FRANCHISING 201: EFFECTIVE AND COMPLIANT
USE OF BROKERS AND SALES AGENTS

J. Mark Dady
Dady & Gardner P.A.
Minneapolis, MN

and

Robert A. Lauer
Haynes and Boone, LLP
Austin, TX

October 18 – 20, 2017
Palm Desert, CA
TABLE OF CONTENTS

I. INTRODUCTION ............................................................................................................... 1

II. TYPES OF THIRD-PARTY FRANCHISE BROKERS AND SALES AGENTS ............... 2
   A. Franchise Sales Brokers .......................................................................................... 2
   B. Franchise Consultants ........................................................................................... 3
   C. Franchisee and Other Third-Party Referral Agents ............................................... 3
   D. Lead Generation Networks .................................................................................... 4
   E. Business Brokers ................................................................................................... 5
   F. Area Representatives ............................................................................................. 5
   G. Master Franchisees ............................................................................................... 6

III. WHY DO FRANCHISORS USE THIRD-PARTY BROKERS AND SALES AGENTS? ..... 7
   A. Pros for Franchisors .............................................................................................. 7
      1. Reduced Employee Count and Obligations .......................................................... 7
      2. Incentive Based Compensation for Sales Team ................................................... 8
      3. Professional Salespersons .................................................................................. 8
      4. Increased Number and Geographic Scope of Sales Team .................................. 8
      5. Increased Access to Potential Clients .................................................................. 8
   B. Cons for Franchisors ............................................................................................. 9
      1. Reduced Control and Oversight in Sales Process .................................................. 9
      2. Reduced Knowledge and History with Brand ...................................................... 10
      3. Potential for Conflicting Incentives or Allegiances ............................................ 10
      4. Less Concern for Long-Term Success and Relationships .................................. 10
      5. Direct Liability for Acts, Errors, or Omissions .................................................... 10
      6. Reduced Likelihood of Long-Term Relationship with Brand .............................. 11
   C. Pros for Franchisees ........................................................................................... 11
      1. Ability to Explore Multiple Brands ..................................................................... 11
2. More Knowledgeable Sales People................................................................. 12
3. Ability to Act as a Liaison for the Prospective Franchisee ....................... 12

D. Cons for Franchisees .......................................................................................... 12
   1. Reduced Knowledge of and History with the Brand ......................... 12
   2. Potential for Conflicting Incentives/Allegiances ................................. 13
   3. Less Concern for Long-Term Success/Relationship ......................... 14

IV. COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS .... 15
   A. Introduction........................................................................................................ 15
   B. FTC Rule Definitions ..................................................................................... 15
   C. State Law Definitions ..................................................................................... 17
      1. NASAA .................................................................................................. 17
      2. Hawaii ................................................................................................. 17
      3. Illinois ................................................................................................. 18
      4. New York ............................................................................................ 18
      5. Virginia ............................................................................................... 18
      6. Washington .......................................................................................... 18
   D. Federal/State Disclosure and Registration Obligations ........................... 19
      1. FTC Rule ............................................................................................ 19
      2. Registration States ............................................................................. 22
   E. Sales Representative Laws .......................................................................... 27

V. CASE LAW............................................................................................................. 28
   A. Cases Involving Third-Party Brokers and Agents ................................. 28
      1. Franchisor Held Liable ..................................................................... 28
      2. Franchisor Not Held Liable ................................................................. 29
      3. Third-Party Broker Liability .............................................................. 29
VI. CONTRACTING AND PRACTICAL TIPS FOR ENTERING INTO A RELATIONSHIP WITH A BROKER OR SALES PERSON .................................................................................................................. 31

A. Defining the Scope of Services ........................................................................... 31

B. Allocating Responsibilities in the Franchise Sales Process ................................. 31

C. Defining Geographic Scope, Broker’s Exclusivity (or Lack Thereof), Efforts Requirements and Broker Noncompete (or Lack Thereof) .......................................................... 33

D. Timing, Types and Triggers for Fees, Reimbursements and other Compensation ................................................................................................................................. 34

E. Defining Term, Renewal ...................................................................................... 35

F. Compliance with Laws ......................................................................................... 36

G. Indemnification/Insurance/Confidentiality ............................................................ 36

H. Inspections, Audits and Records ......................................................................... 37

I. Governing Law and Forum .................................................................................. 37

VII. CONCLUSION ................................................................................................................ 37

Biographies
I. INTRODUCTION

A key tenet of franchising is the building of a brand through a realignment of traditional notions of use and allocation of capital and personnel. Franchisors that focus on expansion through franchisor-owned units rather than Company-owned units generally desire to be as lean as possible in terms of their use and allocation of capital and personnel. Franchising—as a method to grow a brand and business—allows the brand owner to use the money, time, and expertise of third-party franchisees. In turn, these third-party franchisees buy into the concept based on a belief that the brand name and system offered by the franchisor provides a competitive advantage over that of a comparable person starting his or her own brand and business from scratch.

The world of franchise brokers and sales agents is in some ways a microcosm of franchising. Indeed, some franchisors have determined that they can lower capital and personnel needs at the brand-owner level in connection with the offer and sale of their franchises by engaging independent, third-party franchise brokers, sales agents, and other similar companies or persons to perform sales under alternative compensation models. Franchising by its very nature call for almost continuous new franchisee prospects and sales for the franchise model to prosper. Independent, third-party franchise brokers buy into the concept of franchising based upon their expertise in selling, identifying a product or service to sell, and locating and obtaining new franchisee prospects and sales.

The traditional delineation in many franchise systems between franchise sales persons and franchise operations persons provides a perfect platform for franchise brokers. For example, a franchise system with sales persons who need not be fully immersed in operations is a perfect fit for a franchise broker acting as a “hired gun.” Of course, guns can be dangerous in the wrong hands, and many franchisors have horror stories surrounding the use of franchise brokers and sales agents.

This paper focuses on the effective and compliant use of franchise brokers and sales agents. Section II of this article provides a brief overview of the types of third-party brokers and sales agents. While the initial overview includes area representatives and master franchisees, the focus of this paper is on salespersons only, not persons that may also provide direct services such as area representatives and master franchisees. Section III addresses the pros and cons related to the use of third-party brokers and sales agents for both franchisors and franchisees. Section IV provides a brief overview of the federal and state compliance requirements for franchisors and/or third-party brokers and sales agents. Section V takes a look at the limited case law available in this area. Finally, Section VI offers practical tips for franchisors that are interested in entering into a broker agreement with a third-party franchise broker or sales agent.

---

1 This paper does not focus on master franchising or area representatives. For a discussion of the use of these franchise mechanisms, see, e.g., Michael S. Levitz, Christina M. Noyes, & Les Wharton, The Perils of Third Parties Selling or Servicing Your Brand: Broker, Area Representative and Area Developer Programs, ABA 34th Ann. Forum on Franchising, W-18 (2011); Wayne A. Steinberg & Callum Campbell, International Expansion: Is Master Franchising the Best Approach?, 16 FRANCHISE LAW. (Spring 2013), https://www.americanbar.org/content/dam/aba/publishing/franchise_lawyer/2013/spring/spring2013-franchlawyersarticle-internatl_expan_is_master_franchising_best_approach.authcheckdam.pdf.
II. TYPES OF THIRD-PARTY FRANCHISE BROKERS AND SALES AGENTS

While most people familiar with franchising understand the general concept of a third-party sales agent, the definitions and labels used to describe those agents are a bit more nuanced than one might expect. Further, many third-party agents use labels to describe and sell themselves which may not, in fact, be an accurate description of the services they actually provide. For example, a third-party agent may claim to be a “franchise consultant,” when he or she really is a “franchise sales broker.”

In an attempt to provide some clarity to the terms used by and for third-party sales agents, this section of the paper will identify and describe some of the most common types of third-party sales agents, many of which are included in the Federal Trade Commission’s Disclosure Requirements and Prohibitions Concerning Franchising (FTC Rule), definition of “franchise seller.”

A. Franchise Sales Brokers

The term “franchise sales broker” is best defined as a company or individual that helps franchisors sell franchises to prospective franchisees and/or helps prospective franchisees find the franchise opportunity that is right for them. A broker typically represents multiple brands, which allows the broker to present multiple options to a prospective franchisee. Some brokers will take the time to get to know a potential franchisee and refer the franchisee to the franchisor that best matches up with the franchisee’s background, interests, lifestyle, financial resources, and other expectations he or she may have. Other brokers may simply provide the prospective franchisee with a list of available brands and then let the franchisee make a choice, with little or no guidance. Brokers can also serve as sort of “liaison” between the franchisee and the franchisor—presenting questions to the franchisor on behalf of the franchisee and providing the franchisee with answers—or they can simply make referrals and collect fees from the franchisor. Brokers typically do not charge the potential franchisee for their services, and, instead, receive a fee from the franchisor for successful sales. While the fees brokers receive can vary depending

---

3 The FTC Rule defines “franchise seller” as:
   a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor’s employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.
4 MICHAEL H. SEID AND DAVE THOMAS, FRANCHISING FOR DUMMIES 61 (2d ed. 2010).
6 As discussed below, to the extent the franchise broker’s assistance amounts to nothing more than passing the prospective franchisee off to the franchisor, the franchise broker may be more aptly described as a “lead generator” than an actual franchise broker.
upon the brand, a broker will typically receive fees from the franchisor equal to approximately 50% of the initial franchise fee paid to the franchisor by the prospective franchisee.7

B. Franchise Consultants

The definition of a “franchise consultant” has changed over the years. Many third-party agents, including franchise sales brokers, now identify themselves as “consultants,” and the term does not necessarily have a standardized definition within the industry.8 In the more traditional sense, and as used in this paper, a franchise consultant is someone who assists existing business owners franchise their businesses or assists existing franchisors to expand their businesses. While this assistance can include some aspects related to franchise sales, a typical consultant will do more than just that, and will also provide assistance with respect to the decision to franchise (or not to franchise), the creation of operations and training manuals, the development of a sales process and branding, and, in some instances, may even assist in preparing the FDD.9 Traditional franchise consultants typically charge a fee for their services, but, unlike franchise sales brokers, the fee is typically either a flat fee for a bundle of services or an hourly charge.

C. Franchisee and Other Third-Party Referral Agents

Existing franchisees are often a valuable referral source for franchisors, especially if those existing franchisees are operating profitable franchises. Franchisors oftentimes provide monetary incentives to existing franchisees, and/or franchisees’ employees, who successfully refer new franchisees.10 Some franchise systems have a referral process where anyone, regardless of his or her affiliation with the franchise, can simply provide the franchisor with the contact information of potential franchisees and receive compensation for any successful referrals.11 These types of referrals, however, typically only involve either passing on the name and contact information for the prospective franchisee or having the prospective franchisee mention the referring franchisee. Existing franchisees and other more informal third-party referral sources do not typically take a meaningful or active role in the ongoing sales process.

---


9 See, e.g., Our Services To “Franchise Your Business,” MCGROW CONSULTING, http://www.mcgrow.com/services.htm (last visited August 2, 2017) (listing the various services offered by this particular franchise consultant).


