PROS AND CONS OF USING BROKERS, DEVELOPMENT AGENTS AND REFERRAL SOURCES

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October 10-12, 2007
JW Marriott Desert Ridge
Phoenix, AZ

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>SECTION</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>II. WHY FRANCHISORS USE SALES INTERMEDIARIES</td>
<td>4</td>
</tr>
<tr>
<td>III. TYPES OF SALES INTERMEDIARIES</td>
<td>6</td>
</tr>
<tr>
<td>A. Commercial Representation Arrangements</td>
<td>6</td>
</tr>
<tr>
<td>1. Area Representation</td>
<td>6</td>
</tr>
<tr>
<td>2. Franchise Brokerage</td>
<td>7</td>
</tr>
<tr>
<td>a. Traditional Franchise Brokers</td>
<td>8</td>
</tr>
<tr>
<td>b. In-House Brokers or Commissioned Sales Agents</td>
<td>8</td>
</tr>
<tr>
<td>c. Lead Generators or Lead Generation Networks</td>
<td>8</td>
</tr>
<tr>
<td>3. Business Brokers</td>
<td>9</td>
</tr>
<tr>
<td>4. Other Referral Agents</td>
<td>9</td>
</tr>
<tr>
<td>B. Master Franchisors or Subfranchisors</td>
<td>9</td>
</tr>
<tr>
<td>IV. LEGAL FRAMEWORK</td>
<td>10</td>
</tr>
<tr>
<td>A. Rationale for Regulation of Sales Intermediaries</td>
<td>10</td>
</tr>
<tr>
<td>B. Who Qualifies As a Broker?</td>
<td>10</td>
</tr>
<tr>
<td>3. Differences Between Federal and State Broker Definitions</td>
<td>13</td>
</tr>
<tr>
<td>C. Compliance with Disclosure Obligations to Prospective Franchisees</td>
<td>13</td>
</tr>
<tr>
<td>D. Prohibited Conduct by Franchise Sellers Under the 2007 Rule</td>
<td>13</td>
</tr>
<tr>
<td>E. Required Disclosure of Broker Information</td>
<td>14</td>
</tr>
<tr>
<td>F. State Registration and Regulation of Franchise Brokers</td>
<td>16</td>
</tr>
<tr>
<td>G. Unique Legal Issues Related to Franchise Resale</td>
<td>18</td>
</tr>
<tr>
<td>V. ADVANTAGES AND DISADVANTAGE OF USING SALES INTERMEDIARIES</td>
<td>23</td>
</tr>
<tr>
<td>A. Area Representation</td>
<td>24</td>
</tr>
<tr>
<td>1. Advantages</td>
<td>24</td>
</tr>
<tr>
<td>2. Disadvantages</td>
<td>25</td>
</tr>
<tr>
<td>B. Franchise Brokerage</td>
<td>26</td>
</tr>
<tr>
<td>1. Advantages</td>
<td>26</td>
</tr>
<tr>
<td>2. Disadvantages</td>
<td>26</td>
</tr>
<tr>
<td>C. Master Franchising</td>
<td>27</td>
</tr>
<tr>
<td>1. Advantages</td>
<td>27</td>
</tr>
<tr>
<td>2. Disadvantages</td>
<td>27</td>
</tr>
<tr>
<td>SECTION</td>
<td>PAGE</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>VI. AGREEMENTS WITH SALES INTERMEDIARIES</td>
<td>29</td>
</tr>
<tr>
<td>A. Duties of the Sales Intermediary</td>
<td>30</td>
</tr>
<tr>
<td>B. Franchise Sales Process</td>
<td>30</td>
</tr>
<tr>
<td>C. Term, Renewal, Termination</td>
<td>32</td>
</tr>
<tr>
<td>D. Territory and Market</td>
<td>32</td>
</tr>
<tr>
<td>E. Exclusivity</td>
<td>32</td>
</tr>
<tr>
<td>F. Compensation</td>
<td>32</td>
</tr>
<tr>
<td>G. Costs and Expenses</td>
<td>34</td>
</tr>
<tr>
<td>H. In-Term Noncompete</td>
<td>34</td>
</tr>
<tr>
<td>I. Post-Term Obligations</td>
<td>34</td>
</tr>
<tr>
<td>J. Compliance with Laws</td>
<td>34</td>
</tr>
<tr>
<td>K. Legal Description of Relationship</td>
<td>35</td>
</tr>
<tr>
<td>L. Indemnification</td>
<td>35</td>
</tr>
<tr>
<td>M. Surveillance</td>
<td>35</td>
</tr>
<tr>
<td>N. Miscellaneous Provisions</td>
<td>35</td>
</tr>
<tr>
<td>VII. CONCLUSION</td>
<td>35</td>
</tr>
</tbody>
</table>
I. INTRODUCTION

