of the materials to any prospective investor.

b. Control of Franchise Units

The development and operation of the individual franchise units may be governed by a single agreement, or the franchisor may use a single agreement to govern the development of all units and separate individual agreements for the operation of each unit. There are severe disadvantages to using a single agreement. Principal among these, according to most franchisors, is that a single agreement locks in the terms applicable to each franchise unit throughout the entire period of development. During that time, the franchisor is likely to have modified its franchise agreement to reflect changes in its system. Most franchisors prefer to have the development agreement provide for each new franchise unit to be operated under the then-current form of

franchise agreement being offered to new franchisees of the system. This approach also may be preferable from the standpoint of compliance with state and federal registration and disclosure laws. (See Section D.I., below.) Moreover, even if a franchisor wanted to lock-in the terms applicable to all franchise units to be developed, it could do so by providing in a separate development agreement for each franchise unit to operate under the form of franchise agreement in effect at the time the development agreement was signed.

There are additional advantages to using a separate franchise agreement, whether the then-current form or the form in effect at the time the development agreement is executed. First, if it becomes desirable or necessary to transfer individual franchise units, only the franchise agreement need be transferred; otherwise, a separate agreement would have to be prepared for the transferred unit and the former development agreement would have to be modified. Second, separate agreements provide more flexibility to respond to defaults at individual units. If desirable, only the agreement applicable to the unit in default need be terminated. Other units, which may be in full compliance, would not be affected. Although the same result perhaps could be accomplished by amending a single development agreement, that approach is apt to be cumbersome. (*Note:* Due to the advantages of, and common approach to, using a development agreement and separate franchise agreements, this chapter assumes that this approach is taken by a franchisor.)

2. The Development Schedule

The development schedule sets forth the parties' agreement regarding the pace at which development will take place. Typically, the area developer will be required to meet certain goals by designated dates. The goals may be based upon such measures as franchise agreements executed, units open and operating, or units substantially under construction. The phrase "substantially under construction" typically is defined with reference to the amount spent on construction, in which case the development agreement should state what types of expenditures will be included in determining such amount. These expenditures may include the cost of locating the site, fees for approvals and permits, architectural fees, materials, costs, and wages. In addition, it should be clear whether open units which are subsequently closed will be counted toward completion of the development schedule.

3. Term and Renewal

The purpose of the development agreement is to provide for the opening of a fixed number of franchise units within a specified period of time. Accordingly, development agreements, and the area developer's exclusive rights to the territory, often expire on the date the area developer successfully completes the development schedule; that is, opens the final franchise unit which it is obligated to develop. Under this approach, however, an area developer which completes its development obligation ahead of schedule is penalized by the early loss of his exclusive rights to the territory.

This "penalty" may be avoided through careful drafting of the

development agreement. First, the term of the area developer's exclusive rights could expire on the last day of the development schedule specified in the development agreement, without regard to whether the last unit is opened before that time. A variation on this approach would grant the area developer an option, to be exercised upon the early completion of its development schedule, to develop additional franchise units. This option would expire on the date by which the area developer was obligated to complete the development schedule. This approach would provide an incentive for early completion of the development schedule and may encourage additional development.

Finally, the agreement may provide the area developer with a right of first refusal as to any additional development proposed by the franchisor for the area developer's territory, including:

- As to any additional franchise agreements offered by the franchisor;
- As to any additional development agreements offered by the franchisor; or
- As to the then-current franchise agreement with regard to any unit which the franchisor proposes to establish as a company-owned unit.

The right of first refusal may begin either on the date on which the area developer successfully completes the development schedule, or on the date by which development must be completed. The right of first refusal may be effective for a specified period of time (regardless of the number of opportunities presented to the area developer for the exercise of the right of first refusal), or may, for example, expire once the area developer rejects a single opportunity to exercise the right of first refusal.

The franchisor may prefer to offer rights of first refusal rather than options for further development because the right of first refusal approach permits the franchisor to initiate further development (either by soliciting other franchisees or with company-owned units), even if the area developer decides not to develop additional units. The existence of a right of first refusal, however, often has a chilling effect on offers to third parties, who may be reluctant to negotiate a serious offer which is subject to a right of first refusal. A franchisor which offers a right of first refusal needs to recognize that this chilling effect may significantly hinder the franchisor's ability to initiate further development while the area developer retains its right of first refusal.

4. Fees and Charges

a. Development Fee

The development agreement typically will specify a development fee to be paid by the franchisee for the development rights granted by the franchisor. The development fee should compensate the franchisor for holding open the development territory and for such services as are provided under the development agreement.

The development fee may be structured in several ways. The franchisor should be aware that the structure selected may affect the extent to which the franchisor is allowed to recognize the entire development fee as income when received, as opposed to when each individual franchised unit is opened (an issue which may be especially significant for a franchisor if there is a significant period of time between the signing of the development agreement and the opening of units there under). While there are presently no precise guidelines in this area, a number of factors have emerged as relevant. For example, recognition of the development fee may depend upon whether the franchisor charges a lump sum development fee as opposed to a fee based upon the number of units to be developed. Also, where a separate franchise agreement is used, and a separate franchise fee is charged, it may be relevant to consider whether the franchisor provides for all or a portion of the development fee to be credited toward the fee due for each franchise unit. In general, the franchisor is more likely to be required to defer recognition of income where the revenue can be characterized as directly attributable to the individual franchise units.

It also appears that, where a portion of the development fee is attributable to services to be performed for each individual franchise unit, the franchisor may not be permitted to recognize the development fee, or at least the portion of the development fee which is attributable to a unit, until the unit is open. This restriction could apply, for example, to site selection and approval services offered by the franchisor under the development agreement. It may, therefore, be desirable to provide for these services in the franchise agreement or, for example, in a separate site selection agreement. In the face of the uncertainty as to the proper accounting procedures in this area, however, any guidelines are of somewhat uncertain utility.

b. Individual Unit Fees

The franchisor must determine whether to establish the initial franchise fees, royalty fees, and advertising contributions in advance, or at the time each franchise unit is developed. The franchisor should consider a number of factors, including the term of the agreement, the number of units involved, and market conditions. (In addition, state and federal franchise laws must be considered. *See* Section D. I., below.) The longer the term of the development agreement, the more likely it is that the fees specified at the time the development agreement is signed will be inadequate to meet the franchisor's needs when the last few franchise agreements are executed. Where a large number of units are to be developed, the franchisor may project that subsequent franchise units will cost less to open, due to increasing area developer experience. These reduced costs may justify lower fees for subsequent units. Alternatively, the franchisor may want to "guarantee" the amount of the fees to be charged for each franchise unit in order to make the development agreement more marketable. The franchisor's own growth plans also may influence the decision of whether to establish in advance the fees to be charged for each franchise unit. Retaining control of the franchise fees charged on individual units can be of great importance to a franchisor anticipating rapid growth due to the accompanying need for capital to expand and service the growing franchise system.

The franchisor also may establish some fees at the time the development agreement is signed, while reserving the right to charge other fees based upon the then-current rates being charged to new system franchisees at the time each unit is established. Thus, the franchisor may lock-in the initial franchise fee charged upon the exercise of each development right, but retain the right to require the then-current royalty and advertising fees. Whatever the franchisor's decision, it should be clearly expressed in the development agreement.

5. Site Selection and Construction

Where separate franchise agreements are used for the development of individual franchised units, the provisions governing site selection for, and construction of, each unit may be contained in either the development agreement or the franchise agreement, or may be split between the two agreements. Depending on the approach chosen, the development agreement generally will require that the franchise agreement be signed either prior to site selection, prior to construction, or prior to opening.

Including the site selection and construction provisions in the development agreement may avoid unnecessary repetition in the individual franchise agreements. This approach also may be appealing where the franchisor's site selection process requires some territory-wide review of potential sites, in addition to review of individual sites. Accounting considerations, however, may argue against including these provisions in the development agreement. (*See* Section C.4.a., above).

Alternatively, if these provisions are included in the franchise agreement, and the area developer is required to execute the then-current form of franchise agreement for each unit, the franchisor may impose the current requirements for site selection and construction on the area developer for each unit. Whether such flexibility is necessary is questionable, because the franchisor's general procedures for evaluating and approving sites, and the procedures governing construction, are unlikely to change fundamentally over time. Instead, those changes which are made are likely to be implemented through the use of separate site evaluation forms and construction procedures set forth in the operations manual, to which the development agreement can refer.

6. Transfer

The primary issue to be addressed by the transfer provisions of the development agreement is the extent to which the area developer will be permitted to dispose of the development rights and the franchise units developed pursuant to the development agreement. The limitations imposed typically will take the form of requirements which must be met as a condition to obtaining the franchisor's consent to a transfer.

The development agreement may grant the area developer substantial freedom to "sell off" some or all of the development rights to entities in which the area

developer has no ownership interest. Such an arrangement is akin to subfranchising, and raises the considerations associated with subfranchising which will be explored in Chapter III, "Subfranchising." At the opposite extreme, the development agreement may prohibit the transfer of any development rights, or interests in franchise units developed pursuant to the development agreement, unless all of the area developer's rights and established units are transferred together. This approach might be favored by a franchisor which wants to deal only with a few major area developers, rather than a multitude of operators of one or a few units. Some franchisors also believe that a single operator can better coordinate development of certain natural markets, such as the advertising in a single Area of Dominant Influence. Requiring transfer of all rights under the development agreement will limit the fragmentation and uncoordinated development of natural markets. Typically, however, most franchisors do not reach this extreme and impose only such requirements as are necessary to assure that a transferee acquiring a significant or controlling interest in the area developer, or in the development agreement, meets the minimum qualifications required by the franchisor for new area developers.

7. Default

The development agreement principally will provide for default in the event of an area developer's failure to meet the development schedule. Other defaults may include bankruptcy, disclosure of confidential information, and violation of covenants not to compete.

The development agreement may expressly provide the franchisor with alternative remedies in the event of default. Thus, the agreement may authorize the franchisor to:

- reduce the size of the assigned territory;
- reduce the number of development rights granted;
- accelerate the development schedule; or
- delay the development schedule.

Specifying alternative remedies is a flexible approach to dealing with defaults under the development agreement. Some franchisors may choose, however, to provide expressly only for termination of the development agreement, believing that the threat of termination will deter defaults and that, in the event of default, if the franchisor has the right to terminate, some lesser remedy may be imposed when justified by the circumstances.

It is noteworthy that most franchisors provide for termination as the only remedy under the development agreement, and never seek additional remedies in the event of default for failure by the area developer to satisfy the development schedule under the development agreement. In this fashion, a development agreement may be

viewed as more of an “option” agreement than of a contract as to which the franchisor may seek specific performance and/or damages. While the franchisor’s decision to forego additional remedies may be appropriate in given circumstances, this decision need not be made at the time the development agreement is entered into, and franchisors should consider providing for additional remedies in the event of breach by the area developer under the development agreement.