D. Lead Generation Networks

Lead generation networks are persons or organizations that solicit the names and contact information of prospective franchisees and turn them over to franchisors.\textsuperscript{12} Franchisors often begin the sales process with leads generated through the internet or professional franchise consultants.\textsuperscript{13} Franchisors utilize online lead generation networks for two primary reasons: to optimize costs and for faster scaling.\textsuperscript{14}

In today’s world, as one might expect, both qualified and unqualified prospective franchisees use the internet to locate franchise opportunities and to conduct substantial research on franchises being offered.\textsuperscript{15} Online lead generation websites, which are also known as franchise portals, provide a directory of franchises and brands along with boilerplate descriptions of each franchise opportunity.\textsuperscript{16} Interested prospects are directed to fill out a form and wait to be contacted by the franchisor or a franchise salesperson.\textsuperscript{17} These websites, in turn, sell the prospective franchisees’ contact information to franchisors.\textsuperscript{18}

While franchise portals were once widely revered by franchisors, franchise salespersons, in recent years, have grown frustrated with the large amount of unqualified leads received from these portals.\textsuperscript{19} As a result, some franchise portals have attempted to distinguish themselves by conducting more intensive vetting of their leads, targeting only qualified leads, or by changing their receipt of fees to performance-based models.\textsuperscript{20}

\textsuperscript{12} Levitz, et al., supra note 1 at 3.

\textsuperscript{13} Id. at 13.


\textsuperscript{17} Id.

\textsuperscript{18} Id.


Despite some franchisor dissatisfaction, the internet has become the dominant source of sales generation for franchisors. According to Franchise Update’s 2017 Annual Franchise Development Report (AFDR), half of ad spending by franchisors for recruitment of potential franchisees is digital and one-third of the surveyed franchisors’ digital spending was on “franchise opportunity sites” i.e., lead generation networks. In fact, according to the 2017 AFDR, digital marketing has been the number one source for franchise sales since 2012. This trend will likely continue, as potential franchisees are also able to use their mobile devices to explore franchise opportunities.

E. Business Brokers

Business brokers are another source of franchise sales, although they are most commonly associated with the sale of an existing franchise, rather than the sale of new franchises. A number of business brokers, however, no longer limit themselves to the sale of existing franchises, and many business broker websites now include listings related to new franchises, as well as existing franchised and non-franchised businesses.

As is the case with most of the other third-party sales people, the purchasing franchisee typically does not pay a fee to the business broker. Instead, in the case of the sale of an existing business, the selling franchisee will pay the business broker the fee (typically a percentage of the sale price or a fixed fee), and, in the case of a sale of a new franchise, the franchisor will pay the business broker (typically a percentage of the initial franchise fee). In addition to traditional business (i.e., non-franchised businesses) listings, many business brokers have websites which list existing franchises that are for sale and allow prospective franchisees to search by state/region, asking price, cash flow, key word and more.

F. Area Representatives

Area representation arrangements are another sales method employed by franchisors to rapidly effectuate sales, expand operations, and benefit from the area representative’s network and knowledge of local demographics and real estate.

With this arrangement, the area representative pays the franchisor an up-front fee to enter into an area representative agreement with the franchisor. The agreement grants the

---


22 Id at 31.

23 Id at 30.


25 Id.

26 W. Michael Garner, 1 Franchise & Distrib. Law & Prac. § 1:19 (West, 2010-2011 ed.) (Area Representation); Levitz, et al., supra note 1 at 2.
area representative the right to solicit prospective franchisees, the obligation to develop a
certain number of franchises (in a defined territory and in a defined time period), and the
obligation to provide ongoing services to the franchisees in the territory.\textsuperscript{28} Area representation
differs from sub-franchising in that the franchisor, not the area representative, contracts directly
with the franchisee.\textsuperscript{29} Therefore, the franchisor is directly responsible to the franchisee to
perform the franchisor’s obligations under its franchise agreements, although the franchisor
delegates the responsibility to the area representative.\textsuperscript{30} While the franchisee generally pays all
of its fees to the franchisor, the franchisor generally remits a portion of the initial franchise fee
and ongoing royalties to the area representative in exchange for the area representative’s sales
efforts and ongoing service obligations.\textsuperscript{31}

\textbf{G. Master Franchisees}

Franchisors can also sell and expand their brand by using the master franchise/sub-
franchise concept. The Amended FTC Franchise Rule (Franchise Rule) defines a sub-franchisor
as “a person who functions as a franchisor by engaging in both pre-sale activities and post-sale
performance.”\textsuperscript{32} This arrangement involves at least three parties: the franchisor, the master
franchisee, and the sub-franchisee.\textsuperscript{33} In master franchising, similar to area representation, a
master franchisee pays the franchisor an up-front fee to enter into a master franchise
agreement with the franchisor.\textsuperscript{34} The master franchise agreement grants the master franchisee
the (generally exclusive) right to solicit prospective sub-franchisees, and the obligation to
develop a certain number of sub-franchisees (in a defined territory and in a defined time
period).\textsuperscript{35} However, in master franchising, in contrast with area representation, the master
franchisee directly enters into a franchise agreement with the sub-franchisee, and the franchisor

\textsuperscript{27} NASAA Multi-Unit Commentary, Sept. 16, 2014, “Definitions” at Part C, http://www.nasaa.org/wp-

\textsuperscript{28} Levitz, et al., supra note 1 at 4-5.

\textsuperscript{29} NASAA Multi-Unit Commentary, Sept. 16, 2014, Definitions part C, http://www.nasaa.org/wp-

\textsuperscript{30} W. Michael Garner, 1 Franchise & Distrib. Law & Prac. § 1:19 (West, 2010-2011 ed.) (Area Representation); Levitz,
et al., supra note 1 at 4-5.

\textsuperscript{31} Keith Kanouse, Special Issues for an Area Representative, http://www.kanouse.com/sites/default/files/Special_Issues_for_an_Area_Representative.pdf (last visited August 2, 2017).


\textsuperscript{33} John R. Dunne, Run Through the Wringer: How Cleaning Industry Franchisors Exploit Franchisees’ Hope for an
American Dream, 47 J. MARSHALL L. REV. 827, 834 (2013); NASAA Multi-Unit Commentary, Sept. 16, 2014,

\textsuperscript{34} Ved P. Nanda & Ralph B. Lake, 1 THE L. OF TRANSMATIONAL BUSINESS TRANSACTIONS § 5:34 (2016) (Structuring an
international franchise network—Master franchise agreements); NASAA Multi-Unit Commentary, Sept. 16, 2014,

\textsuperscript{35} Id.
is not a party to the agreement. In fact, the sub-franchisee and the franchisor often will not even interact with one another. The master franchisee is typically obligated to provide support services to those third parties, and both the franchisor and the master franchisee receive a portion of the initial franchise fee and the continuing fees paid by each sub-franchisee.

Master franchising is the sales method most universally employed by franchisors to expand, sell, and support franchises internationally. Master franchising is used in the international context because a franchisor is able to expand its footprint without initially investing as much as would be required set up a foreign operation on its own. In addition, the franchisor benefits from the master franchisee’s familiarity with the foreign culture, customs, traditions, and political and legal systems, and more quickly allows the franchisor to adapt to these new norms.

III. WHY DO FRANCHISORS USE THIRD-PARTY BROKERS AND SALES AGENTS?

A. Pros for Franchisors

1. Reduced Employee Count and Obligations

The main financial and administrative pro for the use of a third-party broker is part and parcel with the main pros for franchising in general: grow the business without exponentially increasing capital or employee needs and related obligations.

One need only witness the proliferation of cases involving employee versus independent contractor status in industries as varied as janitorial services, bakery goods distribution, and package carriers such as Federal Express to understand that employees receive special rights and protections not afforded independent contractors. The ability to outsource the franchise-sales component to independent contractors eliminates an entire division of a franchise company and the related employment obligations. This is perhaps the greatest pro for the use of a third-party broker.


37 Levitz, et al., supra note 1, at 27.


39 Nanda et al., supra note 34 at § 5:34.


2. **Incentive Based Compensation for Sales Team**

Salaries are expensive, and good salespersons garner attractive salaries, but in the franchise sales world production is key. While salespersons can be employees and work on a partial salary with incentives, brokers generally work solely on incentive based compensation. For a small, young, or struggling franchisor, the purely incentive-based compensation structure of broker programs are highly attractive and often provide a win-win situation for the franchisor and broker without committing precious resources to salesperson employees who may not ultimately produce (regardless of their proficiency and focus).

3. **Professional Salespersons**

Many of the larger, more sophisticated, and well capitalized broker networks engage experienced brokers. These brokers might command large salaries and incentive-based perks if employed on a captive basis with a franchisor, but prefer the freedom and ability to broker for multiple businesses. Smaller franchisors without access to these types of brokers as employees can still bring them into the fold and benefit from their expertise and contacts through contracting with a broker network.

4. **Increased Number and Geographic Scope of Sales Team**

Many smaller franchisors have a single franchise salesperson who started out early with the company and covered a targeted geographic area. As franchisors grow, what used to be a one-person job can turn into a multiple-person job if or when the franchisor pursues franchise prospects in all 50 states. While hiring more sales employees and building an employee based sales team is certainly a viable model, franchisors can typically expand their geographic reach more quickly and cheaply by contracting with a broker network with an existing U.S. network of brokers, or at least a greater geographic reach than a smaller salesperson team can cover. The larger broker networks specifically advertise and promote their numbers and geographic scope as one of their greatest selling points and differentiating factors.

5. **Increased Access to Potential Candidates**

Most franchise salespersons will represent that the number of leads is the most important factor to success in franchise sales. While franchisors may want to quibble with quality over quantity, quantity is often the initial focus in sales efforts.

As a result, franchise broker networks focus the bulk of their time and effort finding potential franchise prospects irrespective of any particular brand. These networks focus first on bringing in candidates, qualifying them, and obtaining information on the types of franchises that interest them and for which they may be a fit. Then, only after bringing them into the fold, these brokers begin to match the franchise prospects to specific opportunities. This process allows the broker to cast a much wider net for potential franchise prospects, especially for smaller, regional franchises that do not yet have broad name recognition, but that may ultimately be a good fit.
B. Cons for Franchisors

1. Reduced Control and Oversight in Sales Process

Just as reducing cost and obligations is a key tenet of the use of the franchise model and third-party franchise brokers, the reduction in actual and effective control over their actions is the primary con for the use of the franchise model and third-party franchise brokers.

Section VI of this paper outlines key terms for broker agreements, including the allocation of rights and responsibilities in the system, but there is no substitute for an employment relationship in terms of control and oversight over a person’s performance of their duties. Just as franchisees are not under the franchisor’s direct control, franchise brokers are likewise not under the franchisor’s direct control.

In addition, depending on how much latitude is given the broker and how much franchisor oversight and involvement occurs, there is always the concern that the franchisor misses potential red flags or concerns with a prospect that they might have seen if they were more involved with the franchise onboarding process. While these types of concerns can certainly be mitigated by franchisors who maintain a through discovery day or other vetting process for broker-fed franchisee leads, there is in most instances no substitute for the franchisor personnel’s sixth sense when it comes to prospects for their franchise system.