Franchising has experienced explosive worldwide growth since its modern era began in the late 1950’s. According to the International Franchise Association, 760,000 U.S. franchisors and their franchisees generate in excess of $1.5 trillion in economic activity and produce one out of every seven jobs. From 2003 to 2005, approximately 900 new concepts began franchising, and 17 of the 18 categories of existing franchised businesses experienced significant growth. There are now 3,450 active franchisors in the United States in over 75 different industries, and more than 8 million employees work in franchising. One of every 12 retail businesses is a franchise.

Founders of early franchising systems and their top executives were often, of necessity, generalists, expected to wear all of the hats necessary for business growth and success. Explosive growth in franchising has caused an ever-increasing niche specialization in the various component tasks associated with franchised systems, including operations, marketing, and training. With the addition of a significant number of franchised concepts each year, one of the fastest growing and most competitive specialties is franchise sales. Effective franchise salespeople have specialized aptitudes, education, and techniques. This focused approach to selling new franchises sharpened further when franchisors began using independent contractors, in addition to or instead of employees, as intermediaries to perform franchise sales duties. In addition, as franchise systems grew in size and age, existing franchisees demanded options for a profitable and smooth exit from franchise systems, including assistance with selling their franchised businesses.

1 The authors wish to thank the following individuals for their substantial contributions to this paper: Maureen O’Brien and Kimberly Sikora Panza, associates at Wiley Rein LLP; and Elizabeth Minogue, Kate Couch and Karin Hessler, summer associates at Wiley Rein LLP.


4 The established businesses included automotive, baked goods, building and construction, business services, child-related services, education-related services, fast-food restaurants, lodging, maintenance services, personnel services, printing, real estate, restaurants (other than fast-food), retail food, retail, other services businesses, sports and recreation, and travel.

5 Id.

6 Telephone Interview by Nick Bibby with Christine Harris, Director of Client Solutions, FRANdata, in Arlington, Va. (Jul. 25, 2007).


8 Id.
The growth in the use of “sales intermediaries” to assist with the franchise sales process is borne out by the percentages of franchisors who use one category of sales intermediary -- “traditional franchise brokers” -- to assist with selling new franchises. According to a recent FRANdata study, 24% of franchisors use traditional franchise brokers as part of their franchise sales team.\(^9\) As the following chart reflects, however, the extent to which franchisors utilize traditional franchise brokers varies substantially by industry:

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percent Of Franchisors Using Traditional Franchise Brokers</th>
</tr>
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<tbody>
<tr>
<td>Fast Food Restaurants</td>
<td>13.6%</td>
</tr>
<tr>
<td>Automotive</td>
<td>9.2%</td>
</tr>
<tr>
<td>Maintenance Services</td>
<td>8.4%</td>
</tr>
<tr>
<td>Sit-Down Restaurants</td>
<td>8%</td>
</tr>
<tr>
<td>General Service</td>
<td>8%</td>
</tr>
<tr>
<td>Education Related</td>
<td>1.2%</td>
</tr>
<tr>
<td>Travel</td>
<td>1.2%</td>
</tr>
<tr>
<td>Pet-Related Goods &amp; Services</td>
<td>1.2%</td>
</tr>
<tr>
<td>Computer Products &amp; Services</td>
<td>0.8%</td>
</tr>
<tr>
<td>Beauty-Related</td>
<td>0.4%</td>
</tr>
<tr>
<td>Publications</td>
<td>0.4%(^{10})</td>
</tr>
</tbody>
</table>