The franchisor also must consider whether a default under the development agreement should constitute a default under the franchise agreements and other development agreements. Similarly, some franchisors provide that a default under one or more franchise agreements is a default under the development agreement. Such “cross-default” provisions appear logical when applied in the case of defaults under a franchise agreement. The franchisor should not be required to grant additional franchises to an area developer who cannot properly operate its existing franchises. There seems less justification, however, for providing that default under a development agreement creates a default under all of the area developer’s franchise agreements. In many cases, the default will have no relationship to the area developer’s ability to continue to operate successfully its existing franchises. Moreover, the courts are reluctant to permit a franchisor to take away a franchisee’s business, especially where the default under the development agreement is limited to failure to meet the development schedule. (In at least one state, Virginia, the franchise administrators will not register a development agreement which permits the franchisor to terminate the underlying franchise agreements solely due to a default under the development agreement, although default under the franchise agreement is a permissible ground for termination of the development agreement.)

D. Registration and Disclosure Requirements

The area development approach raises issues under both the FTC Rule and the state laws which regulate the offer and sale of franchises. The issues relate to whether registration is necessary, and disclosure must be furnished, in connection with the execution of both the development agreement and individual franchise agreements. The issues also relate to the contents of the disclosure documents.

1. Registration and Disclosure

The sale of area development rights involves two types of transactions; (a) the sale of the area development rights, pursuant to a development agreement, and (b) the sale of the franchise rights for individual units, pursuant to separate franchise agreements. Each type of transaction must be examined separately under the registration and disclosure laws.

a. Development Agreement

As indicated in Section C.7., above, the development agreement

may grant the area developer either an option to acquire a franchise, or the right and obligation to do so. Even when the development agreement only grants an option to acquire individual franchises, it is itself considered a franchise under the FTC Rule. In an advisory opinion issued to *Real American Real Estate Corp.*, Bus. Fran. Guide (CCH) ¶ 6428 (Apr. 9, 1982), the staff of the Federal Trade Commission advised that disclosure is required to be furnished in connection with the grant of an “option” to acquire franchise rights, not just in connection with the obligation to establish franchises. While there is no comparable state law pronouncement, the FTC Rule preempts state disclosure requirements. In this fashion, it is generally recognized that registration of all development agreements is necessary, and that disclosure must be given in connection with the offer or sale of a development agreement.

b. Individual Franchise Agreements

It is generally not clear whether disclosure is required with respect to each franchise agreement entered into under a development agreement. A few states (Hawaii, Maryland, Michigan, and New York) have exemptions for sales of additional franchises to existing franchisees. In these states, registration and disclosure may not be necessary in connection with the execution, pursuant to a development agreement, of individual franchise agreements. (With respect to the first franchise agreement, we are assuming that the disclosure document furnished in connection with the execution of the development agreement also contained disclosure of the franchise agreement.) In the majority of states, however, the law is not clear. Also, the FTC advises that, when franchisees exercise rights under existing agreements to establish new outlets for themselves, it will employ a flexible standard to determine whether disclosure is needed based upon the extent to which the disclosure will assist in making an informed decision. On this basis, it also may be difficult to determine when disclosure is necessary in connection with the execution of a franchise agreement.

There are a number of factors to analyze in considering whether registration and disclosure **should** be required in connection with the execution of individual franchise agreements signed pursuant to a development agreement. For example, one might argue that if the area developer is **obligated** to open the franchise unit, disclosure is not useful because there is no choice to be made which the law should recognize, *i.e.*, the only choice is whether to breach the development agreement. Conversely, where the area developer has the **option** to open additional units, disclosure is likely to be useful in making a decision. In addition, disclosure might be appropriate where the area developer has brought in additional investors who did not previously receive disclosure, but who will be acquiring an interest in a franchise – especially if that interest is significant.

The development agreement might require each franchise unit to be operated pursuant to the form of franchise agreement in effect at the time the development agreement was signed. Under these circumstances, one might argue that the franchisee received full disclosure at the time the development agreement was signed (assuming, of course, that disclosure was provided as to both agreements), and therefore

further disclosure is merely repetitive. Only part of the disclosure relates to the agreements, however – the rest contains information about the franchisor, such as financial information and litigation history, which may be material to the franchisee. The difficult issue here is whether, assuming that registration and disclosure are required, the disclosure document must contain information on the actual form of franchise agreement to be executed. If so, registration and disclosure burdens are potentially enormous, as the franchisor may need, at any given time, an effective registration and disclosure document which relates to all forms of franchise agreements which the franchisor has used in the past and which area developers may be entitled to execute. To avoid this potential burden, and for other reasons as well (*See* Section C.I.b., above), most franchisors provide only for execution of the then-current franchise agreement pursuant to a development agreement. If the development agreement requires the area developer to sign the then-current form of franchise agreement being offered to new system franchisees, the new terms, coupled with potentially new factual information about the franchisor, may make the case for registration and disclosure far more compelling, but far less burdensome as well.

2. Disclosure Documents

In theory, separate disclosure documents could be used for the development agreement and for individual franchise agreements. As a practical matter, however, separate disclosure documents are not required and the development agreement may be included with the disclosure concerning the franchise agreement. As the area development approach contemplates that the area developer and the franchisee will be the same person, having both agreements in a single disclosure document is unlikely to confuse the area developer/franchisee. This situation can be contrasted with, for example, a subfranchise arrangement in which the franchisee might be confused if furnished with a disclosure document containing not only the terms of the franchise agreement he will sign, but also the terms of the agreement between the franchisor and the subfranchisor.

To a slight extent, therefore, the area development approach will increase the franchisor's burden in preparing a disclosure document. Also, in some states, it will be necessary to make changes to the disclosure document and to the development agreement to conform those documents to the requirements of state law and to administrative requirements. In general, these increased burdens will be modest.

E. Summary

The area development approach should be carefully considered by any franchisor contemplating multiple-unit development. This approach can provide many of the advantages, including more rapid growth, and few of the disadvantages, common to multiple-unit development, while enabling the franchisor to retain substantial control over the pace and direction of development. The principal disadvantage of this approach, increased registration and disclosure burdens, can be minimized through careful planning and design. For many franchisors, then, the area development approach will be the

method of choice for multiple-unit development.

CHAPTER III

SUBFRANCHISING

A. Introduction

Subfranchising is an arrangement whereby a franchisor grants to an entity (herein called the “subfranchisor”) the right, and the subfranchisor undertakes the obligation, to grant to others the right to establish and operate franchised units within a specified territory. Under this technique, the subfranchisor is given the right to sell and grant franchises to individual franchisees. It is this characteristic of granting the subfranchisor the right **to contract** with individual franchisees which most distinguishes subfranchising from other types of multiple-unit franchise arrangements. The subfranchisor, in large part, assumes the role of a franchisor in a specified territory, and provides much of the assistance to franchisees in that territory which normally would be provided by the franchisor. Frequently, the subfranchisor is also permitted the right to develop some of the franchised units itself. This chapter does not deal with issues arising out of the subfranchisor’s right to establish its own units (as this was dealt with in detail in the previous chapter on the area development approach), except where this right affects the subfranchising arrangement.

Although subfranchising originally was conceived as a method for expansion in the United States, it is no longer the preferred means of expansion in this country. In international franchising (sometimes, in the international context, called “master franchising”), however, an increasing number of franchisors are relying on subfranchising, with apparent success. Domestically, subfranchising enjoys a few of the advantages, but suffers many of the disadvantages, associated with multiple-unit arrangements. This chapter first examines these advantages and disadvantages. The chapter then considers some of the principal contractual issues which must be addressed, particularly with regard to the agreement between the franchisor and the subfranchisor. Finally, this chapter discusses the application to domestic subfranchising of federal and state laws which require registration and/or disclosure in connection with the offer and sale of franchises.

B. Advantages and Disadvantages of Subfranchising

The advantages and disadvantages of subfranchising vary somewhat between domestic subfranchising and international subfranchising. Thus, in our discussion of advantages and disadvantages, a comparison is sometimes provided of considerations in international subfranchising.

1. Advantages

Domestic subfranchising has two main advantages. First, subfranchising enables a franchisor to achieve more rapid development of the franchise system than possible through single unit sales. This is because in a subfranchising arrangement, the franchisor may have several subfranchisors who will each solicit, sell, and grant franchises. Under no other form of multiple-unit development does a franchisor delegate so much power and responsibility to a third party. Such delegation is likely to lead to a loss of control and related problems, however, as discussed below under “Disadvantages.”

Second, subfranchising frees up the franchisor’s resources more than do single unit sales. This is because the franchisor uses another party’s resources to perform certain services the franchisor otherwise would have to perform. As a result, the franchisor’s administrative burden – and, correspondingly, administrative costs – may be substantially reduced. (As noted below, however, under “Disadvantages,” the franchisor’s decreased costs may be offset by income lost from the sharing of fees with the subfranchisor.) As in common under area development arrangements, a separate and substantial initial fee may be charged for the right to subfranchise an area or territory. The franchisor also may enjoy some initial financial benefit from the grant of exclusive subfranchise rights in a territory. Accelerated development of individual subfranchised units is also likely to translate into increased royalty revenue, as the number of units may grow more quickly than under other franchise arrangements. Such royalties may have to be shared with the subfranchisor, however, as discussed below under the subheading “Disadvantages.”

In international expansion, the advantages described above exist, along with others. Frequently, franchisors considering international expansion consider subfranchising as among several alternatives (*e.g.*, establishment of company-owned units, grant of individual or multiple-unit franchise rights, or use of joint venture partner). Subfranchising offers several advantages over these means of expansion. First, use of a foreign subfranchisor spreads the franchisor’s risk, by using another party’s resources where, due to the distance, it might otherwise be too costly for the franchisor to develop units itself, to franchise on a one-by-one basis, or to enter into a joint venture arrangement. Second, subfranchising offers considerable flexibility (particularly when coupled with the right of the subfranchisor to establish units itself). Third, subfranchising permits rapid expansion in a foreign country by a party who usually has a keener knowledge of local economic and market conditions, a stronger local presence, and greater local credibility. Fourth, foreign subfranchisors are particularly useful as a source of ideas and know-how both to adapt the system to the local conditions in the host country and to provide innovations in the system as a whole. Fifth, the initial financial benefits to franchisors may be greater internationally than domestically. As franchisors often grant the subfranchise rights for an entire country, the rights usually sell for a substantial fee. (While the advantages described above may, in some cases, exist domestically as well, they are clearly amplified in an international setting.) Finally, as discussed in Section D., below, subfranchising on an international scale does not involve the registration and disclosure difficulties and complexities which exist domestically.

2. Disadvantages

Domestic subfranchising suffers from four significant weaknesses. First, franchisors customarily must share fees with subfranchisors, and therefore lose revenue and income. Under most subfranchising arrangements, subfranchisors retain a percentage of initial and ongoing fees received from franchisees. Such a loss of revenue can retard the growth of the franchisor and reduce the franchisor's cash flow, notwithstanding the lower per unit costs of selling and servicing individual franchises which result from the subfranchisor's assistance.