One author’s experience representing a franchisee prospect with a brand is representative of this potential concern. The prospective franchisees met the founder of the brand at a sales expo and were excited by his energy and vision, and his apparent willingness to work with these particular franchise prospects who would be bringing the concept to an entirely new part of the country. The prospects went home, did some due diligence (including by hiring a franchise attorney) and then started making plans for a discovery day. Unbeknownst to the prospects, but set forth in the FDD they received and discussed before their trip, the founder has recently engaged a broker system whose modus operandi is to take over almost the entire franchise sales and contracting process, including the discovery day. The discovery day turned into an unmitigated disaster for the prospects as they were told at the start of the program in their brief face-to-face meeting with the broker team that the offering was “take it or leave it” and the agreements were not open to negotiation, and when they questioned that position and talked about their prior meeting with the founder, they were told they were not team players and were disinvited to the all prospect Q&A sessions due to concerns they would poison the other prospects with respect to their negotiation desires. They never actually got to see the founder during the abbreviated discovery day, and only later got ahold of him via email and were told that he (the founder) had been pulled in too many directions with the sales process and that it was in his best interests to “farm out” (the founder’s words) the sales process. He said he had promised to stick to his broker firm’s positions and therefore could not intervene. For this franchisor, while the new process may have resulted in a streamlined process for the franchise system and freed up the founder’s time, it lead to a horrible experience for one potential prospect. While this experience may have been part and parcel of the timing of the hiring of the broker team, it probably could have been alleviated with better communication between the franchisor’s founder, the new broker team and franchise prospects who were involved in the franchisor’s transition to the broker.
2. **Reduced Knowledge and History with Brand**

By their nature, franchise broker networks that represent multiple brands will have less history, interaction, and institutional knowledge than employee sales persons. While the best brokers can compensate with general experience and salesmanship, there is really no substitute for an employee whose livelihood is intertwined with the success of the franchise system and who have history, institutional knowledge, and relationships to aid the franchise prospect through the process and act in the best interest of the franchisor. Of course, with the advent of broker networks that effectively take over the entire sales process, it is quite possible that the brokers assigned to the particular franchisor are in a captive situation and develop an institutional knowledge and history with the brand.

3. **Potential for Conflicting Incentives or Allegiances**

As stated above, franchise broker networks that represent multiple brands and focus efforts on identifying and securing large quantities of franchise prospects will most likely have different contracts in place with various franchisors and, in certain instances, widely disparate financial compensation models. Inherent conflicts may exist as well as the disincentive to focus on a particular franchisor’s program where another franchisor (also looking for similarly situated franchise prospects) has offered the broker a materially larger commission on completed sales. Additionally, a broker may desire to sway prospects to a franchise system that that broker believes holds a more valuable, long-term relationship or streamlined approval process.

Ultimately, franchisors may find themselves in an additional beauty contest before even being introduced to prospects, with the broker as the judge and jury. And, because of the minimal oversight involved, the franchisor may not even know how many candidates it “lost” because of the questionable steering tactics by an unscrupulous broker whose primary focus rests on compensation versus long-term success of the franchisor’s system.

4. **Less Concern for Long-Term Success and Relationships**

Essentially, most franchise brokers are hired guns. They go where the work is, and frequently negotiate their contracts in a way that provides them an “out” to leave for greener pastures if the work is not fruitful.

In addition, where broker compensation is solely based on an initial fee, the broker is less likely to be motivated towards the long-term success of the franchisor’s system or the franchisee prospect itself. While brokers understandably want to point to past success stories to garner new work, brokers regularly measure such success by the number of franchises sold, not the percentage remaining in the system after 5 or 10 years.

5. **Direct Liability for Acts, Errors, or Omissions**

As detailed below in Section IV of this paper, the intent of the FTC Rule and state franchise laws is to make the franchisor ultimately responsible for disclosure, registration and compliance, even in the case where a third-party franchise seller is used and may have some concurrent responsibility. While this type of liability is part and parcel of having employees in the sales process, as detailed above, the franchisor gives up a certain level of control and oversight when engaging a third-party franchise broker yet remains liable for their acts, errors, or omissions in the franchise sales process. This is the “Catch-22” of franchising, and each franchisor must weigh the pros and cons of using a franchise broker with this underlying liability
in mind. While indemnification may be a contractual term with the broker, the practical extent to which the indemnification (or insurance) is available to the franchisor is subject to multiple variables, most of which are dependent on the broker and not the franchisor.

6. Reduced Likelihood of Long-Term Relationship with Brand

By nature, franchise sales personnel are some of the most transient in franchising, however, brokers seem to be even more so. Such turnover may result from the contract itself or the transformative nature of how younger or smaller franchise systems test different structures and options. When the franchise prospects are plentiful and the franchise sales easy, the broker relationship will likely continue, but reality is that almost every franchisor that experiences a sales honeymoon will also face a slowdown at some point in its growth cycle that will test the broker relationship both from a contract and relationship standpoint.

C. Pros for Franchisees

While there is no universally-accepted answer to whether the use of third-party sales agents benefits prospective franchisees, there are some potential benefits to prospective franchisees, including the potential to explore multiple brands, access to professional sales people, and the third-party sales agent’s ability to act as a liaison for the prospective franchisee.

1. Ability to Explore Multiple Brands

One of the primary benefits a prospective franchisee may receive as a result of working with a third-party sales agent, as opposed to directly with a franchisor, is that the prospective franchisee may have the opportunity to explore multiple franchised brands, rather than only having the option to purchase a franchise in the single brand being sold by a sales person directly employed by the franchisor, and the broker should have insight into multiple brands that could only help the prospective franchisee in determining what is market or normal in a particular segment.

While this may not be true for every third-party sales agent (e.g., area representatives, master franchisees, and/or franchise brokers/consultants that only represent one brand), a third-party sales agent that represents multiple brands should, in an ideal world, listen to the franchisee, attempt to understand what the franchisee is looking for, and then provide the prospective franchisee with a small subset of potential brands that are the best fit for the franchisee. Even though, as discussed below, the third-party sales agent will certainly have an incentive to make a sale, there may be less of an incentive to steer the prospective franchisee to a particular brand. Indeed, if the prospective franchisee is working directly with a franchisor-employed sales person, there is only one “successful” outcome—selling the franchisee a franchise of that particular brand. But, for third-party sales agents representing a number of different brands, “success” is simply the sale of a franchise, not a franchise of a particular brand.

Overall, the ability to explore multiple brands can result in the prospective franchisee finding a franchise that is a better “fit,” and, hopefully, in the franchisee being more successful, which is good for both the franchisee and the franchisor.
2. **More Knowledgeable Sales People**

Third-party sales agents may also be more knowledgeable about the sales process than franchisor employees who only spend a portion of their time selling franchises. Whether it is simply explaining the purpose and scope of the FDD, or comparing the nuances associated with a variety of quick service restaurants and the norms and outliers, a third-party agent provides a potential franchisee access to a knowledgeable, motivated, accessible, and often free (to the franchisee) resource who can aid in the process of buying a franchise. The third-party sales agent may also be more up-to-date on deal term norms, industry trends or emerging industries, and, hopefully, use that information to steer the prospective franchisee to a franchise with more upside, as opposed to a franchisor-employed sales agent, who may only be in a position to rely upon the “sales pitch” the franchisor provides.

3. **Ability to Act as a Liaison for the Prospective Franchisee**

One final potential benefit to prospective franchisees is that third-party sales agents have the ability to act as a “liaison” between the prospective franchisee and the franchisor. If a franchisee has questions, the third-party sales agent can directly pose those questions to the franchisor on the prospective franchisee’s behalf, and assist the prospective franchisee in understanding the response. Prospective franchisees may feel uncomfortable directly questioning a franchisor, but, through the third-party sales agent, may feel more comfortable asking for more information or challenging the franchisor on a particular issue. Third-party sales agents also provide a level of insulation between the prospective franchisee and the franchisor that may encourage the prospective franchisee to be more candid, ask questions, and express concerns without worrying about starting their long-term relationship with the franchisor on shaky ground.

**D. Cons for Franchisees**

While there are some potential advantages, there are a number of potential disadvantages for franchisees interacting with third-party sales agents, including, but not limited to, a lack of knowledge of and history with the brand, the potential for conflicting incentives/allegiances, and a reduced concern for the long-term relationship/success of the prospective franchisee.

1. **Reduced Knowledge of and History with the Brand**

Except for situations where the third-party represents only one brand (e.g., area representatives, master franchisees, and, in limited situations, some franchise brokers/consultants), most third-party sales agents will not have the same level of knowledge of, or history with, a particular brand that the franchisor itself will have. This lack of knowledge regarding current events and the history of the brand can often lead to problems for the prospective franchisee.

For example, the third-party sales agent may simply not be in a position to answer relevant questions that a prospective franchisee might ask, e.g., how the brand was started, the history of the franchisor’s personnel that will ultimately be working closely with the franchisee, and, most importantly, what changes may soon be coming to the brand. This can lead to prospective franchisees both becoming a franchisee of a brand that they would not have chosen had the third-party sales agent properly provide them of all of the information, and prospective franchisees missing out on a franchised system that would have been right for them had
additional information been disclosed. Ill-conceived matches of prospective franchisees and franchisors may lead to lower productivity and higher failure rates, damaged goodwill, and lost investments.\textsuperscript{43}

Third-party sales agents may also have less access to information than an employee of a franchisor. For example, a salesperson employed by a franchisor might be able to simply walk down the hall and ask an operations employee the answer a prospective franchisee’s question, whereas it might be more difficult for the third-party sales agent to obtain that same information. This potential lack of information can lead to a prospective franchisee’s questions remaining unanswered, or, in some instances, the third-party sales agent having an incentive to invent an answer to the prospective franchisee’s questions.

\section*{2. Potential for Conflicting Incentives/Allegiances}

Third-party sales agents are not compensated for turning a lead away; they are compensated with commissions earned by making sales.\textsuperscript{44} Whether it be a broker, consultant, area representative, or master franchisee, the desire to make a sale and earn a commission may result in the salesperson overselling the chances for success in a particular franchise, pressuring the prospective franchisee to make a quick decision, or to invest against the prospective franchisee’s best interest.\textsuperscript{45} Oversold franchisees are obviously harmed in these circumstances, but franchisors are not much better off, as third-party sellers recommending unqualified candidates and/or overstating a prospective franchisee’s chances for success as a franchisee almost always leads to problems for the franchisee, in the form of litigation, underperforming franchisees, etc.

For sub-franchisees/master franchisees and area representatives, the pressure to meet a development schedule also creates problems. If the master franchisee/area representative falls behind on its development schedule (which can often lead to termination), or is blinded by the desire to sell more and make more, the master franchisee/area representative may be incentivized to sell to unqualified franchisees, to approve unqualified locations, or otherwise to adequately “screen out” unqualified franchisees, just to comply with the minimum development schedule or increase its cash flow.\textsuperscript{46} Needless to say, such situations can result in significant monetary losses.\textsuperscript{47} Moreover, in order to satisfy the development schedule, a sub-franchisor/master franchisee may seek to develop and open competing franchises in close proximity to existing franchises, which oversaturates the market and cannibalizes sales, and

\begin{flushleft}
\end{flushleft}

\begin{flushleft}
\textsuperscript{44} Levitz, \textit{et al.}, supra note 1, at 2.
\end{flushleft}

\begin{flushleft}
\end{flushleft}

\begin{flushleft}
\end{flushleft}

\begin{flushleft}
\textsuperscript{47} \textit{Id.}
\end{flushleft}
harms both the franchise system and the afflicted sub-franchisees.\textsuperscript{48} To minimize these potential conflicts, both parties are well served by understanding each party’s interests and formulating a realistic development schedule that will allow for sustainable growth in the defined territory.