Moreover, in recent years, franchising has witnessed a proliferation in the types of sales intermediaries assisting franchisors with the franchise sales process. Beyond traditional franchise brokers, franchisors are using area representatives, development agents\(^{11}\), franchise lead referral networks, business brokers, and franchise consultants to assist with the franchise sales process.

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\(^9\) Joel Siegel, Presentation at IFA Legal Symposium (May 6-8, 2007) (symposium handout on file with authors).

\(^{10}\) *ld.*

\(^{11}\) Some franchise systems use the terms “area representative” and “development agent” interchangeably.
This paper addresses the business and legal risks associated with using sales intermediaries in the sale of new franchises and the resale of existing franchises. Section II discusses why franchisors consider outsourcing the franchise sales process and the potential repercussions of outsourcing this function on the franchise system. Section III describes the various types of sales intermediaries that help with the selling and reselling of franchises. Section IV covers the complex legal framework that governs the relationship between a franchisor and sales intermediaries. Section V identifies the advantages and disadvantages of using each type of sales intermediary. Section VI explains how franchisors can use carefully drafted agreements and targeted training programs to address the business concerns and minimize the legal risks associated with using sales intermediaries in the franchise sales process.

It is important to introduce, at the outset, a few legal definitions that will be discussed in more detail in Section IV, and to explain how those terms will be used throughout this paper. In January 2007, the Federal Trade Commission (“FTC”) revised the Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, which is commonly referred to as the FTC Rule (“1979 Rule”). The 1979 Rule defined a “franchise broker” as any person “besides the franchisor or the franchisee who sells, offers for sale, or arranges for the sale of a franchise.” Under the revised Rule (“2007 Rule”), the term “franchise seller” includes sales intermediaries who assist with the franchise sales process. The 2007 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.” The term “third-party broker” as used in the definition of a “franchise seller” is defined as “a person who: (1) is under contract with the franchisor relating to the sale of franchises; (2) receives compensation from the franchisor related to the sale of franchises; and (3) arranges franchise sales by assisting prospective franchisees in the sales process.” While the nuances between these definitions will be addressed in more detail in Section IV, since the 2007 Rule does not eliminate the term “broker,” but instead relies upon that term as part of the definition of a “franchise seller,” this paper uses the term “sales intermediary” to refer to the various categories of third parties identified in Section III who may assist a franchisor in the franchise sales process.

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12 This paper’s analysis is limited to business and legal risks within the United States. It does not purport to consider business or regulatory issues outside of the United States.


14 Id. (emphasis added).


16 Id.

17 Final Rule at 15,462.
II. WHY FRANCHISORS USE SALES INTERMEDIARIES

Given how many new franchise concepts enter the market each year, identifying new leads to expand a franchise system can be a daunting task. Every franchisor must decide whether to use its own salaried employees as an in-house franchise sales staff, independent contractor sales intermediaries, or some combination of the two to fulfill the franchise sales function. In making that decision, a franchisor will need to balance its desire to meet established expansion benchmarks for the franchise system against the resources available to hit those targets.

The expansion benchmarks should reflect not only the desired number of additional franchised units, but also where those units will be located. If a franchisor is planning to expand in a geographically remote area or into a new market segment, use of a sales intermediary with a nationally recognized network or staff may be the best way to reach franchise sales goals.