Second, for a variety of reasons, franchisors inevitably lose considerable control through use of the subfranchise arrangement. One reason is that subfranchising inserts a third party between the franchisor and the franchisee. Subfranchisors do not always make decisions, or monitor compliance with the franchise agreement or the franchise system, in the same way as would the franchisor. In addition, under the structure of many subfranchising arrangements, franchisors have only limited power to control certain provisions of the subfranchise agreement between the subfranchisor and the franchisees, as the franchisor may not be a party to the franchise agreement with the franchisees. While efforts have been made to deal with this difficulty through the use of three-party agreements, through reference to the franchisor as a third-party beneficiary of the franchise agreement, or through stringent default provisions, these are less than perfect solutions because they often complicate the arrangement, lead to a lack of clarity as to parties' rights and responsibilities, and in practice may prove difficult to enforce.

Third, aside from the loss of control over franchisees, the franchisor also retains as a practical matter only limited control over the subfranchisor. This limited control is similar to that which exists with area developers. As with area developers, subfranchisors wield more power over the franchisor than do individual franchisees because subfranchisors control a proportionately larger number of units in the system and subfranchisors frequently have considerable financial resources. Moreover, the franchisor loses the leverage of selling franchises on a one-by-one basis, and may have limited ability to control the subfranchisor through litigation, or threats of litigation. Finally, if a subfranchisor opens up a territory more slowly than the franchisor could have otherwise developed it, the franchisor may not only lose royalties, but also an edge over its competitors in that market.

Fourth, compliance with federal and state franchise registration and disclosure laws imposes a considerable burden (and accompanying legal liability) upon both franchisors and subfranchisors. As discussed in Section D., below, these burdens relate primarily to the need for multiple disclosure documents and registrations. In addition, franchisors may be exposed to vicarious liability for representations made by subfranchisors to franchisees with respect to the franchise system.

In international expansion, certain of the disadvantages described above assume less importance than in domestic expansion. For example, the loss of revenue resulting from the sharing of fees is not likely to be a significant consideration if the

franchisor would not have otherwise been able to penetrate the foreign market itself. Some of the other disadvantages may remain, however. Loss of control over franchisees may prove acute, for example, as frequently the physical distance precludes a franchisor from regularly inspecting and overseeing compliance with the standards and quality of its system. Also, control over the subfranchisor may prove difficult due to the distance and a franchisor's inexperience with foreign laws and courts. One disadvantage discussed above, compliance with the registration and disclosure requirements, of course, does not exist.

3. Weighing of Advantages and Disadvantages

Domestically, the disadvantages resulting from the loss of control, loss of royalty revenue, and increased regulatory burden appear to outweigh the potential for rapid expansion and increased revenues from the sale of exclusive territories. As a result, subfranchising appears less desirable as a means of domestic expansion than do other multiple-unit arrangements. Internationally, however, certain of the disadvantages present in domestic subfranchising assume less importance (particularly when compared with other means of international expansion) so that subfranchising provides an attractive vehicle for growth, if the proper provisions are included in the contract, as discussed below.

C. Significant Agreement Elements of the Subfranchise Agreement

1. The Grant of Subfranchise Rights

Typically, the subfranchise agreement will grant the subfranchisor the right, and obligate the subfranchisor, to sell and have established a certain number of franchised units in a designated territory within a specified period of time. In some cases, the subfranchisor also may be granted the right to develop some of the franchised units on its own. Frequently, the franchisor agrees not to establish, or grant to any other party the right to establish, any units within the territory while the subfranchise agreement remains in effect. As under the area development arrangement, this grant of exclusivity may be the franchisor's most important obligation under the subfranchise agreement. For its part, the subfranchisor agrees to have in operation increasing numbers of franchised units in accordance with a schedule specified in the subfranchise agreement. The subfranchise agreement may either obligate the subfranchisor to "open" or "have in operation" a specified number of units at any number of prescribed times. In the latter case, the subfranchisor has an added obligation to replace, by the prescribed time, any units which may have closed.

In most subfranchise arrangements, the franchisor has far less control over the franchisee than in single unit franchising. This is because the franchisor is either not a party to the franchise agreement or, if a party, has nevertheless delegated substantial responsibility to the subfranchisor. In the subfranchising arrangement, it is the subfranchisor, and not the franchisor, who grants to the franchisee rights to establish and

operate a franchised unit. Customarily, under such an arrangement only the subfranchisor and the franchisee sign the agreement. The franchisor may consider being a party to the agreement this could have the advantage of giving the franchisor certain rights under the franchise agreement. It may, however, blur the relationships, and thus the duties of the franchisor and subfranchisor. This is because it is very difficult to set forth accurately in the franchise agreement each duty which belongs to the subfranchisor as opposed to each duty which belongs to the franchisor.

To retain control over the establishment and operation of the franchised units, the franchisor may wish to require, in the subfranchise agreement, that: (1) the subfranchisor use a specific form of franchise agreement, which may be either the form attached to the subfranchise agreement or, to provide greater flexibility, the form designated or used by the franchisor from time to time; (2) the subfranchisor submit each proposed form of franchise agreement to the franchisor for approval; or (3) specific terms be inserted in the franchise agreement. Obviously, requiring use of a specific agreement provides the franchisor with the greatest control over the franchise agreement's terms. Requiring approval of the agreement, or insertion of specific provisions in the agreement, provides for less control.

In international franchising, one of the latter approaches is often the most preferable. Often, requiring approval or insertion of specific provisions allows a subfranchisor the flexibility necessary to draft the franchise agreement provisions which are necessary to conform to the laws and practices of a particular country.

2. Approval of Franchisees

In subfranchising, the subfranchisor, and not the franchisor, will select franchisees. Notwithstanding, many franchisors still may wish to reserve the right to approve franchisees selected by the subfranchisor prior to execution of the franchisee agreement. If the franchisor does not wish to reserve the right to approve franchisees, as is typically the case in international franchising, the franchisor may wish at least to be notified of the grant of franchise rights and identity of the franchisee.

3. The Development Schedule

As with area developers, the development schedule, described in the subfranchise agreement, sets forth the parties' agreement regarding the pace at which development will occur. Typically, the subfranchisor will be required to meet certain goals by designated dates. The goals may be based upon such measures as franchise agreements executed, units open and operating, or units substantially under construction. As noted above, the franchisor must determine whether the subfranchisor has an obligation as part of this schedule to replace units which cease to operate.

Subfranchisors may be granted the right to establish and operate their own units. Very often a subfranchisor will have the option to satisfy all or part of his schedule by establishing units himself. Even if this right is not specifically granted, it can typically

be achieved, for example, by the subfranchisor's establishment of separate corporations to serve as franchisees.

Often, in the subfranchise agreement, franchisors will require subfranchisors to develop one or more units before beginning to sell franchises. Such a provision has the advantage of requiring that a subfranchisor become directly familiar with the operational details of the franchisor's system and of the operation of an individual unit, prior to selling franchises and assisting franchisees. Sometimes franchisors achieve this same effect by only offering franchise agreements to their successful franchisees.

4. Term and Renewal

One of the principal purposes of the subfranchise agreement is to provide for the opening of a fixed number of franchised units, either by the subfranchisor or franchisees within a specified period of time. The subfranchise agreements typically will provide for the subfranchisor's exclusive rights to the territory to expire on the date the subfranchisor successfully completes the development schedule. Such an approach, however, may not adequately consider the expectations of the subfranchisor whose territory could be invaded promptly following his successful completion of the development schedule. Even more disturbing to the subfranchisor would be the early loss of exclusive rights for completing the development schedule ahead of time. This dilemma also exists under the area development approach; Chapter II in this series addressed alternative approaches, including the grant of an option to establish additional units and a right of first refusal with regard to the proposed establishment of additional units.

Subfranchisors may complete their "development obligations" before the expiration of the subfranchise agreement which sets forth those obligations. As a result, the subfranchise agreement which grants the subfranchisor not only the right to solicit and sell franchises, but also to service franchises, may have expired while the underlying franchise agreements continue in force and effect. This approach would be inconsistent, however, with a desire by the subfranchisor (in which the franchisor may join) to continue to "service" franchises (and continue to derive revenue from the serviced franchisees). The need of the franchisee to continue to receive services after the subfranchisor's completion of its development schedule must be addressed in the subfranchise agreement.

This servicing issue may be dealt with in one of several ways. First, for example, the subfranchise agreement can distinguish between the selling and servicing rights and obligations of the subfranchisor, and permit or obligate the subfranchisor to continue to service franchisees as long as the franchisees who were signed up by the subfranchisor continue to operate their franchise units. In such a case, the subfranchise agreement should clearly indicate that the exclusivity which the subfranchisor once enjoyed will no longer exist.

A second approach is that, upon the subfranchisor's completion of the development schedule, the subfranchise agreement terminates in its entirety and the subfranchisor's rights and obligations are then assigned to the franchisor or, as to the servicing aspect, a designee of the franchisor. The disadvantage of this approach is that, if another subfranchisor or designee is not immediately found, the franchisor could become burdened with fulfilling the obligations originally delegated to the subfranchisor. In some cases, however, this may prove feasible as much of the assistance required under a franchise agreement occurs in the initial, start-up period, and less demanding assistance may be required of the franchisor at this later stage. Moreover, at this later stage, the franchisor may have greater financial ability and, correspondingly, less need for a subfranchisor. Although international agreements commonly provide servicing obligations, a franchisor may be reluctant to assume them unless there are a large number of franchisees operating in the country.

5. Fees and Charges

Fees and charges, under subfranchising arrangements, may take many forms, as outlined below. A subfranchisor customarily will pay an initial fee for the right to sell franchises in an exclusive territory. In return, the subfranchisor typically will receive the right to share in initial unit fees and ongoing royalty fees paid by franchisees.

a. Subfranchisee Fee

The subfranchise agreement typically will specify an initial fee to be paid to the franchisor by the subfranchisor for the subfranchise rights. The amount of the fee may depend upon the size of the territory, the length of time the territory is held open, and the number of franchises to be opened.

In international subfranchise arrangements, the fees are typically for entire countries and may be computed and paid differently than in domestic arrangements. First, as fees are typically for a larger territory, they are often higher than under domestic arrangements, and frequently paid over a period of time instead of in one lump sum. Second, as initial entry into an untested foreign market may be viewed by the franchisor and subfranchisor as speculative, the fee could be staggered or adjusted to the number of units which are opened. In international franchising, franchisors also must consider matters such as currency control regulations, local withholding taxes of the host country, and any applicable tax treaties between the foreign country and the United States (for U.S.-based franchisors).

b. Initial Franchise Fee

Subfranchise agreements customarily contemplate that initial franchise fees will be paid by franchisees directly to the subfranchisor. There are two significant issues which arise in the subfranchise agreement with respect to domestic subfranchising in relation to these initial franchise fees. First, there is the issue of what portion of the initial franchise fee will be retained by the subfranchisor and what portion

will be remitted to the franchisor. Second, there is the issue of the degree to which, under U.S. antitrust laws, the franchisor may specify the amount of the franchise fee charged by the subfranchisor.

There is no simple rule as to the amount of the initial franchise fee to be retained by the subfranchisor. In some systems, subfranchisors retain a majority of the fees, while in other systems the majority is turned over to the franchisor. The degree to which a subfranchisor may retain initial franchise fees depends upon the size of the subfranchisor, the relative bargaining power of the parties, the extent to which the franchisor must assist and train the subfranchisor, and the extent of services to be provided by the subfranchisor to franchisees. If it is contemplated that the initial franchise fee charged to franchisees will change over time, the subfranchise agreement may specify that the portion of the initial franchise fee payable to the franchisor be a percentage of the initial franchise fee charged rather than a dollar amount per franchise sale. Typically, the franchisor will require that it receive its portion of the initial fees within a short time (*e.g.*, 30 days) after they are paid by the franchisee.