3. **Less Concern for Long-Term Success/Relationship**

For brokers and consultants, the short-term incentives and varying commissions that franchisors pay brokers create a conflict of interest.\textsuperscript{49} A broker, consultant, or even a lead generation network, benefits in the short-term by making a franchise sale or referral. The broker usually does not have any ongoing financial interest tied to the long-term success of the franchisee. Indeed, although brokers generally disclose to prospective franchisees that they receive a commission from the franchisor on franchise sales, rarely, if ever, do franchise brokers disclose the amount of commissions that brokers receive from each franchisor.\textsuperscript{50} Therefore, even if a prospective franchisee is a better fit for a particular franchise system, the broker may put the prospective franchisee’s interests aside and steer him/her in the direction of a franchisor commissioning the broker more money.\textsuperscript{51} Whether a franchisee ultimately succeeds is of no financial consequence to these salespersons. The conflict is inherent under these arrangements and the resultant harm falls on both the franchisor and the afflicted franchisee.

Master franchisees and area representatives also have less concern for the long-term success of sub-franchisees as the term of the master franchise agreement/area representative agreement approaches expiration without renewal. As expiration approaches, the master franchisee/area representative has almost no incentive to continue develop and service its territory because the master franchisee/area representative will no longer receive continuing royalties from the sub-franchisee or franchisor, making it less likely that the master franchisee/area representative will put forth any substantial efforts.\textsuperscript{52} Absent a renewal of the master franchise agreement/area representative agreement, this problem is almost unavoidable. As a result, the burden falls on the franchisor as the term of the master franchise agreement/area representative agreement draws nearer to expiration to more closely monitor the master franchisee/area representative’s performance and ensure that sub-franchisees receive the support to which they are entitled. Unfortunately, this is not always the case, and sub-franchisees are left without support near the end of the master franchisee/area representative’s relationship with the franchisor.

Overall, third-party sales agents are inherently less concerned with the long-term success of the franchisee by virtue of their arrangement with the franchisor. This is especially true for sales brokers, who are not a party to the franchise agreement and do not have post-sale

\textsuperscript{48} Levitz, et al., supra note 1, at 25.


\textsuperscript{50} Id.

\textsuperscript{51} Id.

contractual obligations to the franchisee. Franchise brokers work with the prospective franchisee until the franchisor takes over to close the sale. The handoff in the sales process from the broker to the franchisor, especially if the broker and the franchisor have materially differently sales styles, may actually disrupt the sales process and make it less likely that a franchise sale eventually occurs. Moreover, especially because franchise brokers eventually hand-off the franchisee to the franchisor, the franchisor broker is not especially motivated for the franchisee to succeed long-term, and may only be concerned with closing a sale and earning a commission.

IV. COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS

A. Introduction

The nuts and bolts of broker and sales agent compliance issues stem from general federal and state franchise laws, rules, and regulations. In this Section, we cover compliance as follows:

- the federal and state definitions that pertain to franchise brokers;
- the related obligations of franchisors and brokers, which depending on the jurisdiction, can range from inclusion by name or general reference in a franchisor’s Franchise Disclosure Document (FDD) and/or franchise sales person disclosure forms to separate broker registrations and filings performed by the franchisor and/or the broker; and
- the related repercussions for franchisors and brokers, which can range from direct liability of the franchisor for the broker’s actions to the broker him or herself being directly liable to the state or even private litigant for infractions.

B. FTC Rule Definitions

The starting point is the FTC Rule (defined above in Section 2), which requires franchisors to provide full presale disclosure to prospective franchise purchasers by providing potential franchisees a copy of the FDD. The FTC Rule is applicable in all 50 states plus the U.S. territories (such as Puerto Rico and Guam). If a transaction satisfies the definition of a franchise under the Franchise Rule, and no exemption or exclusion from the FTC Rule applies, it is a violation of Section 5 of the Federal Trade Commission Act (FTC Act) for a franchisor to

---


56 16 C.F.R. § 436.2(a) (2007) (“[f]or any franchisor [t]o fail to furnish…the franchisor’s most recent disclosure document. . . .”).

fail to furnish an FDD to a prospective franchisee. 58 Although there is no private right of action for a franchisee to enforce the FTC Rule, 59 the FTC may pursue an enforcement action against a party that violated the FTC Rule (and therefore, the FTC Act). 60 If an exemption or exclusion applies, a franchisor need not provide an FDD under federal law. 61

Within this backdrop, the FTC prevented franchisors from avoiding liability under the FTC Rule by merely engaging a third-party to conduct franchise sales activities on its behalf, and in turn also imposed liability on certain third-party sellers. Specifically, the original FTC Rule defined the term “Franchise Broker” as “any person other than a Franchisor or Franchisee who sells, offers for sale, or arranges for the sale of a franchise.” 62 The Franchise Broker was a third-party seller, and not an employee of the franchisor, and to close any potential loopholes, the FTC Rule imposed responsibility on the broker for disclosure and made the broker liable for certain disclosure violations. Importantly, these were independent obligations to comply with the disclosure requirements and a failure of the Franchise Broker to comply meant the possibility of an independent action against the Franchise Broker by the FTC, states or franchisees themselves. 63

The amended FTC Rule, which became effective in 2008, transitioned to a new definition of a “franchise seller”, which was defined as “a person that offers for sale, sells or arranges for the sale of a franchise.” 64 It includes the franchisor and the franchisor’s employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. 65

The amended FTC Rule’s definition of a franchise seller is broader than the original FTC Rule’s definition of a Franchise Broker. 66 Specifically, it includes the employees of the

60 In addition, many states have so-called “Little FTC Acts,” which afford litigants a private right of action against a party that has engaged in deceptive or unfair treatment, which may include a violation of the Franchise Rule. See generally Altersha Q. Burchett-Williams, Robert M. Einhorn, & Paula J. Morency, Claims Under the “Little FTC Acts” The High Stakes of Risk and Reward, ABA 33RD ANNUAL FORUM ON FRANCHISING W-6 (2010). While Little FTC Acts often codify common law concepts, such Acts are often more liberal in permitting causes of action that would fail to satisfy the requirements of a common law claim for fraud or misrepresentation. Id.
61 16 C.F.R. § 436.8(a) (2007) (“The provisions of part 436 shall not apply if the franchisor can establish ‘the applicability of an exemption’). Note that an exemption from the Franchise Rule does not constitute an exemption under applicable state franchise registration and disclosure laws and an analysis of the applicability of state exemptions from disclosure and/or registration must be independently undertaken.
63 See Levitz, et al., supra note 1, at 6.
65 Id.
66 See Levitz, et al., supra note 1 at 6-7.
franchisor, not just third-party sellers. The concept also includes “Third-Party Brokers” but interestingly there is no separate defined term for “Franchise Broker” still, the breadth of the definition covers arrangements such as area representative and master franchisees/subfranchisors that arrange for the sale of a franchise. Some franchise consultants can be considered a “franchise seller” as detailed elsewhere in this paper.

C. State Law Definitions

Fifteen states have separate franchise registration and/or disclosure laws generally applicable to most U.S. franchise programs. The requirements of these laws vary from mere one-page filings to actual registrations involving a comprehensive application and review process by the state. Completion of the registration process is necessary, in most cases, prior to a franchisor initiating any offering activity in a state.

1. NASAA

As all franchise attorneys know, the state franchise laws are a patchwork of laws, regulations and advisory opinions such that it is no surprise that the states are not aligned on what constitutes a broker or salesperson, or what requirements or restrictions are applicable to them.

However, the North American Securities Administrators Association (NASAA) has tried to offer franchisors some guidance in its 2008 Franchise Registration and Disclosure Guidelines by adopting verbatim the FTC’s definition of “franchise seller.” As a result, a third-party broker’s disclosure obligations under state disclosure laws will generally be consistent with the requirements of the FTC Rule if the particular state has adopted the NASAA Guidelines, although the NASAA Guidelines add several additional requirements.

Several registration states (Hawaii, Illinois, New York, Virginia and Wisconsin) independently regulate the conduct of franchise brokers, and in certain states brokers may need to separately register with a state regulatory agency, a franchisor may be obligated to identify a third-party franchise seller to a state regulatory agency as part of the franchise registration process, or certain third-party franchise sellers may need to be disclosed in certain FDD items.

2. Hawaii

Hawaii’s Franchise Investment Law defines a “franchise broker” or “selling agent” as a person who directly or indirectly engages in the sale of franchises.

---

67 Id. at 7.
68 These states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. See Appendix A for a chart outlining the corresponding state statutes.
3. **Illinois**

The Illinois Franchise Disclosure Act defines a franchise broker as “any person engaged in the business of representing a franchisor in offering for sale or selling a franchise,” and excludes franchisors and the officers, directors, and employees of franchisors. A person who merely provides a prospective franchisee with information about specific franchises, other than the franchisor’s name, address, and telephone number, also is deemed a franchise broker under Illinois law. Generally, the franchisor’s payment of a fee to the person upon the consummation of a franchise sale is considered evidence of franchise broker status, except when the sale is an “isolated transaction” or when a franchisee merely refers a prospective franchisee to the franchisor. An “isolated transaction” occurs when a referral source provides the name of a prospective franchisee to a franchisor and receives a fee but otherwise has no involvement in presenting the advantages of the franchise, handles no franchisee payments owed to the franchisor, and has made no referral to that franchisor during the preceding 12 months.

4. **New York**

The New York Franchise Law uses the term “franchise sales agent” and defines a “franchise sales agent” as any person who engages in the offer or sale of any franchise on another’s behalf and excludes franchisors, subfranchisors, and their respective employees.

5. **Virginia**

Virginia’s Retail Franchising Act defines a franchise broker as a person engaged in the business of representing a franchisor or subfranchisor in the offer for sale or sale of a franchise, but excludes any person disclosed in Item 2 of the disclosure document.

6. **Washington**

The Washington Franchise Investment Protection Act defines a franchise broker as a person who directly or indirectly engages in the business of the offer or sale of franchises and excludes from the definition franchisors, subfranchisors, and their respective officers, directors, and employees. Additionally, a Washington interpretive opinion identifies the following persons as engaged in the business of the offer or sale of franchises and therefore likely franchise brokers.


72 See Levitz, et al., supra note 1, at 3.


74 Id.


76 21 VA. ADMIN. CODE § 5-110-10 (LEXIS through issue 33:21 VA.R June 12, 2017), reprinted in Bus. Franchise Guide (CCH) ¶ 5460.01.

brokers: (1) an independent agent, contractor, or consultant representing one more franchisors; (2) a person who receives commissions or other compensation in connection with the offer or sale of a franchise; (3) a person who offers or sells two or more franchises; and (4) a person who advertises, promotes, or identifies himself or herself as a broker.\textsuperscript{78} The opinion further counsels that an employee of a franchise broker is not “in the business” of offering or selling franchises and, accordingly, is unlikely to be deemed a franchise broker.\textsuperscript{79}

D. Federal/State Disclosure and Registration Obligations

1. FTC Rule

The intent of the FTC Rule is clear; the franchisor is ultimately responsible for disclosure regardless of whether the franchisor outsources the franchise sale process to a third-party franchise seller.\textsuperscript{80} Accordingly, franchisors must vet, train, supervise, monitor and hold third-party franchise sellers accountable for compliance just as they do their employees, but (as addressed elsewhere in this paper), without the same control and oversight mechanisms.