Typically, in evaluating how to maximize the use of limited resources, the franchisor first conducts a simple cost/benefit analysis. Often, the franchisor may decide to use sales intermediaries because the up-front costs are less: while the franchisor must pay an in-house salesperson a salary regardless of the success of his or her sales tactics, the franchisor pays a sales intermediary a commission only if a franchise is sold and the franchise agreement is executed. Accordingly, this simple cost/benefit analysis favors the use of sales intermediaries over in-house salespersons.

However, the analysis is not that straightforward. The franchisor must consider many other potential direct and indirect costs of using sales intermediaries, including, among others, the costs associated with familiarizing the sales intermediaries with the franchise system and the potential increased compliance costs to manage (potentially, remotely) a sales process in which third parties play an active role.

In addition to cost-related concerns, a franchisor should carefully consider: the likely high rate of turnover in the franchisor’s sales staff; the difficulty of identifying leads and closing franchise sales; the potential lack of understanding of franchise regulations and the long-term nature of franchise relationships; poor planning by the franchisor in setting up an internal franchise sales staff; inadequate lead generation sources; the absence of established minimum criteria for prospects; a generalized lack of understanding of the qualification and screening process; and the potentially high rate of commissions to be paid to sales intermediaries. In light of these and other issues, franchisors often view sales intermediaries who have specialized knowledge and experience as an attractive option to fulfill the franchise sales function.

Sales intermediaries compensated based upon the number of leads generated, however, may pursue a “quantity over quality approach,” causing a decline in the number of quality prospects. The sales intermediary is less likely than the franchisor to adhere to a rigorous qualification process designed to determine whether a prospect is likely to be a good long-term fit with the franchise system. If, during the qualifying process, the sales intermediary fails to determine that a prospect does not satisfy the franchisor’s typical franchisee profile, the prospect that is a bad fit becomes a franchisee that is a bad fit and, over time, the franchise system is likely to suffer an increased franchisee failure rate. Regardless of the cause, increased failure rates are likely to lead to increased franchisee dissatisfaction and overall system distress. More important, in a franchise system that may already be experiencing slow franchise growth due to the inability to generate quality leads, when new prospects talk to
existing franchises, that increased failure rate can make identifying new leads and closing additional franchise sales even more difficult. Ultimately, of course, a poor fit between franchisee and franchise system often breeds protracted legal battles that require the diversion of a franchisor’s resources.

Before using any sales intermediary, the franchisor should carefully review the credentials of the sales intermediary, including statements from the sales intermediary’s clients and the litigation history of the intermediary and its clients. In selecting a sales intermediary, the franchisor has a number of options and should carefully review those options and identify the type of sales intermediary that fits the franchisor’s specific needs. In order to ensure that a sales intermediary identifies quality leads, the franchisor should establish a franchise sales process with minimum criteria for prospects, assist the sales intermediary with setting up effective ways to profile the prospects, and train the sales intermediary as to the franchisor’s expectations for its franchisees.

Finally, in considering whether to use a sales intermediary, a franchisor should be aware of a number of inherent conflicts of interest that arise. When a prospect with little or no knowledge or experience regarding the available franchise opportunities approaches the sales intermediary, the sales intermediary may represent that the sales intermediary is providing the prospect a service at no charge, that the prospect is the sales intermediary’s client, or that the sales intermediary will help the prospect identify the perfect franchise opportunity. These types of representations are not true. Even if the sales intermediary does not make these types of statements, since the franchisor pays the sales intermediary a commission for each sale, the sales intermediary’s recommendations will necessarily be biased in favor of its franchisor clients, without regard to the prospect’s interests or needs. Furthermore, a sales intermediary paid by commission has no stake in the long-term relationship between a franchisor and a prospective franchisee and, ultimately, could sell a bill of goods to both the prospective franchisee and the franchisor.

