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

J. Mark Dady
Robert A. Lauer
INTRODUCTION

1) FTC and State Definitions of Franchise Broker
2) Types Of Third-Party Franchise Brokers And Sales Agents
3) Pros and Cons of Using Third-Party Agents
4) War Stories and Case Law
5) Contracting and Practical Tips for Entering Into a Relationship With a Broker or Sales Person
6) Compliance Requirements For Brokers and Sales Agents
DEFINITIONS

• Why do the definitions matter?
• The FTC Rule (16 CFR Part 436.9) declares it to be an unfair and deceptive act or practice for “franchise sellers” to engage in certain conduct
• State franchise statutes impose obligations and liability on “franchise sellers”
DEFINITIONS

FTC Rule defines a “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.”

DEFINITIONS

State Law Definitions

- **NASAA** - follows updated FTC Rule’s definition
- **Hawaii** - “franchise broker” or “selling agent” is a person who directly or indirectly engages in the sale of franchises.
- **Illinois** - franchise broker is “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.
State Law Definitions

• **New York** - “franchise sales agent” is any person who engages in the offer or sale of any franchise on another’s behalf and excludes franchisors, subfranchisors, and their respective employees.

• **Virginia** – “franchise broker” is 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.
State Law Definitions

- **Washington** – “franchise broker” is 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.
DEFINITIONS

State Law Definitions

• Washington interpretive opinion specifically identifies the following persons as likely to meet the definition of a “franchise broker”:
  • an independent agent, contractor, or consultant representing one or more franchisors;
  • a person who receives commissions or other compensation in connection with the offer or sale of a franchise;
  • a person who offers or sells two or more franchises; and
  • a person who advertises, promotes, or identifies himself or herself as a broker.
TYPES OF THIRD-PARTY FRANCHISE BROKERS AND SALES AGENTS

• Franchise Consultants
  • Term “consultant” is often misused
  • Can provide a wide range of services to franchisors
  • Increasing in popularity?

• Franchise Sales Brokers
  • Outside person or company focusing principally on selling
  • Paid by franchisor (percentage of initial franchise fee)
  • Often the initial point of contact for prospective franchisees
TYPES OF THIRD-PARTY FRANCHISE BROKERS AND SALES AGENTS

• Franchisee and Other Third-Party Referral Agents
  • Limited role
  • Is using existing franchisees a good idea?

• Lead Generation Networks
  • Limited role
  • Collect and pass on information from prospective franchisees to franchisors
TYPES OF THIRD-PARTY FRANCHISE BROKERS AND SALES AGENTS

• Business Brokers
  • Typically, but not always, relates to existing businesses
  • Paid by seller (could be franchisor or franchisee)
  • Level of involvement varies

• Area Representatives and Master Franchisees
  • Newer franchisors (area representatives)?
  • International (master franchisees)
WHY DO FRANCHISORS USE THIRD-PARTY BROKERS AND SALES AGENTS?

Pros for Franchisors

• Reduced Employee Count and Obligations
• Incentive Based Compensation for Sales Team
• Professional Salespersons
• Increased Number and Geographic Scope of Sales Team
• Increased Access to Potential Clients
WHY DO FRANCHISORS USE THIRD-PARTY BROKERS AND SALES AGENTS?

Cons for Franchisors

• Reduced Control and Oversight in Sales Process
• Reduced Knowledge and History with Brand
• Potential for Conflicting Incentives or Allegiances
• Less Concern for Long-Term Success and Relationships
• Direct Liability for Acts, Errors, or Omissions
• Reduced Likelihood of Long-Term Relationship with Brand
WHY DO FRANCHISORS USE THIRD-PARTY BROKERS AND SALES AGENTS?

Pros for Franchisees

• Ability to Explore Multiple Brands
• More Knowledgeable Sales People
• Ability to Act as a Liaison for the Prospective Franchisee
WHY DO FRANCHISORS USE THIRD-PARTY BROKERS AND SALES AGENTS?

Cons for Franchisees

• Reduced Knowledge of and History with the Brand
• Less Concern for Long-Term Success/Relationship
• Potential for Conflicting Incentives/Allegiances
Experiences with Consultants

Positive Example

• Founder is obsessed with the brand and product
• No experience running an organization
• Consultant can fill the “gaps” in knowledge
• Founder can focus on improving the brand and product, instead of focusing on “franchising” aspects of the business
• Consultant may be able to help founder see the brand is not “perfect” and changes may need to be made in order to fit franchising model
Experiences with Consultants

Negative Example

- Prospects meet founder at Expo and love his zeal.
- Month or two later founder hires third party to take over entire franchise sales process (addressed in FDD sent to prospects).
- Prospects attend Discovery Day.
- Negative Experience. Told no negotiation of the franchise agreement.
- Later disinvited to the main prospect event.
Your Experiences with Consultants/Brokers

Positive Examples?

Negative Examples?