The FTC Rule primarily focuses disclosure responsibility directly on the franchisor or subfranchisor versus the franchise seller.\textsuperscript{81}

In connection with the offer or sale of a franchise to be located in the United States of America or its territories, unless the transaction is exempted under Subpart E of this part, it is an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act:

(a) For any franchisor to fail to furnish a prospective franchisee with a copy of the franchisor's current disclosure document, as described in Subparts C and D of this part, at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale.

(b) For any franchisor to alter unilaterally and materially the terms and conditions of the basic franchise agreement or any related agreements attached to the disclosure document without furnishing the prospective franchisee with a copy of each revised agreement at least seven calendar-days before the prospective franchisee signs the revised agreement. Changes to an agreement that arise out of negotiations


\textsuperscript{79} Id.

\textsuperscript{80} See 16 C.F.R. § 436.1(j) (2007); Levitz, \textit{et al.}, \textit{supra} note 1, at 6-7.

\textsuperscript{81} There are state franchise rules which may directly require the franchise seller to make disclosures. See Section IV.C.2. below.
initiated by the prospective franchisee do not trigger this seven calendar-day period.\textsuperscript{82}

However, the FTC Rule has “Additional prohibitions” which apply to all franchise sellers and make it an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any franchise seller to:

- Make any claim or representation, orally, visually, or in writing, that contradicts the FDD;\textsuperscript{83}
- Misrepresent that any person (i) purchased a franchise from the franchisor or operated a franchise of the type offered by the franchisor; or (ii) can provide an independent and reliable report about the franchise or the experiences of any current or former franchisees;\textsuperscript{84}
- Disseminate any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time the representation is made, and the representation is included in Item 19 of the franchisor's disclosure document. And, in conjunction with any such financial performance representation, the franchise seller shall also (i) disclose the required information if the representation relates to the past performance of the franchisor's outlets, and (ii) include a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation;\textsuperscript{85}
- Fail to make available to prospective franchisees, and to the FTC upon reasonable request, written substantiation for any financial performance representations made in Item 19;\textsuperscript{86}
- Fail to furnish a copy of the FDD to a prospective franchisee earlier in the sales process than required, upon reasonable request;\textsuperscript{87}
- Fail to furnish a copy of the franchisor's most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement;\textsuperscript{88}
- Present for signing a franchise agreement in which the terms and conditions differ materially from those presented as an attachment to the disclosure document, unless the franchise seller informed the prospective franchisee of

\textsuperscript{82} 16 C.F.R. § 436.2(a) (2007). Of note, in 2007, the FTC Rule removed the “first personal meeting” requirement for disclosure, although certain states still have this requirement. This was a very important loosening of the rules of engagement of potential franchisees for both franchisors and brokers.

\textsuperscript{83} 16 C.F.R. § 436.9 (a) (2007).

\textsuperscript{84} Id. at § 436.9 (b).

\textsuperscript{85} Id. at § 436.9 (c).

\textsuperscript{86} Id. at § 436.9 (d).

\textsuperscript{87} Id. at § 436.9 (e).

\textsuperscript{88} Id. at § 436.9 (f).
the differences at least seven days before execution of the franchise agreement;[^89]

− Disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments (the FTC notes that this provision is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sale negotiations);[^90] or

− Fail to return any funds or deposits in accordance with any conditions disclosed in the franchisor’s disclosure document, franchise agreement, or any related document.[^91]

Importantly, the FTC Rule does not currently require franchisors to provide broker bios in Item 2 of the FDD.[^92] This was a change from the prior FTC Rule which required Item 2 disclosure as well as related Item 3 litigation and Item 4 bankruptcy disclosures for brokers.

This 2007 change was especially important to franchisors from a logistical standpoint as franchise broker networks grew in size and scope. The process of creating and maintaining Item 2 type disclosures for engaged broker networks had become an extremely burdensome undertaking for franchisors, the broker networks and the brokers themselves, and in some instances broker networks took different views on what the law required and how they were to be disclosed (or not disclosed) in a franchisor’s FDD.

The FTC justified this omission as follows:

Item 2 appropriately requires franchisors to disclose the background of those individuals who **control** the franchisor and those who actually **manage** franchisees. That information is material because prospective franchisees need to know the identity and business experience of the individuals in command of the franchisor in order to assess whether these individuals are likely to be able to perform as promised under the franchise agreement. Unlike franchisors, brokers do not create or implement franchisor policy, nor do they oversee performance of post-sale obligations to the franchisee. Accordingly, prospective franchisees are less likely to give decisive weight to an individual broker’s expertise or background in assessing the merits of purchasing a franchise.[^93]

Instead, the FTC Rule requires that the franchisor include on the receipt pages of the disclosure document the name and contact information of any franchise seller dealing with the prospective franchisee.[^94] Importantly, the FTC Rule definition of “Franchisee Seller”

[^89]: Id. at § 436.9 (g).
[^90]: Id. at § 436.9 (h).
[^91]: Id. at § 436.9 (i).
expressly excludes most franchisee transfers by excluding from coverage as a franchise seller “existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.”

While not the focus of this paper, it should be noted that a subfranchisor has certain other requirements that exceed those of other franchise sellers, including preparing its own disclosure statement and, as stated in the FTC’s Franchise Rule Compliance Guide, “[b]oth the franchisor and any subfranchisor are responsible for each other’s compliance with the amended Rule and are jointly and severally liable for each other’s violations.”

Finally, since the FTC Rule is solely a disclosure law, it makes sense that the FTC Rule does not contain any specific registration requirement for franchisors or their franchise brokers.

2. Registration States

Most registration states follow the NASAA 2008 Franchise Registration and Disclosure Guidelines and require disclosure of franchise salesperson information.

Of note, among the NASAA Guidelines’ “risk factors” for the FDD’s State Cover Page, NASAAA requires use of the following where “a Franchise Broker or a referral source” is used in franchise sales:

We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A Franchise Broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise.

However, only a handful of registration states impose any registration requirement on franchise brokers directly beyond submission of franchise salesperson forms with initial and annual renewal applications. Nor do most registration states have express methods to notify


97 The list includes California, Hawaii, Illinois, Maryland, Minnesota, North Dakota, New York, Rhode Island, and Washington, and the forms (NASAA “Franchise Seller Disclosure Form” (or “Form D”)) and format are familiar to franchisors who file salesman disclosure forms for their direct employees and personnel. The form contains the name and business address of the broker, along with employer and title, as well as a five year employment history, and then information on any “administrative, criminal or material civil action” “alleging a violation of franchise, antitrust or securities law, or alleging fraud, unfair or deceptive practices, or any comparable allegations”, as well as any matters concluded within “the 10-year period immediately before the” date of the FDD, resulting in a felony conviction or nolo contendere (no contest) pleading; or civil liability in an action alleging “violation of a franchise, antitrust or securities law, or allegations of fraud, unfair or deceptive practices or comparable allegations.” Finally, the form requires disclosure of whether the broker “[i]s subject to a currently effective injunction or restrictive order or decree resulting from a pending or concluded action brought by a public agency and relating to the franchise, or to a … franchise, securities, antitrust, trade regulation or trade practice law” must also be disclosed, along with the details of any such proceeding.

the state when a franchise salesperson is no longer authorized to represent the franchisor.\textsuperscript{99}

That said, as provided below, California, Illinois, New York, and Washington all contain specific requirements, ranging from creating direct liability for the broker to prohibiting a franchise broker from offering or selling franchises in the respective state unless the broker registers with the state.

a. \textbf{California}

California expressly prohibits third-parties such as brokers from making certain misrepresentations of a prospective Franchisee:

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communications not enumerated in [any application, notice or report filed with the California Commissioner] which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.\textsuperscript{100}

This type of direct liability is an important check and balance for the franchisor, the state and the franchise prospects.

b. \textbf{Illinois}

Illinois requires that third party brokers also complete certain forms as follows (although in practice franchisor routinely prepare and present these forms on the brokers' behalf):

Each franchise broker shall file with the Administrator the documents listed below in duplicate and pay an annual $100.00 registration fee.

a) Franchise Broker application page, Appendix B, Illustration A;

b) Certification page, Appendix A, Illustration G;

c) Salesperson Disclosure Form for each person who will be offering or selling franchises, Appendix A, Illustration C;

d) Corporate, Partnership or Individual Acknowledgment, Appendix A, Illustrations E and F;

e) Uniform Consent to Service of Process naming the Illinois Attorney General as agent to receive service, Appendix A, Illustration D;

f) Broker Authorization Form, Appendix B, Illustration B. This form must be filed with the Administrator for each franchisor the broker purports to represent, before making such representations to any prospective franchisee. The franchisor must amend its UFOC to disclose each broker

\textsuperscript{99} Id. at 162.

\textsuperscript{100} \textit{CAL. CORP. CODE} § 31201 (LEXIS through MAY 26, 2017).
relationship before the respective broker(s) represent the Franchisor, except under the “isolated transaction” exemption;

g) A broker who is authorized to accept cash, checks or other payments from prospective franchisees on behalf of a franchisor shall comply with the provisions of this subsection (g) requiring an unaudited balance sheet and income statement externally prepared by an independent CPA in accordance with GAAP current within 120 days certifying the net worth of the franchise broker to be not less than $50,000.

1) In lieu of unaudited balance sheet and income statement, the broker may post a surety bond in the amount of $50,000 (Appendix B, Illustration C); or

2) In lieu of the franchise broker's unaudited balance sheet the franchise broker may submit an audited balance sheet and income statement of a person, corporation or partnership having a net worth of $50,000 a Guaranty of Performance from such other entity (Appendix B, Illustration D), a Corporate Resolution (Appendix D, Illustration B), a Secretary's Certificate (Appendix D, Illustration C), a Consent to Service of Process from the guarantor (Appendix A, Illustration D), and an Acknowledgment from the guarantor (Appendix A, Illustration E or F); and

h) $100 registration fee.\textsuperscript{101}

Importantly, Illinois law dictates that any person who offers or sells a franchise in violation of the Illinois statutes is liable to the Franchisee who may sue for damages.\textsuperscript{102}

Further, any person who directly or indirectly controls a person liable under that statute, including every principle officer or director, any person who acts in those functions and every employee, is also jointly and separately liable for a violation of the Illinois franchise statutes unless the person had no knowledge, or no reasonable basis to know, of the violation.\textsuperscript{103}

Ideally, brokers are aware of this type of direct liability and it acts as an incentive towards compliance, but it may fall on the franchisor to alert the broker to this type of liability.

c. \textbf{New York}

New York law requires that franchise sales agents who are offering or selling non-exempt franchises in New York be registered. Specifically, New York regulations set forth the below specific requirements for franchise sales agents:

(a) In compliance with section 683.13 of the General Business Law, all persons acting as franchise sales agents as defined in General Business Law section

\textsuperscript{101} ILL. ADMIN. CODE tit. 14, § 200.900 (LEXIS through May 26, 2017).