Once a sales intermediary is in place, the franchisor should actively monitor and manage the relationship. The sales intermediary should be treated as a tool to assist the franchisor’s sales staff rather than a substitute for a franchise sales department. In addition to using the franchise sales process to attract new prospects, a successful franchisor also utilizes the process to measure a prospect’s potential for forming and maintaining a long-term relationship with the franchisor. If the franchisor has no role in the franchise sales process, the franchisor cannot begin to assess the franchisee and potential success of a long-term franchisor/franchisee relationship. Finally, before any prospect enters into a franchise agreement, the franchisor should reserve the right to give final approval of the prospect. If the prospect does not meet the franchisor’s minimum criteria or the franchisor reasonably believes that the prospect is not a good fit with the franchise system, the franchisor should refuse to approve that the prospect.

While weighing these basic concerns, the franchisor should also remember that the wisdom of introducing sales intermediaries into the franchise sales process may depend upon where the franchise system is in its growth circle. Has the franchisor established criteria for new franchisees? How well does the franchisor understand the franchise sales process? How much training, and of what quality, can the franchisor provide to sales intermediaries regarding the franchise system? The answers to these questions are critically important because a franchisor’s introduction of sales intermediaries into the franchise sales process at the wrong time or for the wrong reasons may stunt the long-term growth of the franchise system.
Moreover, what makes sense at one stage of the franchisor’s growth cycle may no longer work at a later stage. Over time, the needs of the franchisor will change, requiring some flexibility in the analysis of whether to engage sales intermediaries.

III. TYPES OF SALES INTERMEDIARIES

Traditionally, most third parties assisting franchisors with the franchise sales process were known as “franchise brokers.” Over time, additional categories and types of sales intermediaries have arisen to fill the gaps between the services provided by a franchisor’s in-house franchise sales staff and the needs of the franchisor. Today, sales intermediaries come in many forms, often with a blurring of the lines between the different types of relationships. This section of the paper identifies the most common sales intermediary models, explains how each model is established, and outlines how each model is generally intended to work.

A. Commercial Representation Arrangements

The commercial representation arrangements common in franchise sales can be grouped into four basic categories: (1) area representation; (2) franchise brokerage; (3) business brokers; and (4) other referral agents. Under each of these arrangements except business brokers, the franchisor engages a third party as its representative to solicit prospective franchisees. The franchisor (not the third party) contracts directly with the franchisee, and the franchisor therefore maintains control over the enforcement of system standards and use of the franchisor’s trademarks.

1. Area Representation

Typically, area representation involves two separate agreements: (1) the agreement between the franchisor and the area representative (“area representation agreement”); and (2) the agreement between the franchisor and the franchisee (“franchise agreement”). This type of sales intermediary can also be referred to as a “development agent,” “area franchisee” or “regional developer.”18 Under an area representation arrangement, a franchisor grants the area representative the right to solicit and screen prospective franchisees on behalf of a franchisor in a specified, usually exclusive, territory; however, the franchisor has final approval over the selection of franchisees. The area representative’s development of his or her territory may be subject to a development schedule. The area representative does not have the right to contract directly with franchisees.

For clarity, the relationship between a franchisor and an area developer should be explained. A franchisor grants an area developer the right to develop a specific number of franchised units within a limited geographic area. Normally, the area developer has exclusive development rights within the geographic area, so long as the area developer meets the development schedule. Area developers are primarily focused on the development of franchised units to be operated by the area developer and, therefore, are not sales intermediaries who assist franchisors in identifying additional franchisees. However, there are instances where area developers refer prospects to the franchisor.
While the franchisor retains ultimate responsibility to the franchisee for the franchisor’s obligations under the franchise agreement, the franchisor delegates to the area representative many of the franchisor’s post-sale operational responsibilities to franchisees. The area representative provides various local and regional services. The area representative’s duties may, in addition to franchise sales, include site location assistance, training, consultations, advertising, inspections, and operational assistance to existing and new franchisees in the territory. To maximize the benefits offered by area representation, a franchisor typically uses this method where there is no geographical proximity between the territory and the franchisor’s headquarters.