In domestic franchising, the antitrust laws prohibit a franchisor from specifying the minimum or maximum fees a subfranchisor may charge to franchisees. A partial solution is for the franchisor to specify a minimum dollar amount payable by the subfranchisor to the franchisor out of the initial franchise fees paid. In international franchising these antitrust considerations may not exist.

c. Continuing Royalty Fees

The above discussion concerning initial franchise fees is equally applicable to continuing royalty fees paid by franchisee to the subfranchisor.

6. Trademarks and Advertising

In a subfranchise agreement, the franchisor grants to the subfranchisor the right not only to use the franchisor's mark but to sublicense its use to other parties. Thus, aside from provisions related to the use of the mark by the subfranchisor, the franchisor must set forth in the subfranchise agreement provisions relating to the use of the mark by franchisees. Coupled with the grant to the subfranchisor of the right to sublicense is a delegation of the duty to police the franchisee's use of the franchisor's trademark. This grant of rights and delegation of duties is permissible under the Lanham Act. The franchisor, as owner of the licensed trademark, however, still remains responsible for assuring that the subfranchisor and its franchisees comply with the applicable quality control standards. Accordingly, it is crucial for the franchisor to protect its trademarks adequately by reserving in the subfranchise agreement the right to inspect franchised units and requiring the subfranchisor to provide for this in the franchise agreement. If the franchisor is not a party to the franchise agreement it would be necessary to name the franchisor specifically as the third party beneficiary of the agreement with the right to inspect in this manner. It is equally important to reserve the right to enforce the franchise agreement if the subfranchisor fails to do so.

As part of the policing of its trademark, a franchisor also should provide in the subfranchise agreement, and in the franchise agreement, for the approval of any advertising developed for use by the subfranchisor and its franchisees, prior to the use of such advertising. If the advertising proposed for use by a subfranchisor relates to the offer or sale of franchises, the approval process also can be used by the franchisor to verify that the advertising has been, or will be, approved by state authorities in those states in which such approval is necessary. In international subfranchising, distance often renders advance review of advertising difficult. The alternative which achieves the desired result is to require that the franchisor receive a copy of advertising used by the subfranchisor or the franchisees within a certain number of days after its use.

7. Covenants Against Competition

Franchisors customarily provide for covenants against competition in multiple-unit arrangements. Franchisors normally will want to restrict the subfranchisor from competition by engaging in a business similar to that for which the subfranchisor has been granted rights by the franchisor. The covenant would, of course, have to provide an exemption for the subfranchisor's operation of franchised businesses pursuant to franchise agreements with the franchisor.

In addition, the franchisor has an interest in enforcement of the covenants in the franchise agreement. As the franchisor is not a party to the agreement, the franchisor may wish to be able to enforce any restrictive covenant against a franchisee in case the subfranchisor does not do so. To do so, the franchisor can provide, in the franchise agreement, that it be named as a third party beneficiary with the independent right to enforce the covenant.

8. Default and Termination

The subfranchise agreement will provide for default in the event of a subfranchisor's failure to meet the development schedule or to fulfill its obligations by providing assistance or enforcing provisions of the franchise agreements into which it has entered with franchisees. Thus, for example, some subfranchise agreements provide that, if the subfranchisor fails to perform substantially the obligations of the subfranchisor under the franchise agreement, such action will constitute a default under the subfranchise agreement. In the case where a subfranchisor also is given the right to develop its own franchised units (pursuant to franchise agreements with the franchisor), consideration also must be given as to whether a default under the franchise agreements should constitute a default under the subfranchise agreement, and vice versa.

One difficult, but extremely important, issue is how to ensure in the subfranchise agreement, upon its termination or expiration, that the franchisees signed up by the subfranchisor are properly serviced. As discussed above in Section C.4., under "Term and Renewal," one approach is to permit the subfranchisor to continue to "service" franchisees, while losing its right to solicit and sell franchises. The

disadvantage to this approach, of course, is that, as a result of the initial breach (assuming termination for breach of the subfranchise agreement, rather than expiration by its terms), the subfranchisor will feel less loyalty and obligation to the franchisor to service franchisees properly, and the franchisor is likely to have less confidence in the subfranchisor, particularly if the termination of the subfranchisor's solicitation and sales rights is disputed. A second, and more common, approach is for the subfranchise agreement to provide, in the event of termination or expiration of the subfranchise agreement, for the subfranchisor immediately to transfer its interest in all franchise agreements to the franchisor (or the franchisor's designee) and for the franchisor (or its designee) to assume all of the subfranchisor's obligations under those agreements. Although the franchisor could become burdened with servicing as a result, this appears preferable to the first approach. In international franchising, this approach, although commonly used, imposes a greater burden on a subfranchisor operating in a foreign country. After assuming the servicing obligation, however, the franchisor is always free to delegate its responsibility to a third party. Through either of the above mechanisms franchisees are assured of continuity for servicing and, therefore, need not be concerned about their receipt or continued assistance, in the event of expiration or termination of the subfranchise agreement.

Finally, if a subfranchisor develops and operates its own franchised units, it would be wise to deal with an additional issue in the subfranchise agreement. That is, the franchisor should either permit the subfranchisor to continue to operate its units or provide the franchisor with an option to purchase these units, in the event of default by the subfranchisor under the subfranchise agreement.

9. Other Obligations of the Parties

Some franchisors may wish to impose additional obligations upon the subfranchisor, depending upon the nature of the arrangement. Thus, for example, in addition to recruiting and selecting franchisees, subfranchisors may be required to: (1) provide site selection and assistance, (2) provide training, (3) provide opening assistance, and (4) provide ongoing assistance. Generally speaking, in international subfranchising arrangements it may be more sensible for the subfranchisor to assume a greater role as a substitute franchisor, because of the franchisor's difficulty in providing such services long-distance. Thus, in addition to providing certain additional services, such as training, as described above, the subfranchisor may, for example, be required to translate and adapt into the host country language the operating manual. In addition, the franchisor may require the subfranchisor to provide all training after the subfranchisor has achieved a sufficient degree of understanding and familiarity with the franchisor's system.

D. Disclosure and Registration Requirements

The subfranchising arrangement imposes far greater registration and disclosure requirements on franchisors than does any other multiple-unit arrangement. These requirements arise under both the FTC Rule and the state franchise laws, although there

are some differences from one regulatory scheme to another. The issues relate to:

- whether disclosure must be furnished (and registration is necessary) in connection with the offer of both the subfranchise agreement and individual franchise agreements;
- whether it is preferable to prepare one or two disclosure documents for the offer of subfranchise and franchise rights;
- the extent to which information on the franchisor, the subfranchisor, or both must appear in the disclosure document(s);
- whether the franchisor or subfranchisor should handle state franchise registrations; and
- whether subfranchisors must be registered as franchise brokers.

As discussed above, the subfranchising arrangement involves two types of transactions: (1) the sale of the subfranchise rights pursuant to the subfranchise agreement, and (2) the sale of the franchise rights for an individual unit, pursuant to a separate franchise agreement. Each type of transaction must be examined separately under the registration and disclosure laws.

Compliance with the two types of transactions in subfranchising complicates the registration and disclosure process and can overburden franchisors and subfranchisors. For example, as discussed below, in any subfranchising agreement, two separate offering circulars are necessary – one for the subfranchisor and one for the franchisee. In addition, information on two separate entities - the franchisor and the subfranchisor – must be included in the offering circular provided to the franchisee. Further, a franchisor which sells multiple subfranchises in a given registration state could create complications for subfranchisors in that state (or for the franchisor, if the franchisor registers on behalf of its subfranchisors) as a result of the need for each subfranchisor’s offering to be registered. While it is theoretically possible to satisfy these difficult and complicated requirements, such requirements, and others described below, often dissuade franchisors from subfranchising.

1. Registration and Disclosure Obligations

a. Subfranchise Agreement

Under the FTC Rule, disclosure is required in the sale of subfranchise rights if the elements necessary for a franchise exist (*i.e.*, the franchisor permits the use of its trademark, provides significant control or assistance, and requires the payment of a franchise fee or other payment). Although neither the FTC Rule nor its interpretive guidelines specifically address whether disclosure must be provided to a subfranchisor for the sale of such franchise rights, in most cases it is highly likely that the

elements necessary for a franchise exist so that the disclosure requirements of the FTC Rule would apply. Accordingly, disclosure would have to be provided to the subfranchisor in a timely fashion, as required by the FTC Rule.

Under state law, registration and disclosure is required for the offer of subfranchise rights to a subfranchisor. This requirement arises through two means. First, as under the FTC Rule, the sale of subfranchise rights is likely to satisfy the definition of “franchise” under state franchise laws. Second, and more directly, the registration and disclosure laws of most states define the sale of subfranchise rights as an “area franchise”; an “area franchise” is in turn defined as a form of “franchise.” The Uniform Franchise Offering Circular Guidelines note, for example, that the offer of area franchises by the franchisor typically constitutes an offer separate from the offer of franchises by the franchisor and/or subfranchisor, and accordingly, requires separate registration or exemption.

b. Franchise Agreement

The offer and sale by the subfranchisor of franchises to franchisees constitutes the sale of a franchise under both the FTC Rule and state franchise laws. Accordingly, disclosure must be provided and registration must be effective in states requiring registration in connection with the offer and sale of franchises by subfranchisors.

2. Number of Disclosure Documents

Neither the FTC Rule nor state registration and disclosure laws contain requirements about whether one or two disclosure documents must be prepared. Most franchisors find it preferable for business reasons, however, to have two separate offering circulars prepared. Preparation of two offering circulars is recommended as there is no reason for the franchisee to know all the details of the franchisor’s arrangement with the subfranchisor. That is, certain of the details of the franchisor’s agreement with the subfranchisor are not relevant for, and would likely be confusing to, a franchisee.

3. Which Entity’s Information Must Appear in the Offering Circular?

a. Disclosure to Subfranchisor

If separate disclosure documents are prepared, only information on the franchisor would be necessary in the offering circular furnished to prospective subfranchisors.

b. Disclosure to Franchisees

When disclosure is furnished to franchisees, both the FTC Rule and state franchise laws require responses to the offering circular requirements for both

the franchisor and the subfranchisor. The FTC Rule is flexible as to the relative amount of information to be provided concerning the franchisor and the subfranchisor. The interpretive guides to the FTC Rule note that the more power and responsibility the franchisor has with respect to franchises sold by the subfranchisor, the more necessary are disclosures about the franchisor. State franchise laws appear to be less flexible as to the information provided by franchisors and subfranchisors. Because the obligations of the parties must be included in either an FTC or state-specific offering circular, as a practical matter, the amount of detail provided in either document is likely to be the same. Under both the FTC Rule and state franchise laws, both parties must provide financial statements, unless one entity guarantees the obligations of the other. The need to coordinate this gathering and assembly of information is one reason why many franchisors avoid subfranchising. Franchisors' concerns are heightened by the joint and several liability which exists for violations of some franchise laws, such as the FTC Rule.