\textsuperscript{102} ILL. REV. STAT. CH. 85-55, SEC. 705/26 (LEXIS through May 26, 2017).

\textsuperscript{103} Id. See also Michael S. Levitz, Christina M. Noyes, & Les Wharton, \textit{The Perils of Third Parties Selling or Servicing Your Brand: Broker, Area Representative and Area Developer Programs}, ABA 34th Ann. Forum on Franchising, W-18(2011), at 39.
681.8 in the offer for sale or sale of a franchise shall file a Sales Agent Disclosure Form (UFRA-E) with New York State Department of Law. The Department shall issue an order of registration upon the receipt of a properly executed application and no offer for sale or sale of a franchise shall be made by a franchise sales agent until said registration order has been issued.

(b) In compliance with section 683.13 of the General Business Law, every person acting as a franchise sales agent who shall have filed a Sales Agent Disclosure Form (UFRA-E) with the Department of Law shall file an updated Sales Agent Disclosure Form (UFRA-E) whenever any of the following changes have taken place, to indicate the change of information originally filed.

1. **Name.** The change in name of registrant (in the event the registrant incorporates, an entirely new registration statement must be filed).

2. **Address.** Change of business address and addresses of new branch offices in New York.

3. **Management.** Changes in the officers, directors, general partners or other principals of the registrant, giving the new names and addresses involved in such changes.

4. **Litigation.** Upon each occasion when the registrant becomes the subject of any criminal action, or is convicted of any misdemeanor or felony, is the subject of any injunction or cease and desist order relating to the offer or sale of securities or franchises or is the subject of a money judgment or injunction in a civil action involving fraud, embezzlement, fraudulent conversion or misappropriation of property.\(^\text{104}\)

**d. Washington**

Washington has perhaps the most comprehensive broker regime. Specifically, Section 10,100.140 of the Washington Franchise Investment Protection Act states:

1. It is unlawful for any franchise broker to offer to sell or sell a franchise in this state unless the franchise broker is registered under this chapter. It is unlawful for any franchisor, subfranchisor, or franchisee to employ a franchise broker unless the franchise broker is registered.

2. The franchise broker shall apply for registration by filing with the director an application together with consent to service of process in such form as the director shall prescribe and payment of the fee prescribed in RCW 19.100.240.

3. The application shall contain whatever information the director requires concerning such matters as:

   (a) The applicant's form and place of organization.

(b) The applicant's proposed method of doing business.

(c) The qualifications and business history of the applicant.

(d) Any injunction or administrative order or conviction of a misdemeanor involving a security or any aspect of the securities business and any conviction of a felony; and

(e) The applicant's financial condition and history. 105

Washington law affords itself fairly broad powers over brokers. Specifically, Washington may by order:

[D]eny, suspend, or revoke registration of any franchise broker if the director finds that the order is in the public interest and that the applicant or registrant, or any partner, officer, or director of the applicant or registrant: (1) Has filed an application for registration as a franchise broker under RCW 19.100.140 which, as of its effective date, or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect or contained any statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact; (2) Has willfully violated or willfully failed to comply with any provision of this chapter; (3) Has been convicted, within the past five years of any misdemeanor involving a franchise, or any felony involving moral turpitude; (4) Is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any aspect of the franchise industry; (5) Is the subject of an order of the director denying, suspending, or revoking registration as a franchise broker; (6) Has engaged in dishonest or unethical practices in the franchise industry; and (7) Is insolvent, either in the sense that his or her liabilities exceed his or her assets or in the sense that he or she cannot meet his or her obligations as they mature. 106

Washington also requires special record-keeping and retention practices:

Every franchise broker shall make and keep current the following books and records relating to his business:

(1) Records of original entry containing the sale of franchise, to whom sold, the aggregate price, the amount paid down, the installment payments, if any, the commission paid to the broker, the amount dispersed for advertising and other amounts to be funded to the franchisor.

(2) An individual registration card for each franchisee, his name and address, aggregate amount to be paid, terms of the payment, a copy of the receipt signed by the purchaser that he had received a copy of the

105 WASH. REV. CODE ANN. § 19.100.140 (Westlaw through 2017 Reg. Legis. Sess.).

106 WASH. REV. CODE ANN. § 19.100.252 (Westlaw through 2017 Reg. Legis. Sess.).
offering circular and that it had been received ten business days before the sale.

(3) Every franchise broker shall keep a copy of all advertising used in the sale of said franchise, including but not limited to the radio, newspaper, T.V. media, letters, brochures, etc.

(4) Every franchise broker shall preserve for a period of not less than six years from the closing of any franchise account, all records, books and memorandums that relate to the franchisee.107

Franchisor who include language in their FDD stating that they may use third party brokers are likely to have received a comment letter from a Washington examiner outlining the broker requirements and stating that any such brokers active in Washington should be filed as part of the franchisor application. It is fairly common to provide a response that no such brokers are active in Washington, but if any are to be active in Washington filing will be made prior to them becoming active.

e. Hawaii

Hawaii requires persons selling franchises in the state to maintain a record of sales and, if requested by the state, file a report with the state identifying the franchises sold and the revenues derived from each sale. Virginia’s Retail Franchising Act actually defines the term “franchise broker,” but it does not actually impose any registration, recordkeeping, or other obligations on franchise brokers.108

E. Sales Representative Laws

Interestingly, in some ways similar to franchise brokers, many states regulate a manufacturer’s relationship with sales representatives who promote the manufacturer’s products. The primary focus of these laws is to ensure proper compensation of the sales representatives. A sales representative is generally defined as “a person who engages in the business of soliciting, on behalf of a principal, orders for purchase at wholesale of the product or products of the principal” and who is compensated, in whole or in part, by commission.109 A “principal” is defined broadly under state laws and typically applies to any person who engages in manufacturing, producing, importing, or distributing a product or products for sale to customers who purchase the product or products for resale; utilizes sales representatives to solicit orders; and compensates the sales representatives, in whole or in part, by commission.110


108 See Bibby, et al., supra note 92, at 18.

109 See, e.g., ALA. CODE § 8-24-1 (defining “Commission,” “Principal,” and “Sales Representative” under Alabama law).

110 See id.
Some states have exclusions from their statutes, including: (i) sales representatives who place orders for their own account,111 (ii) employees,112 and (iii) door-to-door salespeople.113

If applicable, these laws regulate compensation from the outset (terms of the written contract) to the termination of the business relationship. Of particular importance is the time-period during which the manufacturer must pay post-termination commissions to the sales representative; state laws can vary from a few days to 45 days. Manufacturers that overlook these nuanced state regulations risk liability for treble damages as well as attorneys’ fees and court costs for such violations, which underscores the significance of considering whether a state sales representative law applies and determining the applicable procedural requirements upon termination.

V. CASE LAW

Given the increasingly widespread use of third-party brokers and sales agents, the authors were somewhat surprised to see that there was not an abundance of reported cases on the issue. There was, however, some interesting case law out there, which we have broken out into three different categories—cases where the franchisor was held liable for the actions of the third-party, cases where the franchisor was not held liable for the actions of the third-party, and cases involving the third-party’s liability.

A. Cases Involving Third-Party Brokers and Agents

1. Franchisor Held Liable

Even if the alleged misrepresentations are not made directly by the franchisor, franchisors are often found liable for the actions of third-party sales agents if the unlawful actions were taken on behalf of the franchisor and were within the scope of the agent’s authority.

For example, in In re Butler,114 a prospective purchaser of a PR System franchise met with the franchisor’s most successful franchisee, who was also a sales broker for the franchisor. The prospective franchisee met with the broker at the broker’s store. The broker made glowing remarks about the system and the franchisor, and eventually introduced the prospect to the franchisor. After the prospect became a franchisee, and things did not turn out as promised, the franchisee brought suit. In response, the franchisor’s principals claimed they were not liable and attempted to shift liability to the broker. The Butler court found that the broker was “simply an agent” of the franchisor. As a result, under the doctrine of respondeat superior, the franchisor,

---


113 KAN. STAT. ANN. § 44-341 (Westlaw through 2017 Reg. Sess.); MISS. CODE ANN. § 75-87-1(c) (Westlaw through 2017 Reg. Sess.).

as the party controlling (or with the right to control) the actions of the broker, was liable for the broker’s unlawful actions undertaken on the franchisor’s behalf within the scope of the broker’s agency.

Similarly, in *Spahn v. Guild Indus. Corp.*,[115] a group of former franchisees brought suit against the franchisor for misrepresentations made by an agent who was expressly empowered by the franchisor to establish franchises in the area and to act as the franchisor’s agent. Even though the agent was the only party who made the fraudulent misrepresentations to the franchisees, the court held that the franchisor could be held responsible. In *Spahn*, the court held that an agent’s liability for compensatory and punitive damages can be imputed to an innocent principal when all of the agent’s acts were within the scope of his or her express authority. The franchisor argued that there was no evidence presented at trial to establish the franchisor’s control over the agent, but the court rejected this argument based on the fact that the franchisor controlled the entire franchised system and actual control was irrelevant.

Accordingly, so long as the agent is acting within the scope of authority granted to him or her by the franchisor, the franchisor can oftentimes be held liable for misrepresentations made by the agent, regardless of the franchisor’s control or knowledge of the representations being made.

### 2. Franchisor Not Held Liable

The franchisor’s liability, however, depends heavily on the relationship between the franchisor and the third-party sales agent. Franchisors may be able to escape liability for misrepresentations made during sales by third parties who are not actual agents of the franchisor, provided there is minimal involvement by the franchisor in the sale. For example, in *Drake v. Maid-Rite Co.*,[116] the plaintiff bought an existing franchise from an existing franchisee. Plaintiff attempted to characterize the seller-franchisee as an agent of the franchisor and hold the franchisor liable for alleged violations of the Franchise Disclosure Act that occurred during the sale. The court held that the franchisor was entitled to judgment as a matter of law because the franchisor had no duty to comply with the Franchise Disclosure Act in a transaction between plaintiff and seller-franchisee in which the franchisor’s only role was approving the sale.

### 3. Third-Party Broker Liability

While franchisors may be held liable for the actions of their agents regardless of whether the franchisor was actually aware of the unlawful behavior, the same is not true with respect to liability of the third-party sales agent. For example, in *Salkeld v. V.R. Bus. Brokers*,[117] plaintiff’s alleged misrepresentations regarding the success of the franchise and the support and resources provided by the franchisor were made during the sale of the franchise. Defendant V.R. Business Brokers (“V.R.”), the third-party agent, introduced plaintiff to the opportunity and the franchisor, and was at the meeting where the agreement was signed. V.R. avoided liability largely because there was no evidence that V.R. actually made the alleged misrepresentations. Rather, it was the franchisor itself which made the fraudulent representations to plaintiff. The court held, based on common law agency principles, that the broker had no duty to investigate.

---


or substantiate the franchisor’s representations “absent any fact indicating that the representations were untrue.”