We want to hear from you, but please no names to be fair to everyone!
• Surprisingly, not a lot of reported cases involving outside brokers
• But, some cases showing:
  • When franchisors are held liable for broker statements;
  • When franchisor are not held liable for broker statements; and
  • When brokers can be held liable for franchisor statements
CASE LAW
(Franchisor Held Liable)

_In re Butler_, 2012 WL 6106586 (Bankr. W.D. N.C. 2012)

- Franchisor hires an existing franchisee to broker and market franchises
- Broker meets with prospect and makes misstatements
- After buying multiple, unregistered franchises, prospect sues franchisor
- Franchisor claims no involvement in sale, and says the broker, not it, should be liable

**RESULT:** Court holds franchisor “liable for the unlawful solicitation which was admittedly undertaken on behalf of the franchisor and within the scope of this agency.”
CASE LAW
(Franchisor Held Liable)


- Franchisor grants broker authority to sell and establish franchises
- Broker was an agent and employee of franchisor
- Broker engages in fraudulent activities
- Franchisor attempts to place blame solely on broker
- **RESULT**: Franchisor held liable under three theories:
  1) Broker was franchisor’s agent and Franchisor authorized wrongdoing
  2) Broker was an employee and acting within the scope of employment; and
  3) Franchisor ratified wrongdoings based upon knowledge of wrongdoing and acceptance of funds
CASE LAW
(Franchisor Not Held Liable)


- Existing franchisee sells established franchise to prospective franchisee
- Prospective franchisee does not receive a disclosure document
- Prospective franchisee later sues franchisor for violation of state franchise act
- Franchisor claims it had no involvement in the sale

**RESULT:** Franchisor not liable for alleged violations because:

1) Existing franchisee had no actual or apparent authority to act on franchisor’s behalf; and
2) Sale was not effected by or through franchisor
CASE LAW
(Broker Liability)


- Broker participated in two meetings with prospective franchisee and franchisor
- Franchisor made all of the representations, broker was merely present
- Prospect sues franchisor, broker, and officers for fraud and franchise act violations when things do not turn out as represented

**Result:** Court finds broker is not liable for franchisor’s conduct, and states broker owes no duty to investigate franchisor’s representations “absent any fact indicating that the representations were untrue.”
CASE LAW
(Broker Liability)


- Broker forwards FDD and marketing materials to prospective franchisee
- After discovering falsity of information in FDD and marketing materials, franchisee sues franchisor and broker, making common law and statutory claims

**RESULT:**
- Common law claims dismissed—no evidence broker knew statements were false;
- Franchise act claims not dismissed—broker was a “person who sells,” which does not require knowledge of falsity; BUT
- Broker could pursue affirmative defense that it “did not know and ... could not have known of the untruth or omission.”
Case Law
(Summary)

• **Two General Theories**—Agency and Statutory

• **Common law (Agency)**
  • Was the third-party sales person an agent of the franchisor?
  • Was the third-party sales person acting within the scope of the agency?
  • Did the third-party sales person know or have reason to know of falsity?

• **Statutory**
  • State Franchise Acts
  • Little FTC Acts
Litigation Considerations

Considerations for Franchisees:
• Suing the broker/consultant or simply calling as a witness?
• Settling with broker/consultant but not franchisor or vice versa?

Considerations for Franchisors:
• Naming the broker/consultant as a third-party defendant?
• Seek indemnity in same action or separate action?
CONTRACTING AND PRACTICAL TIPS FOR ENTERING INTO A RELATIONSHIP WITH A BROKER OR SALES PERSON

• Defining the Scope of Services

• Allocating Responsibilities in the Franchise Sales Process

• Defining Geographic Scope, Broker’s Exclusivity (or Lack Thereof), Efforts Requirements and Broker Noncompete (or Lack Thereof)
CONTRACTING AND PRACTICAL TIPS FOR ENTERING INTO A RELATIONSHIP WITH A BROKER OR SALES PERSON

• Timing, Types and Triggers for Fees, Reimbursements and Other Compensation
• Defining Term, Renewal
• Compliance with Laws
CONTRACTING AND PRACTICAL TIPS FOR ENTERING INTO A RELATIONSHIP WITH A BROKER OR SALES PERSON

• Indemnification/Insurance/Confidentiality
• Inspections, Audits and Records
• Governing Law and Forum
COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS

Federal Disclosure Obligations

• Key Takeaway -- Franchisor has ultimate responsibility

• Unfair or Deceptive Act or Practice Targeted at Franchise Sellers
  • Contradict FDD;
  • Misrepresent prior purchasers;
  • Make any claim or representation that contradicts the FDD;
  • Make illegal financial performance representations;
  • Fail to provide substantiation for any financial performance representations;
COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS

Federal Disclosure Obligations

• Unfair or Deceptive Act or Practice Targeted at Franchise Sellers (cont.)
  • Fail to timely furnish a copy of the most current FDD;
  • 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;
  • Fail to comply with 7 day rule for the franchise agreement;
COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS

Federal Disclosure Obligations

• Unfair or Deceptive Act or Practice Targeted at Franchise Sellers (cont.)
  • Disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document; 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.
COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS

Federal Disclosure Obligations

• Broker Bios?

• Master Franchisees vs. Area Representatives vs. Franchise Brokers

• FTC FAQs
  • FAQ 7 – Referral Fees
  • FAQ 12 and 23 - Franchise Seller/Receipt Page
COMPLIANCE REQUIREMENTS FOR BROKERS AND SALES AGENTS

State Disclosure and Registration Obligations

• NASAA
  • State Cover Page
  • Salesman Disclosure Forms

• State Laws
  • California, Hawaii, Illinois, New York, Washington
THANK YOU!