4. Who Should Handle Registration?

a. Subfranchise Agreement

The franchisor is required to handle the registration in connection with offers and sales to subfranchisors.

b. Franchise Agreement

Most franchisors delegate to the subfranchisor the obligation to register the offering circular for the offer and sale of the franchise. In some states this approach is contemplated by the statute and/or administrator. Where a subfranchisor has been given the responsibility for registration, the franchisor typically will prepare a portion of the offering circular, and furnish this portion to the subfranchisor who will complete the offering circular and file the registration application. In some cases, the first draft will be prepared by the subfranchisor and then finalized by the franchisor. This latter approach is often used in cases where a three-party agreement is executed. As the franchisor will share in liability for the information contained in the document, the franchisor should insist on approval of the document prior to submission to the state authorities.

5. Are Subfranchisors Franchise Brokers?

The interpretive guides to the FTC Rule deem the subfranchisor to be a "franchise broker" in the offer and sale of franchises to franchisees. The principal consequence of this (aside from disclosure concerning the subfranchisor discussed in Section C.I., above) is that the franchisor and subfranchisor have joint and several liability for non-compliance or violation of the Rule by the other. It does not appear that subfranchisors are required to be disclosed as "franchise brokers" under state franchise laws. This position seems sensible, inasmuch as extensive information concerning the subfranchisor must appear throughout the offering circular itself.

E. Summary

Subfranchising, while initially appealing to many franchisors, has not been a preferred method of expansion for franchisors in the United States. This is because the disadvantages resulting from loss of control, loss of royalty revenue, and the increased regulatory burden outweigh the benefits of rapid expansion and increased revenues from the sale of exclusive territories. In addition, practically all of the advantages, and very few of the disadvantages, are available under the area representative approach (to be discussed in detail in Chapter IV, "Area Representation"). For franchisors wishing to expand internationally, however, subfranchising is an attractive means of expansion, currently used by many franchisors. Many of the disadvantages inherent in domestic subfranchising assume less importance when a franchisor is dealing in a foreign country. For many franchisors expanding internationally, the subfranchising approach will be the method of choice for multiple-unit development overseas.

CHAPTER IV

AREA REPRESENTATION

A. Introduction

The area representative approach is, essentially, a variation on subfranchising which attempts to achieve the same benefits as subfranchising, but without certain associated costs, such as loss of control and certain burdensome registration/disclosure requirements. In an area representation arrangement, the franchisor grants to a third party – the “area representative” or “area rep” – the right to solicit for prospective franchisees, and to provide certain services to existing franchisees (services which usually relate both to the establishment and the operation of the franchised units). These rights and obligations typically are limited to a defined territory. As with subfranchising, the area rep is often required to solicit a specified number of new franchisees within a territory during a specified period of time. Unlike subfranchising, however, the area rep does not contract directly with franchisees – the franchise agreement is executed only between the franchisor and the franchisee.

The franchisor may or may not charge the area rep an initial fee for the right to solicit and service franchisees within an exclusive territory. Initial fees are typically not charged, however, only in situations in which the area rep is an existing franchisee. Regardless of whether an initial fee is charged, the franchisor will pay the area rep a portion of each initial franchise fee paid by new franchisees, and a percentage of the royalty fees paid by existing franchisees. The amounts paid to the area rep will depend upon the nature and extent of the services performed by the area rep.

This chapter will first examine the advantages and disadvantages of the area representative arrangement. The chapter then considers some of the principal issues to be addressed in the area representative agreement, including the appropriation of fees and of the delegation of duties between the franchisor and the area rep. Finally, the chapter will address the application to the area representative approach of federal and state laws which require registration and/or disclosure in connection with the offer and sale of franchises.

B. Advantages and Disadvantages of the Area Representative Approach

The area representative approach provides the franchisor seeking to expand the franchise system rapidly with many of the advantages inherent in other multiple-unit franchising arrangements. Similarly, the franchisor will face some of the same costs and disadvantages which are common to other multiple-unit arrangements. However, as mentioned above, the area representative approach is designed to achieve many of the goals of subfranchising, while minimizing the economic and practical costs faced by

subfranchisors. The following discussion highlights these advantages and disadvantages.

1. Advantages

Perhaps the primary advantage of the area representative approach is that the franchisor retains direct control over the franchise by contracting directly with the franchisee. Even though the area rep may be in frequent contact with the franchisee due to its obligations to provide training and other services, the franchisor still maintains ultimate control to assure that its franchisees are operating in conformity with the system. Many franchisors prefer using an area representative, rather than a subfranchisor, for just this reason! As discussed in the previous chapter, subfranchising injects an additional contractual layer between the franchisor and the franchisee, which may hinder the franchisor from monitoring and enforcing the franchisee's operations under the system. As a corollary, under the area representative approach, the franchisor retains the ultimate responsibility to service the franchisees (as required by the franchise agreement) in the event the area rep does not do so. It is doubtful, however, that the franchisor could (as a practical matter and in light of its trademark concerns) avoid such obligations under the subfranchise arrangement even in the absence of a direct contractual relationship.

The ability to achieve rapid expansion by utilizing the capital resources of others is another advantage to this technique. The area rep, and not the franchisor, must maintain a sales staff and network of field representatives and other franchisee service personnel. The degree of savings to the franchisor, however, is directly proportional to the amount of responsibility delegated to the area rep. Also, as discussed below under "Disadvantages," as more duties are delegated to the area rep, the more compensation the area rep will require, which translates into a greater loss of revenue to the franchisor.

The area rep ordinarily will be familiar with the territory with regard to franchisee prospects, real estate, construction, financial matters, and competition to system outlets. The franchisor and the area rep should be able to utilize and profit from that knowledge, and to profit from increased local credibility. Also, the existence of a local or regional area rep allows for quick response in servicing franchisees, as well as swift reaction to changes in the local marketplace and the development of area-sensitive marketing programs. The area representative approach also may be desirable in that the franchisor usually will be dealing with an entity which, unlike an area developer, does not have as much financial strength and "clout" as the franchisor.

Finally, the area representative approach enables the franchisor to furnish an offering circular to prospective franchisees which contains less disclosure than would be the case with a subfranchising arrangement. Also, if the area rep does not pay a fee for acquiring his area representative rights, the area rep may not be acquiring a "franchise" as that term is defined under the FTC Rule and state franchise laws; and, therefore, registration and disclosure of the area representative agreement may not be necessary. (As discussed below, however, the franchisor always will be obligated to prepare and furnish an offering circular to prospective franchisees.)

2. Disadvantages

Despite the above-noted advantages of the area rep arrangement (especially when compared to subfranchising), the area representative approach is not without its costs. While there is no particular disadvantage unique to the area representative approach, it is susceptible to the problems of giving away a significant portion of the revenue, vicarious liability concerns, complexity of the agreements, and additional registration/disclosure requirements. The structure of the area representative agreement usually provides for the area rep to receive compensation through a sharing of initial franchise and royalty fees with the franchisor. This entitlement to a large share of the franchisor's income stream represents the potential for a significant loss of revenue to the franchisor. However, because the franchisor will not need to maintain as large a sales and field representative staff as he would minus an area rep, the franchisor should be able to reduce some of its costs.

3. Weighing the Advantages and Disadvantages

Unlike subfranchising, which has developed into a legal and practical quagmire for many franchisors, area representation offers many of the advantages of subfranchising without as many disadvantages. Rapid growth can be achieved without a significant loss of control. If properly structured, the arrangement can mitigate the loss of revenue from sharing initial fees and royalty fees by a reduction in expenses. Furthermore, the franchisor is not beholden to the abilities of one large area developer to franchise an entire territory. Finally, while the registration and disclosure requirements are more extensive than with single unit franchising, these are not as burdensome as those common to subfranchise arrangements.

On balance, the area representation approach provides an attractive and useful vehicle for expansion. The advantages regarding registration/disclosure have made the area representation option attractive to, and widespread among, domestic franchisors. For international franchising, however, the area representative approach is less useful, especially with regard to franchisees in distant countries with whom, in light of the franchisor's lack of control in any event, it might not make sense for the franchisor to have direct contractual relationships.

C. Significant Elements of the Area Representative Agreement

Area representative agreements often vary from franchisor to franchisor, and, sometimes, even from area rep to area rep within a franchise system. These variations reflect the versatile nature of area representation arrangements, as well as the franchisor's wish to craft individualized agreements to respond to unique and changing circumstances. The following is a description of necessary, and frequently occurring, aspects of area representative agreements.

1. The Grant of Area Representative Rights

The typical area representative agreement – if there is such a thing as a “typical” agreement – will grant the area rep the right to solicit and evaluate potential franchisees within a specified territory, and to undertake some of the franchisor’s field responsibilities for development, training, and service to the franchisees who will operate within the territory. The territorial boundaries usually will reflect the location of the area rep’s personnel and the franchisor’s territorial objectives.

a. Exclusivity

While an area rep usually demands exclusivity, the structure of the agreement will dictate the type of exclusivity granted, if any. The area rep’s duties are easily segregated into pre-sale solicitation and post-sale servicing of franchises. Therefore, the franchisor may impose different exclusivity restrictions with respect to the different aspects of the contract. Franchisors should remember that exclusivity relates as much to what the franchisor **cannot** do, as it does to what the area rep **can** do.

As a practical matter, franchisors typically agree not to grant area representation rights to another entity during the term of the agreement. This grant of exclusivity should relate solely to the area representation rights (*i.e.*, solicitation and service), and not to the establishment of company-owned or certain franchised stores within the territory. The agreement should, for example, expressly reserve to the franchisor the right to establish company-owned units or to grant new franchises to prospective franchisees who contact the franchisor directly. As discussed below under “Fees and Compensation,” the franchisor may wish to provide some compensation to the area rep in these circumstances, *i.e.*, if the franchisor establishes company-owned or franchisee-solicited, franchisee-owned units within the territory granted to the area rep.

While it may be desirable to allow for the establishment of units through the efforts of both area reps and the franchisor, the area representation rights with respect to servicing of franchises ordinarily should be “exclusive.” In most cases, the area rep should be obligated to service each franchise in the territory regardless of whether the area rep or the franchisor solicited the franchisee. Otherwise, the delegation of servicing responsibility is likely to be inefficient, and the area rep may consider that it has not received a right to conduct a business with any meaningful grant of exclusivity.

b. Schedule or Quota

In the area representative agreement, the franchisor will typically impose a schedule or quota for solicitation of prospective franchisees. While other multiple-unit arrangements may easily encompass a performance schedule or quota (*e.g.*, the area developer must establish, or the subfranchisor must sell, X franchised units within Y time period), the area representative agreement is less susceptible to the establishment of a schedule or quota. This is primarily because the decision to establish or sell franchises rests exclusively with the franchisor. As described below under “Duties

of the Area Representative” (See Section C.2.), the area rep’s obligations to solicit are not easily identifiable. The essential requirement is often only that the area rep must locate franchise prospects which meet certain requirements established by the franchisor. If the area rep cannot meet the performance schedule, the area rep may suffer a loss of exclusivity or the agreement can be terminated.

c. Area Representative Ownership of Franchised Units

While the area representative agreement primarily will be concerned with pre-sale solicitation of franchisees and post-sale service obligations, it should set forth whether the area rep may have any ownership interest in franchises. As a practical matter, an area rep may be an existing franchisee or multiple-unit franchise owner within the system. Consequently, as an owner of franchised units, the area rep will, most likely, want to be an owner of additional units in the territory. The agreement may permit the area rep to have an interest in any franchisee entity it proposes as a prospective franchisee to the franchisor. This ownership interest can be as large as 100 percent, with the area rep being the franchisee, or it could be a smaller ownership interest through a partnership or corporate entity. To the extent that the area rep is involved with a prospective franchisee, either financially or in a managerial capacity, such involvement affords the franchisor greater assurances that the franchisee will operate properly and profitably within the system. It also gives the area rep additional incentives to develop franchises with the territory.