Third-party liability may also largely depend on the language and definitions of governing statutes. For example, in *Stewart v. Lucero*, plaintiffs sued defendants for a debt owed under a sales agreement which transferred a catalog sales business from plaintiffs to the defendants. Defendants filed a counterclaim against plaintiffs alleging that plaintiffs violated franchise disclosure regulations and made fraudulent misrepresentations to defendants in order to get defendants to buy the business. While there was a question as to whether the business was actually a “franchise,” it was not addressed since the court held that, even if the business was a franchise, the plaintiffs were neither “franchisors” nor “franchise brokers,” as those terms are defined under the FTC regulations, and therefore not subject to the disclosure requirements promulgated by the FTC.119

In some cases, both knowledge and statutory language come into play. For example, in *Hanley v. Doctors Exp. Franchising, LLC*, the United States District Court for the District of Maryland held that a franchise broker could be held liable under the Maryland Franchise Law because a franchise broker constituted “a person who sells or grants a franchise” under B.R. § 14–227(a)(1). While the court dismissed the franchisee’s common law fraud claims because, under common law agency and fraud principals, the agent must know of the falsity of its representation, the Maryland Franchise Law claims were not dismissed. Id. at *34–36.

The franchise broker’s argument that it lacked knowledge of the falsity of the representations at issue failed because the burden is shifted under the Maryland Franchise Law. Specifically, the franchise broker’s lack of scienter is an affirmative defense: “B.R. § 14–227(a)(2) expressly states: ‘In determining liability under this subsection, the person who sells or grants a franchise has the burden of proving that the person who sells or grants a franchise did not know and, in the exercise of reasonable care, could not have known of the untruth or omission.’”121 Therefore, the court refused to dismiss the franchisee’s statutory claim.122

In sum, third-party liability often depends largely on whether the applicable statute prescribes liability to the particular third-party at issue, whether the third-party was aware of the fraudulent statements, and whether the third-party was actually involved in making the fraudulent statements.

---

118 918 P.2d 1, 1 (N.M. 1996).
119 Importantly, this case was decided under the FTC Rule as it existed in 1996, and, as a result of the new FTC Rule, the result in this case might be different today.
121 Id. at *36.
122 Id.
VI. CONTRACTING AND PRACTICAL TIPS FOR ENTERING INTO A RELATIONSHIP WITH A BROKER OR SALES PERSON

A. Defining the Scope of Services

As discussed throughout this paper, brokers come in all shapes and sizes. Some brokers will simply be a referral source for the franchisor on a non-exclusive basis—for example, an existing franchisee that receives a small payment for passing along names of other prospective franchisees. Others will be captive to the franchisor and perform duties that are akin to a full-time employee. Whatever the source, the key is this: agreeing upon and documenting the scope of services in a written broker agreement.

As a preliminary point, the broker must be granted the right to act as a broker for the franchisor to identify, locate, and in traditional broker roles, screen franchise prospects in a defined geographic area. Some broker agreements will also provide for the broker to help negotiate and facilitate the signing of franchise agreements with such franchise prospects. In many instances, it will be as important to outline what the broker cannot do as it will be what they can do.

B. Allocating Responsibilities in the Franchise Sales Process

The allocation of rights and responsibilities in the franchise sales process is part and parcel with the type of broker and arrangement, as is the broker’s compensation.

A franchisor typically provides the franchise broker with general information on the franchise, including written materials that the franchisor deems appropriate for the franchise broker to use to perform its broker services under the broker agreement. Depending on the type of arrangement, the franchisor may provide training sessions—whether short or prolonged—for brokers, which may focus on compliance or even overlap with prospective franchisee training.

With respect to compliance, franchisor must ingrain into its brokers the various general disclosure and registration compliance obligations as outlined above in this paper, from federal and state disclosure requirements, financial performance limitations, FDD delivery and timing requirements (including vestiges of the first-personal meeting requirement that exists in a few lingering states such as New York and Rhode Island), to the broker’s own compliance requirements and potential exposure. Noting that brokers can be directly liable under certain federal and/or state laws can be an extremely important teaching moment. For instance, confirming that direct exposure is potentially applicable in states like California and North Dakota can be persuasive.

123 One factor that must be taken into consideration. Several states (California, Maryland, Minnesota, New York, North Dakota, Rhode Island and Washington) require that all advertising of franchise offerings be filed with the state before to use in that state.

124 NEW YORK GEN. BUS. LAWS SECTION 683.8 (LEXIS through May 26, 2017).


126 CAL. CORP. CODE § 31201 (LEXIS through May 26, 2017).

127 North Dakota law states that it is unlawful for any person in connection with the offer, sale, or purchase of any franchise, to make any untrue statement of material fact or omit a material fact necessary to make the statements made not misleading. N.C. DENT. CODE SECTION 51-19-11.2(a) (LEXIS through May 26, 2017).
Brokers with a greater role in the entire process are best served with an understanding of the business as a whole in order to be able to sell it properly, and while requiring the brokers to go through a full or abbreviated new franchisee training program may seem like overkill, it could in many cases be a great selling point for the broker when meeting with prospects.

The franchisor will also typically agree that it will exercise commercially reasonable efforts to be in compliance with all applicable laws regulating the offer and sale of franchises, and will notify the broker as soon as it becomes aware of any material change which requires the broker to cease activities in a given portion of their agreed territory. At the same time, the franchisor will want to take care that nothing in the broker agreement expressly requires the franchisor to always prepare and maintain a disclosure document, or always file any franchise-specific registrations since the franchisor will not want to be beholden to the broker when making strategic decisions about its business.

Of course, to the extent that the broker agreement contains quotas or sale goals, the franchisor should provide for leeway if the franchisor’s decisions or failures materially impede the broker’s ability to comply with the stated quotas or sales goals.

A typical referral agreement will limit the duties of the referral agent to seeking, qualifying and referring to the franchisor franchise prospects who are interested in acquiring a franchise in the stated territory, and who appear to meet the general qualifications of franchisor as communicated to the referral agent. Typically, the referral agent is authorized by the franchisor to communicate with franchise prospects on franchisor’s behalf and to refer them to franchisor on a non-exclusive basis.

A typical broker agreement will go much further, and may include duties such as: (1) recruiting, soliciting and identifying franchise prospects interested in acquiring a franchise in the stated territory, (2) providing franchise prospects with the specific information and materials that franchisor has designated from time to time about the franchise, (3) guiding franchise prospects on what to expect during the franchise qualification process, and (4) reviewing the preliminary qualification information presented by franchise prospects to verify that the forms have been properly completed and assuring that franchise prospects meet the qualification criteria to be considered a viable franchise prospect.
As between the broker and the franchisor, (i) the franchisor needs to retain the sole discretion to evaluate whether a prospect whom the broker identifies meets the franchisor's then-current criteria for new franchisees in the territory; (ii) the franchisor needs to retain the right to refuse to grant a franchise to a prospect in its discretion, even if the prospect satisfies franchisor's then-current criteria; and (iii) it must be clear that the award of a franchise can only be effected upon due execution of a franchise agreement by franchisor and the prospect and receipt of the full "franchise fee", and that the broker is not be entitled to any compensation based on a prospect's execution of a letter of intent or payment of any deposit if franchisor and the prospect do not enter into a franchise agreement.

Finally, in all cases, the franchisor must retain sole and exclusive ownership and oversight over the franchise system and trademarks, including infringements or misuses identified by the brokers.

C. Defining Geographic Scope, Broker's Exclusivity (or Lack Thereof), Efforts Requirements and Broker Noncompete (or Lack Thereof)

The scope of the broker’s rights ultimately depends on the business arrangement between the franchisor and the broker. Generally speaking the first point of negotiation is the type of business to be brokered, especially where the franchisor and its affiliates franchise multiple brands. It is crucial to be specific as to the covered brands and any carve-outs that might exist (franchise transfers, refranchised stores, renewals or special outlets, alternative methods of distribution, businesses under other systems or marks, businesses purchased or sold in merger and acquisition transactions, etc.).

The geographic scope of the grant of rights to the broker is equally crucial from both a compliance and practical standpoint. As noted above, the so-called franchise registration states (California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin) have registration requirements that must be satisfied before commencing franchise sales and some still have first personal meeting requirements that require disclosure when first meeting with franchise prospects. While brokers will likely want large swatches of geographic territory, their realistic reach may be much smaller.

Providing a broker a broad geographic scope requires vigilance and coordination in terms of keeping abreast of state filings, registration dates and expiration dates and current franchise disclosure documents or else the franchisor and broker can find themselves in potential trouble by conducting sales when not registered or with an outmoded franchise disclosure document.

Due to these complexities, some non-exclusive broker agreements will limit broker rights to non-registration states where there are fewer compliance pitfalls. Others will provide for green light/red light written notification and confirmation processes similar to what is done for corporate employees for when and where sales are permitted with respect to annual franchise disclosure updates and any related material change amendments.

While perhaps only viable with experienced brokers and franchisors that have done extensive training with the brokers, some franchisors may permit their brokers to perform preliminary exemption screening on prospects in registrations states where the franchisor and franchisee know the franchise has not been registered. Exemption screening amounts to obtaining just enough information from a potential prospect who based on the franchisor’s FDD
and/or state registration status and the prospect’s domicile(s) for state franchise law jurisdiction purposes would otherwise be subject to disclosure and/or a state registration to determine if they satisfy a federal or state exemption that would alleviate the need for disclosure and/or a state registration before pursuing the potential transaction.

Exemption screening could entail the franchisor and/or broker obtaining: (1) the name and contact information of the prospect and each individual that broker knows to be an owner of or directly associated with such prospect; (2) information regarding the domicile of the prospects; (3) the city and state in which broker believes the prospect will desire to develop and operate franchises; (4) information regarding the net worth and restaurant and/or food service experience of the Prospect and its respective affiliates; and (5) such other information that the franchisor may deem reasonably necessary to conduct exemption screening.

From there, some combination of the franchisor and/or broker will endeavor to review each prospect submitted for exemption screening to determine whether there is likely an exemption for a franchise transaction with the prospect or whether it is unlikely there is an exemption for a franchise transaction with the prospect. It is of course crucial that the franchisor have the final decision and the broker refrain from any further discussions with any such prospect for which the franchisor has determined it is unlikely there is an exemption for a franchise transaction.

Exclusivity (or lack thereof) is typically one of the toughest negotiation points between franchisors and brokers. Generally speaking, full territorial exclusivity is only viable for brokers that are either captive to the franchisor or have something akin to full-time best efforts requirements or aggressive sales quotas for the stated territory. Otherwise, the franchisor may be limiting its franchise prospect pipeline with no functional recourse. The larger broker networks by nature represent multiple brands and while franchisors may be able to negotiate non-competes with these brokers for specific segments, it can be an uphill battle with many brokers who prefer using quotas or incentive/penalty compensation structures over non-competes.

Of course, franchisors need the right to retain full rights to advertise for and identify franchisees that come to them directly through other sources. However, many experienced brokers will want franchisee prospect leads that come in directly to the franchisor or through other non-broker needs to be funneled into the broker’s qualification process. This is a structuring and business negotiation point because if the franchisor retains some internal sales or legal compliance staff the franchisor may be fully capable of pursuing and closing a lead without the broker, and should retain such rights without need for compensation. While a “race to the franchisee prospect” model is not ideal, it may be necessary for franchisors that utilize multiple sales avenues. Of course, some of the most experienced broker networks will want to run the entire sales process and may be loath to transact with a franchisor that is not willing to hand over the process to them.