2. Duties of the Area Representative

a. Solicitation of Franchisees

One of the goals of the area representative arrangement is to utilize the area rep to solicit franchisees who will develop units within the territory. However, because the area rep does not “sign up” the franchisee, and is not obligated to open any franchises itself, it is difficult to impose a “development schedule” on the area rep. Nonetheless, the area rep should be bound by a schedule or quota. For example, the area rep should be required to screen and evaluate prospective franchisees actively according to the franchisor’s standards. The “schedule” to be imposed upon the area rep might be one of requiring the area rep to propose to the franchisor a specified number of “ready, willing, and qualified prospects” for franchises within the territory, and within a specific time period. The criteria are much less rigid than those of a development schedule under an area development agreement or a subfranchise agreement. However, the franchisor can and should provide detailed guidance as to the qualifications which a prospective franchisee must have in order to satisfy the schedule or quota.

b. Servicing the Franchisees

In contrast to the obligations to solicit new franchisees, the obligations to service the franchisees can be precisely defined, and should be strictly enforced. These are the elements of the franchisor’s obligations under the franchise

agreement which are delegated to the area rep. These duties could include site selection counseling and assistance, on-site inspections, review of proposed leases and contracts, consultation and assistance with regard to constructing and equipping the unit, providing the initial training to the franchisee and its employees, and providing grand opening assistance. Once the franchise is open, the area rep may provide periodic inspections, follow-up training programs, reports of franchisee compliance under the system (which would be forwarded to the franchisor, sometimes for franchisor action), collection of delinquent accounts, and any other assistance the franchisor deems necessary. Even after the territory has been developed to capacity, these duties would remain in effect. Also, these duties ordinarily will apply to all franchised units within the territory, regardless of whether they resulted from the area rep's solicitation efforts or existed prior to the assumption of responsibilities by the area rep. Some franchisors have found that it is difficult to find an area rep who is an effective "jack-of-all-trades." As a result, franchisors should consider whether to delegate broad servicing responsibilities, some servicing responsibilities while retaining others, or some servicing responsibilities to one area rep and other servicing responsibilities to one or more other area reps. The latter approach has the advantage of enabling a franchisor to choose "experts" in relatively narrow fields.

3. Term and Renewal

Area representative agreements usually are set for a specific period of time. While the overall term may be fixed, the time periods with respect to the two aspects of the agreement may vary. For example, the solicitation requirements may be for 5 years, while the servicing would be for 10 years or longer. The time periods associated with these responsibilities may vary depending upon factors such as the number of units which the parties expect a territory to hold, and their expectations as to when it may be desirable for the franchisor to assume servicing responsibilities. Like many franchise agreements, the area representative agreement may contain an option for the area rep to renew for additional periods of time.

4. Fees and Charges

a. Area Representative Fee

The franchisor may wish to impose on the area rep an initial fee for the granting of the area representation rights. This will usually be a lump sum, non-refundable payment. It may be dependent on the size of territory covered by the area representative agreement, the degree of exclusivity granted to the area rep, or the expected number of potential sales in the territory. The fee is designed to recoup some of the franchisor's expenses in assisting the area rep in establishing its solicitation and service network.

A number of area representative agreements do not include an initial fee paid by the area rep to the franchisor. The primary reason for this approach is to avoid having the area representative agreement being labeled as a "franchise," which may avoid

registration and disclosure requirements concerning the area representative arrangement. (See Section D.I., below.)

b. Franchise Fees

In consideration for the area rep's soliciting, screening, and evaluating prospective franchisees, the franchisor ordinarily will pay to the area rep a percentage of the initial franchise fees paid by new franchisees for each new franchise granted within the area rep's territory. This payment is essentially a sales commission to the area rep, similar to commissions paid to franchise brokers or to the franchisor's salesmen. The agreement also may provide that if the franchisor establishes a company-owned unit within the territory, the franchisor will pay the area rep a designated fee, and may credit that new unit towards the area rep's schedule or quota.

If the franchisor grants a franchise in the territory to a franchisee not screened and recommended by the area rep, the franchisor also may provide for a payment to the area rep in a manner similar to the fee for a company-owned store. This fee will be dependent on the extent to which the area rep has exclusive rights to the territory, and should provide the area rep with some comfort that the franchisor will not sell units in the territory to deprive the area rep of its fees. However, if franchisee sales by the franchisor are permitted, and this compensation fee is high, the payment may become a disincentive for aggressive franchisee solicitation efforts by the area rep. In some senses, this fee could be avoided entirely, as the area rep will reap the benefits of servicing these new franchisees, even though the sales were not garnered by the area rep. To avoid these types of problems, a franchisor could simply refer all prospects to the area rep for initial screening and evaluation.

In determining the appropriate division of fees, the franchisor should establish when it will pay the area rep its portion of the initial franchise fees. The franchisor should consider deducting its expenses before paying the area rep, and should protect itself for contingencies such as a non-payment by the franchisee (and therefore default under the franchise agreement), an escrow or impound of initial franchise fees due to state registration requirements, and instances in which the franchisor defers, waives, or refunds the franchisee's initial franchise fee.

c. Royalty Fees

The area rep will be obligated to furnish many of the pre-opening and ongoing services to the franchisee which would otherwise be provided by the franchisor. Therefore, the area representative agreement will provide for the franchisor to pay to the area rep a portion of the royalty fees collected from the franchisee. For franchisor-owned units located within the area rep's territory (for which the area rep need not provide all, or any services), the franchisor may nevertheless decide to pay the area rep a percentage of gross revenues from those units. This is an element of fairness to protect the area rep from receiving rights to service a territory which later turns out to have one or more, or perhaps many, franchisor-owned units. Whatever arrangement the

franchisor develops with respect to compensating the area rep, the details of how much compensation to pay, when to pay, and under what circumstances the area rep is not permitted to receive compensation (*i.e.*, the area rep is only entitled to compensation based on actual fees received by the franchisor), should be clearly set forth in the agreement. Also, the franchisor's right to waive, defer, and refund fees, with an appropriate effect upon the payments to the area rep, should be set forth.

5. Transfer

The area rep agreement does not contemplate the grant of individual franchise rights as an integral part of the grant of the area representation rights. As a result, area representation agreements frequently permit an area rep to transfer its area representative rights without having to transfer its ownership interests in other franchised units. However, the area representative agreement should require that the area rep obtain the written approval of the franchisor prior to transferring or assigning the area rep's interests. Because the area rep's obligations are central to the franchisor's obligations to the franchisees, the franchisor may impose reasonable restrictions in approving or disapproving a transfer, such as notice, qualifying the assignee, and a fee to cover training of the new area rep.

6. Default

The area representative agreement typically will provide for default in the event the area rep fails to satisfy the performance standards specified in the agreement. Many franchisors provide the area rep with the opportunity to cure defaults under the agreements. Also, because the default may have little relationship to the area rep's ownership or management interest in one or more individual franchises, the area representative agreement need not provide for a default under the area representative agreement to be a default under the area rep's franchise agreements.

7. Franchisor's Duties

As a matter of fairness, and to protect its own interests, the franchisor should provide the area rep with training, consultation, and advice with respect to operating a solicitation and service organization. Because the area representative arrangement involves the area rep undertaking many of the franchisor's duties, the franchisor may not have to establish a new, extra layer of field representatives to service the area reps. If the franchisor expects the area rep to stand in its stead, however, the franchisor must adequately convey to the area rep the full extent of its expectations.

D. Registration and Disclosure Requirements

The area representation arrangement imposes registration and disclosure obligations on the franchisor beyond those found in single-unit sales, but they are not nearly as burdensome as those occasioned by subfranchising. The area representation approach raises issues under both the FTC Rule and the state laws which regulate the

offer and sale of franchises. The issues relate to: (1) whether registration and disclosure are necessary; (2) what disclosure must be furnished in connection with the execution of the area representation agreement and the individual franchise agreements; (3) the contents of the disclosure documents; and (4) who is responsible for complying with the registration and disclosure obligations. Further, as mentioned earlier, the nature of how the arrangement is structured, including the payment of certain fees, may have an affect on the registration and disclosure obligations.

As discussed above, the area representation arrangement involves two separate transactions: (1) the sale of the area representation rights to the area rep; and (2) the sale of franchises pursuant to individual franchise agreements. Even though these are two distinct transactions, and involve separate disclosure obligations, because the franchisor executes all of the agreements, compliance with the registration and disclosure requirements is not particularly difficult.

1. Whether Registration and Disclosure are Necessary

The FTC Rule, and all of the state franchise laws which require registration and/or disclosure (except the Virginia law), require either the payment, or a commitment to make a payment, to a franchisor in order for a “franchise” to exist. As a result, if the area rep is required to pay an initial fee to the franchisor, then the franchisor is offering a “franchise,” and the registration and/or disclosure obligations are triggered. If the area representative agreement is a franchise, the offering circular furnished to the area rep must describe the franchisor, the area representative agreement, and various aspects of the arrangement. In addition, of course, registration must be obtained in most states.

On the other hand, if the area rep is not required to pay an initial fee, the franchisor ordinarily can avoid the “franchise” definition, and thereby avoid the registration and disclosure requirements. However, the avoidance of these obligations only pertains to the area representative arrangement; the franchisor, nevertheless, must provide an offering circular to prospective franchisees with respect to the franchise agreement. The offer of individual franchise rights will require the preparation of an offering circular describing the franchise, and the furnishing of that document to prospective franchisees, even where an area rep is involved.

Under most state laws, if a person is granted the right, for consideration, to sell or negotiate the sale of franchises, that person is considered a “subfranchisor,” and such an arrangement must be registered. In addition, disclosure must be furnished to the subfranchisor. These obligations could arise solely due to the right of the multiple-unit franchisee to “sell” or “negotiate,” and regardless of the absence of a contractual relationship between the multiple-unit operator and the franchisee. However, if the area representative agreement limits the area rep to the “solicitation” of prospective franchisees and does not permit the area rep to “sell” or “negotiate” the franchise agreement, the franchisor is likely to be able to avoid the registration and disclosure obligations imposed by the state franchise laws with respect to the offer and sale of

“subfranchises.” A second advantage of limiting the area rep to a solicitation function is discussed below under the subheading “Which Entity’s Information Must Appear in the Offering Circular?” (See Section D.3., below).

2. Number of Disclosure Documents

If the area representative agreement does not constitute a “franchise,” only a single offering circular would be required. That offering circular would be furnished to the prospective franchisee.

If the area rep pays a fee, and the arrangement with the area rep is recognized as a “franchise,” the area representation agreement must be disclosed. Typically, the use of separate offering circulars for each agreement is recommended. This approach is recommended because there is no reason for a franchisee to know all of the details of the franchisor’s arrangement with the area rep. That is, certain details contained in the area representative agreement are not relevant for, and may be confusing to, a franchisee.

3. Which Entity’s Information Must Appear in the Offering Circular?

a. Disclosure to Area Representative

If a separate disclosure document concerning the area representative agreement is prepared, the only information required to be included in the offering circular provided to the prospective area rep is that which pertains to the franchisor and the area representative agreement.

b. Disclosure to Franchisee

To a large extent, the only information which needs to be disclosed in the offering circular provided to prospective franchisees is that which concerns the franchisor and the franchise agreement. Because the franchisee will be contracting directly with the franchisor, and the ultimate obligation to provide services rests with the franchisor, the disclosure only pertains to the franchisor. This can be a distinct advantage over the subfranchise approach, in which extensive information concerning both the franchisor and the subfranchisor must be furnished to prospective franchisees. It is also for this reason that the franchisor will wish to limit the area rep to a solicitation function and not permit the area rep to “sell” or “negotiate” on behalf of the franchisor. As discussed above, under some state laws the area rep will be deemed to be a “subfranchisor” if the right to “sell” or “negotiate” exists.

There are, however, several situations which may lead a franchisor to disclose certain information about the area rep to prospective franchisees. For example, as an individual who solicits offers to buy franchises, the area rep’s activities are likely to be deemed those of a franchise broker. As such, the area rep must be

disclosed as a franchise broker in the offering circular. To satisfy the franchise broker disclosure requirements, the name and address of the area rep, and its resident agent for service of process, must be identified on the state cover page; the identity and five-year employment history of the area rep (and the principal officers of the area rep for a New York offering prospectus) must be disclosed in Item II; and all applicable litigation history of the area rep must be disclosed in Item III. The area rep, as a franchise broker, is also subject to certain specific franchise broker registration requirements in Illinois, New York, and Washington.

Two other situations may arise which require some disclosure concerning the area rep. First, a few state administrators may interpret the guidelines and the state regulations to require inclusion of information concerning the area rep to the prospective franchisee by noting that disclosure concerning the area rep is material to the prospective franchisee. Second, it may be misleading not to disclose that the franchisor intends to offer certain services through its designee, the area rep. If there is specific information concerning the area rep which is relevant to a prospective franchisee (*e.g.*, litigation history, bankruptcy, financial resources), the disclosure of this information may affect the investment decision of the potential franchisee. In neither circumstance, however, is the extent of disclosure required likely to be comparable to that which is required of subfranchisors.

4. Who Should Handle Registration?

a. Offers of the Area Representative Agreement

To the extent that the area representative approach is a “franchise,” and registration and disclosure are required, the franchisor should prepare and register the offering circular, and provide the offering circular to the prospective area rep.

b. Offers to Franchisees

The franchisor typically handles the preparation and registration of the offering circular used in connection with offers to prospective franchisees. As a practical matter, because most of the information contained in the offering circular pertains to the franchisor, the franchisor is in the best position to prepare the document. As a legal matter, the franchisor will want to assure accuracy in the preparation and registration of the offering circular.

However, the disclosure obligations can be discharged by the area rep. Many area representation agreements provide that the area rep will be obligated to furnish a correct and current offering circular to prospective franchisees as an element of its solicitation obligations. This obligation assumes that the meeting between the “area rep” and the prospective franchisee constitutes a “first personal meeting.” Therefore, while the franchisor will prepare and register the offering circular, the area rep ordinarily will provide the offering circular to prospective franchisees.

E. Summary

Like any multiple-unit franchising arrangement, the area representative approach should be carefully evaluated by any franchisor. The franchisor should assess its growth objectives on a nationwide, regional, and market-by-market basis, and should analyze whether its own capital and managerial resources are sufficient, or will be sufficient, to support the expected growth. That evaluation may lead to the conclusion that utilizing area representatives will enable the franchisor to maximize its objectives and minimize its capital expenses and other costs.

The area representation approach may allow for more rapid growth than with an area developer because the franchisor is not dependent upon the financial and other resources of a single person or entity. If the territory can absorb rapid growth, and there are capable and qualified prospective franchisees, the franchisor is likely to be able to sell more franchises more quickly and establish units in prime locations sooner than with the area development approach. Also, the franchisor does not lose as much control over the individual franchisee operations, as in subfranchising, because the franchisor will be contracting directly with each franchisee. Furthermore, the registration and disclosure requirements are not nearly as burdensome as those required for subfranchising. Unlike a pure franchise brokerage arrangement, the area representative approach offers the advantages of delegated servicing obligations and of a solicitor with a continuing interest in the success of the franchised operations.

An area representative can operate in almost any territory that enables the franchisor to reduce its managerial and personnel costs. However, the area representation arrangement is especially well-suited for use in a territory remote from the franchisor's headquarters or other regional offices, but not so remote (*e.g.*, a foreign country) that the franchisor cannot assume direct control over the franchisees, if necessary. The area representative is often an existing franchisee which has the resources to develop a solicitation and service staff -- and, perhaps, to develop some additional units within the territory.

The use of area representatives has expanded in recent years. It is the method used by some of the fastest growing franchise operations today. It will almost certainly continue to be a preferred method for franchisors seeking multiple-unit growth, as it offers some clear advantages, and few disadvantages, over other means of multiple-unit expansion. Like all methods of multiple-unit expansion, however, the area representative approach is not right for some franchisors, for some territories, or in some periods of time. Accordingly, careful analysis not only of the requirements, but also of the appropriateness, of the area representative approach must be undertaken before embarking on this path.

CHAPTER V

FRANCHISE BROKERAGE

A. Introduction

Franchise brokerage is a technique in which the franchisor retains a third party (the “franchise broker”) to solicit prospective franchisees. Because both subfranchisors and area representatives solicit prospective franchisees, they are likely to be considered franchise brokers under both federal and state law. However, franchise brokerage is also a distinct and separate technique of multiple-unit franchising. Although a subfranchisor and an area representative may be considered a franchise broker, not all franchise brokers are necessarily subfranchisors or area representatives. The distinction between a subfranchisor, an area representative, and a franchise broker arises because both subfranchisors and area representatives assume more of the functions traditionally performed by the franchisor than the franchise broker. The subfranchisor will not only solicit prospective franchisees, but also contract with and service franchisees. The area representative, in addition to soliciting for prospective franchisees, will service those who become franchisees. In contrast, the franchise broker will only solicit for prospective franchisees -- having neither the right to contract with, nor to service, those who become franchisees.

As with the other methods of multiple-unit franchising, the franchise brokerage approach is designed to accelerate growth. A major drawback, however, is that the franchisor may lose some control over the sale of franchises. In addition, franchise brokerage can complicate, albeit to a small degree, the disclosure process. Further, franchise brokerage arrangements trigger the need for a franchise brokerage agreement, an oft times complex document which must be drafted carefully and thoughtfully.

The above concerns and benefits are discussed in detail below. However, whether the benefits of the franchise brokerage technique will exceed its costs for any particular franchisor largely depends upon the franchisor’s state of development, the geographic area in which the broker will operate, the resources available to the franchisor (personnel, financial assets, etc.), and the short- and long-term goals of the franchisor. In order to assist those contemplating the adoption of a franchise brokerage technique, this chapter examines the advantages and disadvantages of using a franchise broker, the principal contractual issues that arise in negotiation of a brokerage agreement, and, finally, registration and disclosure requirements faced by franchisors who adopt the franchise brokerage technique.

B. Advantages and Disadvantages of the Franchise Brokerage Technique

1. Advantages

The advantages of expansion through franchise brokerage are: (1) the franchise sales rate can be increased; (2) some of the risks associated with expansion are assumed by the franchise broker; (3) some of the franchisor's financial and personnel burdens are assumed by the franchise broker; (4) an effective local sales program is developed; (5) local credibility may be increased; (6) the franchisor's sales program can be tailored to meet local conditions; and (7) the franchisor is kept apprised of the local business environment. Of course, many of the above blend together and overlap.

The franchise brokerage arrangement can provide the franchisor with tremendous potential to increase franchise sales because most franchise brokers are experienced salespersons, have established sales forces, and are intimately familiar with their territories. Also, most franchise brokers typically concentrate their efforts on only one objective - sales.

As with subfranchisors and area representatives, employment of a franchise broker allows the franchisor to reduce costs associated with the sale of franchises (*e.g.*, labor, advertising, and travel). In addition, by engaging a broker who works on commission, the franchisor is assured that the cost of sales is directly related to sales. A franchisor's sales staff might be paid whether sales are made or not. However, a broker typically is paid only upon completion of a sale. Of course, the broker's commission implicitly covers not only the cost associated with the completed sale but also all of those costs associated with those sales that fell through. Even so, a franchise broker may work for several franchisors and thereby realize economies of scale which can be passed on to each franchisor. Thus, the commission per sale paid to the broker may be less, in the long run, than the equivalent "commission" a franchisor would pay if the sale were the result of the franchisor's efforts.

A final benefit of employing a franchise broker can be the broker's ability to develop an effective sales program tailored to local business conditions. Not only can the franchise broker be a sophisticated salesperson, but he/she also can adjust selling campaigns and promotion techniques to local competition, such as the offering made by a competitive regional franchisor. Although the retention of a broker does not achieve a significant local presence for the franchisor, local sales do create a local presence which can contribute to further sales. Local sales and local expansion, in turn, contribute to local credibility. Of course, all of this activity is likely to lead to feedback to the franchisor concerning the local business environment.

Many, if not most, of the above advantages are realized under all of the other methods of multiple-unit franchising, and most franchisors have found that, on balance, the disadvantages of franchise brokerage often outweigh the advantages. Therefore, the following disadvantages should be given serious consideration before the franchise brokerage arrangement is undertaken.

2. Disadvantages

The disadvantages of expansion through franchise brokerage include: (1) the franchisor loses control over the sales process; (2) the franchisor runs the risk of being held liable for the broker's representations; (3) a brokerage contract must be drafted and negotiated; (4) compliance with disclosure and registration regulations become more complicated; (5) commission fees reduce cash flow in the short run; and (6) increased expansion may place formidable burdens on franchisee management systems.

By employing a franchise broker, the franchisor loses some control over the sales process, and runs the risk of being held liable for the broker's conduct. Under the FTC Rule, the franchisor and the franchise broker are jointly and severally liable for making the required disclosure. The franchisor also runs the risk of being held liable for the franchise broker's misrepresentations, if any, to prospective franchisees. Because the broker is usually paid a commission on completed sales, he/she often has an incentive to make a sale, not to find hard working and industrious franchisees. Thus, the danger is that a broker, working on commission, will serve only the franchisor's short-run goals (*e.g.*, franchise sales), to the detriment of long-run goals (*e.g.*, franchisee performance). A broker's inclination to emphasize the short-run at the expense of the long-run is of even greater concern because the franchisor has little opportunity to supervise the broker.