D. **Timing, Types and Triggers for Fees, Reimbursements and other Compensation**

The traditional referral agent payment structure is fairly simple. If the broker finds the franchisor a new franchise prospect and that franchise prospect signs a franchise agreement with the franchisor (normally within a defined period of say 6 to 18 months) then the franchisor will pay the referral agent a flat fee (typically anywhere from $1,000 finder’s fees to up to one-half the initial franchise fee). It is important when drafting these provisions to define what a new
franchise prospect means for the franchisor and the broker. Brokers typically do not receive payments for an existing franchisee who purchases a second franchise, a franchise prospect who obtains a franchise through a transfer with another franchisee or a franchise prospect who purchases a company operated unit. That said, broker teams that handle the entire licensing process may receive full or partial payments for these types of transactions, or if engaged as part of a formalized refranchising plan, the brokers’ focus may be on selling the franchisor’s own corporate units and payment is contracted for even if an existing franchisee buys one or more refranchised units. Ultimately, the franchisor and the broker just need to make sure the contract is clear what is and what is not covered to avoid confusion over both specific efforts to be undertaken by the broker and potential disputes over payments.

Typical franchise broker payment structures can get more complicated. Captive franchise brokers may charge the franchisor an initial fee and/or monthly fee for their services irrespective of actual performance or results. Almost all broker arrangements will provide for payment of a portion of a development fee or initial franchise fee to be paid to the broker, but some will also provide for a portion of a continuing royalty. While royalty payments are more likely applicable in master franchise or area representative structures where there are continuing services performed, it is not uncommon for a start-up franchisor to agree to a time-limited split of a royalty fee as part of its efforts to engage a qualified and in-demand broker (and it is fairly common for the broker to ask for it as an initial request in the negotiations with the franchisor).

Broker agreements must also address the broker’s advertising budgets and requirements (if any) as well provide for agreed reimbursements of costs. Many broker agreements contain required minimum advertising spends for the brokers, but where the broker is non-exclusive and represents many different brands there may instead be a reimbursement provision that provides for the franchisor to reimburse costs of the broker related to its activities and/or its specific sale transactions. Reimbursements are typically subject to caps and the providing of evidence of the specific expenditures for pre-approved activities.

E. Defining Term, Renewal

The term of a broker agreement is inextricably tied to the scope of broker rights and any related performance requirements. A captive broker who will have to invest time, money and effort to learn a franchise system is unlikely to agree to an at-will arrangement, and would typically want at least a year initial term, if not three to five years.

Franchisors of course do not want to be tied to any specific broker without performance and a return, so the longer the term the most likely the agreement is non-exclusive or is subject to periodic sales goals with default and termination remedies for failure to meet the sales goals. Interim remedies can match that of a typical development agreement, namely reduction of the sales territory, reduction in compensation payable to the broker, elimination of exclusivity, etc.

Regardless of the term, the broker agreement should contain general default and termination provisions related to non-compliance which allow the franchisor an early out if the broker is failing to perform and cannot cure. This is all a product of negotiation and leverage as with any contract.

Ultimately, regardless of the term and termination rights, broker agreements will contain a tail for purposes of compensation payable to the broker for franchise prospects referred or brokered by the broker during the term of the agreement, but not signing a franchise agreement
until after termination or expiration. The typical tail will be anywhere from 6 to 18 months and require some form of “registration” of the prospect by the broker and obligation for the franchisor to provide information on closings with registered prospects.

F. Compliance with Laws

It is axiomatic that a broker agreement contains express requirements that the broker perform all services in compliance with all applicable laws and regulations. First and foremost, the performance must be in compliance with all franchise laws and any laws relating to brokers or agents in connection with the offer and sale of franchises. There are of course other more general laws that will apply to the agent’s actions, including without limitation: (A) the Foreign Corrupt Practices Act; (B) the Economic Espionage Act of 1996; (C) Export Administration Regulations administered by the Bureau of Export Administration, U.S. Department of Commerce (“BXA”); (D) asset and transactional controls and embargo/sanctions laws, rules and regulations involving certain countries, persons and entities, which are administered by the Office of Foreign Assets Control, U.S. Department of the Treasury (“OFAC”); and (E) the USA PATRIOT Act of 2001 and Executive Order 13224 relating to deterrence and punishment of terrorist acts.

Importantly, less sophisticated brokers may not be aware of the laws that apply to them, and may not be inclined to pay for the attorneys, accountants and other advisors that would be able to provide them with the necessary guidance in these areas.

Finally, the franchisor should also insure by contract that the broker will, in all dealings with franchise prospects, and the public, adhere to the highest standards of honesty, integrity, fair dealing, and ethical conduct.

G. Indemnification/Insurance/Confidentiality

If there is one central tenet of this paper, it is that franchisors have great liability exposure for the acts, errors or omissions of franchise brokers performing franchise sales duties on their behalf. With that in mind, a well-crafted indemnification provision is crucial. In most cases, the franchisor should have broad indemnification with full right and authority to defend any claims with its own attorneys at the broker’s cost.

Of course, while there are certainly some larger, sophisticated and well-capitalized brokers, the majority are small and undercapitalized and indemnification is only worth what can be obtained from the broker unless there is full and adequate insurance coverage. While outside the scope of this paper, it is imperative that any broker agreement contain an insurance coverage obligation on the broker to cover its franchise sales activities for itself and for the franchisor, but the franchisor should also make sure that their own insurance (whether or not a franchisor obtains specific franchisor errors & omissions insurance) is sufficiently broad to cover the acts, errors or omissions of its own employees, but also its third-party brokers and sales agents.

The broker agreement should also clearly reflect that the relationship between the broker and the franchisor created by the agreement is that of an independent contractor, and that neither the broker nor the franchisor will represent to any third-party that there is any employment relationship between them, and that absent a specific agreement to do so, neither the broker nor the franchisor will (i) have the authority to act for the other in any manner to create any obligations or liabilities or incur any debts or expenses binding on the other or (ii) be
responsible for any obligations, liabilities, debts or expenses of the other. Also, to help maintain separateness and independent contractor status, both the broker and the franchisor should be free to exercise their own judgment as to the manner, time, place and persons with whom they conduct their business.

Finally, in addition to addressing competition and other activities by the broker, it is imperative that the broker agree to confidentiality restrictions regarding the franchisor’s business and trade secrets. Brokers can become privy to valuable information that can cause severe loss and damages so some form of liquidated damages and/or right to injunctive relief is important for both deterrence and enforcement purposes.

H. Inspections, Audits and Records

As outlined in Section III.B. of this paper, one of a franchisor’s greatest concerns with independent, third-party brokers is the franchisor lacks control and effective oversight over their actions. Most non-captive brokers will be under a different roof and perhaps in a different city or state. Accordingly, a franchisor must have robust inspection and audit rights for its brokers just as it has for its franchisees, including potentially the right to perform mystery shops and similar unannounced visits. While it might seem devious, mystery shopping the brokers will be the only way for a franchisor to get a direct sense of how the broker performs its duties when they do not believe the franchisor is looking.

Because the FTC Rule and state franchise laws have specific document retention requirements, it is also crucial that brokers be required to retain records related to its activities not only during its tenure, but after. This includes information regarding all contacts with prospective franchisees (who, when, where, how) so that the franchisor can provide information to state examiners or in court or arbitration proceedings to prove up compliance.

I. Governing Law and Forum

Generally speaking, most franchise agreements will contain a governing law and forum for disputes (whether in the courts or through arbitration) that matches with their home jurisdiction. That same governing law and forum should apply to the broker agreement. Besides the traditional practical elements of resolving disputes in your home jurisdiction and breeding greater continuity and certainty, there is the added practical benefit that if the franchisor finds itself in a dispute with a franchisee that includes matters relating to the broker, there is the ability to consolidate the case (or cases) for strategic purposes as well as for indemnification.

VII. CONCLUSION

Whether an educated or uneducated assessment, some consider working with franchise brokers a form of playing with fire, and others might even consider working with franchise brokers a necessary evil. Still others swear by brokers as the means to their growth and cost containment strategies, especially during the crucial early stages of franchise development. Of course, just as with franchising in general, there are good brokers and bad brokers, and good deals made with brokers and bad deals made with brokers.

While there is a fairly straightforward and manageable regulatory path to engaging and using brokers that allows both the franchisors and the brokers to set and manage expectations, as with any franchise system, it is a combination of the quality, competence and cohesiveness of the brand, the management, the salespersons, the operations team and, perhaps above all
else, the franchisees, that will dictate success or failure. And since engaging a third-party broker means giving up some control in the identification and selection of franchisees, franchisors must be extra vigilant with respect to the vetting and selection of their franchise brokers to not only protect themselves, but also to protect the brand and the very franchisees that will become part of their system.
J. Mark Dady

J. Mark Dady is a partner at Dady & Gardner, P.A., a franchisee focused law firm based in Minneapolis, Minnesota. Mark limits his practice to the representation of franchisees, franchisee associations, dealers and distributors. Mark received a Bachelor of Science from the University of Colorado at Boulder, and graduated magna cum laude from William Mitchell College of Law in St. Paul, Minnesota. He has been named a “Rising Star” every year since 2012.

Mark represents clients of all sizes and in all stages of their relationships with their franchisors/suppliers. His experience includes negotiating the terms of his clients’ franchise and dealer agreements, representing franchisee associations in connection with system-wide changes, arguing dispositive motions, obtaining favorable trial and arbitration outcomes—including prevailing in a 22 day jury trial—and, when necessary, successfully defending those outcomes on appeal.

Mark, his wife, and three children reside in the St. Paul, Minnesota area.

Robert A. Lauer

Robert A. Lauer is a Partner in the Austin office of Haynes and Boone, LLP, and a member of the firm’s Franchise and Distribution Practice Group. Mr. Lauer’s practice focuses on all aspects of domestic and international franchise transactions. Mr. Lauer was named to Chambers, Global Franchising, Band 3, 2011, Band 4, 2012 and Band 3, 2013 to 2017; Chambers USA, Franchising (Nationwide), Up and Coming, 2012 and Band 4, 2013 to 2017; the International Who's Who of Franchise Lawyers, Law Business Research, 2010 through 2017; The Best Lawyers in America® for Franchise Law in 2008 through 2017; and a “Texas Rising Star” by Law & Politics Magazine and Texas Monthly for 2005 and 2007 through 2012. Mr. Lauer is also the speaker for the Texas Bar Association’s Ten Minute Mentor video tutorial on "What Every Texas Attorney Should Know About Franchise Law". He is a member of the ABA Forum on Franchising (and former member of the International Division’s Steering Committee from 2008 to 2011), current officer of the International Bar Association’s International Franchising Committee (Treasurer to serve from January 2017 December 2018) and a former vice-chair of the franchise and distribution section of the Dallas Bar Association. Mr. Lauer is a 1997 cum laude graduate of the St. Mary's University School of Law where he served as an Associate Editor of the St. Mary's Law Journal, and a 1994 graduate of Trinity University in San Antonio, Texas.