It would be unwise for a franchisor to engage a franchise broker without a written agreement. Also, any written agreement prepared and presented by the franchise broker is unlikely to satisfy the franchisor's needs. Thus, franchisors often find that they must not only negotiate but also draft a brokerage contract. Franchise brokerage agreements are often as long and complicated as traditional franchise agreements. The franchise brokerage agreement typically will address: (1) the scope of the territory granted to the broker and whether the broker is granted an exclusive right to make sales within the territory, (2) whether the broker will market the franchisor's franchise exclusively or whether the broker will be allowed to market competing franchises, (3) the basis for entitlement to compensation, (4) the timing of payment, (5) the effect of refunds of the initial franchise fee to the franchisees, (6) whether discounts will be given for multiple sales, (7) the term of the agreement, (8) whether the agreement can be renewed and the length of a renewal term, (9) whether the broker can sell options to purchase franchises, (10) whether the broker must meet a schedule or quota, (11) legal compliance (*i.e.*, who will assume primary responsibility for filing broker and salesmen forms), (12) what representations may be made, and must be made, by the broker, (13) record keeping, (14) transfer (*i.e.*, whether the broker may assign its rights and obligations, as well as whether the broker is entitled to a commission on the sale of an existing franchise), (15) default and termination, and (16) post-term obligations.

Compliance with registration and disclosure regulations can be more complicated when the franchise brokerage technique of multiple-unit franchising is employed. In most cases, registration and disclosure documents must contain information not only about the franchisor but also about the franchise broker. (*See* Section D., below, entitled "Registration and Disclosure Requirements.") In addition,

brokers must comply with salesperson registrations in some states, and some localities impose further requirements.

Finally, because a franchise broker's commission is most often a percentage of the initial franchise fee and because, during expansion, a franchisor often relies upon initial fees to expand its franchise management and service capability, the broker's commission may reduce significantly the franchisor's ability to expand its management and service capabilities.

C. Significant Elements of the Brokerage Agreement

When negotiating a brokerage agreement, the principal issues typically relate to: (1) the geographic territory in which the broker will operate and whether he will have an exclusive right to sell within his territory, (2) the term of the agreement and the provisions for terminating the agreement, and (3) the method of compensating the broker. Of course, all of the other broker agreement provisions identified in Section B., above, also may be subject to negotiation.

1. Exclusive Territorial Rights

The territory in which a broker is to concentrate his efforts and whether the broker will have an exclusive right to market the franchise within his territory is usually dictated by the broker's capability, the number of potential brokers in an area, and the franchisor's sales goals. The franchisor may opt to engage only one broker, and give that broker an exclusive right to market the franchise, with the hopes that the broker thereby will have a greater incentive to market the franchise than if he/she were competing with other brokers. Indeed, some brokers will not market a franchise unless they are granted an exclusive right within a given territory. However, this approach may not serve the franchisor's goals. Some brokers will tend to market a franchise more intensively only when competing with other brokers.

The above basic principles are to be considered in negotiating any brokerage agreement. The contents of a specific brokerage agreement will be the result of such negotiation and will depend to a large extent on the bargaining power of the parties. The bargaining process will determine matters such as: (1) the size of the broker's territory, (2) the nature of exclusivity (which may be affected by antitrust considerations), and (3) the franchisor's right to revoke or modify the brokerage agreement. Possible ways to delineate the broker's territory are by designating: (1) a point and a radius to form a circle, (2) streets to form a boundary, or (3) the pre-existing boundaries of political subdivisions. Ultimately, the size of the broker's territory will depend upon such factors as population, per capita income, or other demographic factors. With respect to exclusivity, if a franchisor can sell franchises within the broker's territory, the broker's quota or sales schedule may need to be reduced for each unit sold by the franchisor. Similarly, brokerage agreements usually provide for some type of reduction in the broker's sales quota if the franchisor opens company units, allows others to sell within the territory, or makes sales to existing franchisees. However, the broker's

quota may not be reduced equivalently for each of the above “sales.” A “sale” to an existing franchisee does not reduce the number of prospective franchisees in the broker’s territory; it only reduces the number of viable sites within the territory. Therefore, because different types of “sales” may have different effects on the broker’s territory, different types of “sales” have different effects on the broker’s quota. Finally, short of termination, the brokerage agreement can provide the franchisor with an option to reduce the broker’s geographical territory, or modify the nature of the exclusivity, or both.

2. Term and Renewal

Unlike with franchisors and franchisees, there are no state franchise laws which regulate the relationship between a franchisor and a franchise broker. As a result, the franchisor and the franchise broker are free to negotiate the term and termination provisions of their contract. When negotiating the term of the franchise brokerage agreement, franchisors should take into account the franchisor’s expansion objectives. If the franchisor plans on extensive expansion, a long-term broker contract may be beneficial. However, the franchisor should consider that a broker’s performance generally can be assessed in a relatively short period of time. Therefore, most franchisors would be wise to negotiate a short-term contract initially with one or more options to renew.

With respect to termination, some franchise brokerage agreements allow a franchisor to terminate the agreement if the broker: (1) fails to meet a prescribed sales quota or schedule, (2) transfers his/her interest under the brokerage agreement, or (3) becomes insolvent or makes a general assignment for the benefit of creditors. In addition, in order to ensure that the franchise broker is attentive to the quality of prospective franchisees, some franchise brokerage agreements provide that if the franchisor rejects a certain percentage of prospective franchisees referred by the franchise broker, the franchisor can terminate the contract. A provision such as this provides an incentive for the broker to screen prospective franchisees before referring them to the franchisor.

A well-drafted brokerage agreement also will take into account post-term obligations. Most brokers are interested in receiving commissions for all sales to prospective franchisees who were referred to the franchisor by the franchise broker. That is, brokers want to receive commissions even on sales completed after the brokerage agreement has terminated. From the franchisor’s perspective, however, and as an incentive for the broker not to breach the agreement, the franchisor will wish to provide for such post-term commissions to be paid only if the termination was for reasons other than default by the broker. Of course, if post-term commissions are to be paid, the brokerage agreement will need to provide some procedure for determining which post-term sales are attributable to the broker’s efforts. In any event, it might be sensible for the brokerage agreement to set forth a time beyond which no sale will be attributed to the broker.

3. Broker’s Compensation

Some of the typical methods of payment to franchise brokers are: a percentage of the initial fee, a percentage of the franchisor's royalty stream attributed to those franchises sold by the broker, or a flat fee per sale. In addition to such commissions, brokers sometimes receive fees for consulting and market survey services, neither of which are dependent on sales. The event giving rise to the franchisor's obligation to pay a commission is typically the signing of the necessary contracts and payment of the initial fees. However, payment to the broker at this time may cause problems if, for example, the broker's commission is calculated as a percentage of the initial fee and the franchisor subsequently refunds to the franchisee all or a portion of the initial fee. The issue is whether the broker also should be required to refund all or part of his commission. In order to avoid any ambiguity, the brokerage agreement might require the broker to refund all or part of his commission, in proportion to any refunds made at the discretion of the franchisor.

D. Registration and Disclosure Requirements

In a traditional sale, a franchisor will sell directly to a franchisee. In this situation, the franchisor makes disclosures to the franchisee and, if necessary, registers with the proper state agency prior to the sale. With the introduction of a third party, the multiple-unit franchise party (in this case the franchise broker), the process becomes more complicated. Instead of a single relationship between franchisor and franchisee, there are relationships between: (1) the franchisor and the franchise broker, (2) the franchise broker and the franchisee, and (3) the franchisor and the franchisee.

With respect to the franchisor/franchise broker relationship, there are no special registration or disclosure requirements with which the franchisor must comply because the franchise broker is not considered a "franchisee." However, with respect to both the broker's and the franchisor's relationship with the franchisee, the franchise broker and the franchisor are jointly and severally liable for failure to make adequate disclosure to the franchisee. That is, the franchise broker and the franchisor have the same obligation to make disclosure to the franchisee, and the same disclosure document typically is used by both the franchise broker and the franchisor.

When the UFOC Guidelines are followed, information pertaining to the franchise broker must be included in the franchisor's offering circular. The UFOC Guidelines require the franchisor to disclose the broker's name, address, five-year employment history, and relevant litigation history. If the broker is an entity, such as a corporation, the broker must disclose its state of incorporation, principal business address and any relevant litigation history. In addition, a corporate broker must list by name and position held the directors and principal officers (including the chief executive and chief operations, financial, marketing, training, and service officers) who will have management responsibility in connection with the marketing of the franchise. The FTC Rule, in contrast, does not require broker disclosure.

Under some states' laws, franchise brokers must register with state agencies; most

of these states simply require franchise brokers to file a Uniform Salesman Disclosure Form which contains information on the broker's employment history for the previous five years and any relevant litigation history for the previous ten years. Although the forms must be filed with the applicable state agency, they need not be disclosed to prospective franchisees. In Illinois, New York, and Washington, however, a broker must file a lengthy registration application and is prohibited from selling franchises prior to the issuance of an order of registration.

E. Summary

Due to the increased risk associated with vicarious liability for misrepresentations made by a broker and the franchisor's loss of control over the sales process, the franchise brokerage technique of multiple-unit franchising has not been adopted by many franchisors. Franchisors often say that brokers tend to be too concerned with completing sales, and insufficiently concerned with locating productive and industrious franchisees.

Those franchisors who engage franchise brokers should do so only after extensive planning and preparation. For example, before engaging a franchise broker, a franchisor should: (1) thoroughly investigate the franchise broker's financial position and personnel, (2) draft a comprehensive franchise brokerage agreement, (3) provide the broker with training and manuals about the franchise, and (4) design procedures that allow the franchisor to exercise some control over the broker's marketing activities. It would also be extremely wise for the franchisor to contact other franchisors for whom the broker has sold franchises, in order for the franchisor to determine how effective the broker has been at selling franchises, the sales methods and techniques employed by the broker, and the nature and quality of the relationship between the broker and the other franchisors.

CHAPTER VI

CONCLUSION

Multiple-unit franchising is at the forefront of the current thinking of many franchisors. It is a concept which began some years ago, most notably with Century 21. The approach originally taken by Century 21 has since evolved, however, and today there are new concepts – from area development to franchise brokerage – as well as evolving approaches to each of the concepts.

Franchisors must consider carefully whether a multiple-unit franchising approach is appropriate for their business; if so, which approach; and, if an approach is appropriate, in which territories and time periods the approach should be used. These are difficult decisions, whether made by the franchisor's staff or with the guidance of outside experts.

Multiple-unit franchising should be undertaken only by those who are experienced in its intricacies or by those who obtain expert guidance. The issues of concern are not limited to choosing the appropriate approach, but also include the many options available with regard to each approach. While it is commonly recognized that a franchisor must use a strong and comprehensive agreement for each of these approaches, few realize the many business issues and legal issues which arise under each approach and which must be resolved in order to proceed. All franchisors who choose a multiple-unit franchising approach are encouraged to proceed only after becoming knowledgeable in these many business and legal issues.