Under an area representation arrangement, franchisees pay fees directly to the franchisor. In turn, the franchisor will pay the area representative a portion of the initial franchise fees as compensation for soliciting prospective franchisees, and a portion of the royalties as compensation for servicing franchisees. While the amounts are negotiated and vary from system to system, the area representative may receive up to one-half of the initial franchise fees and one-half of the royalties. A franchisor may also reward an area representative with bonuses if he or she performs ahead of the development schedule for establishing outlets in the territory or penalize the area representative if he or she falls behind schedule.

A franchisor that does not collect an initial fee from its area representative faces fewer regulatory hurdles in complying with registration and disclosure laws. Sharing in the continuing fees, in addition to the initial franchise fees, may create an incentive for an area representative to go beyond selling franchises and work to ensure the success of franchisees. In fact, it is not uncommon for the area representative’s income from continuing fees to exceed that generated from initial fees. To increase the area representative’s stake in successful franchisee operations, some franchisors also may allocate to the area representative some of the costs associated with problem franchisees. For example, an area representative may be responsible for some portion of the legal fees and damages amassed through litigation or arbitration where a franchisor would otherwise be solely responsible. Area representatives typically satisfy the 2007 Rule’s definition of a “third-party broker.”  

2. Franchise Brokerage

Over time, the term “franchise broker” has evolved and ultimately expanded to include a number of variations, including: (a) traditional franchise brokers; (b) in-house brokers or commissioned sales agents; and (c) lead generators or lead generation networks. Traditional franchise brokers who are involved at all levels of the franchise sales process through and including execution of the franchise agreement define one end of the spectrum. Lead generators or lead generation networks, which provide the names of prospective franchisees to the franchisor without further involvement in the sales process, define the other end of that spectrum. In-house brokers or commissioned sales agents fall somewhere in the middle of the spectrum. Generally speaking, these franchise brokerage options satisfy the 2007 Rule’s definition of a “third-party broker.”  

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19 See infra Section IV.B.1.

20 See id.
a. **Traditional Franchise Brokers**

Traditional franchise brokers come in all shapes and sizes – from large broker networks to individual brokers. An individual broker typically generates fewer leads due to smaller marketing budgets, has less negotiating power, and assists regional, new, or emerging franchisors. In comparison, most large networks of franchise brokers work with established and mature franchisors, generate more leads, and have more negotiating power. While the commissions charged by traditional franchise brokers vary, the typical commission is likely to be 50% or more of the initial franchise fee.

Brokers operate independently of the franchisor and, typically, play a significant role in the franchise sales process. A broker is responsible for generating leads, interviewing and qualifying the prospect, disclosing the prospect, assisting the prospect with determining which franchise system offers the best fit with the prospect's capabilities and objectives, providing information about those systems in which the prospect is interested, and arranging for meetings between the prospect and the franchisor's representatives. “Qualifying” the prospect usually means that the broker has confirmed that the prospect meets the franchisor's minimum financial qualifications before the prospect is introduced to the franchisor. The traditional franchise broker does not have the right to contract directly with franchisees; that right is reserved exclusively to the franchisor. Unlike area representative relationships, traditional franchise brokers do not undertake any of the franchisor's post-sale obligations to franchisees. The relationship between a franchisor and a traditional franchise broker is typically memorialized in a written agreement. Moreover, traditional franchise brokers often work with several different franchisors simultaneously.

b. **In-House Brokers or Commissioned Sales Agents**

In-house brokers or commissioned sales agents typically represent just one concept, not multiple concepts. While this option can be seen at all levels of franchising, it is more common for new or emerging franchisors. As with traditional franchise brokers, the franchisor pays the broker a commission for each sale; however, given the widespread variances in this type of relationship, there is no standard commission for in-house brokers.

Advertising by the franchisor supports the broker's efforts to identify leads. The in-house broker contacts leads provided by the franchisor, solicits personal information, helps with the qualification process, and provides disclosure to the prospect. Once the prospect is qualified, other franchisor personnel may participate in the efforts to finalize the sale of the franchise. Franchisors should keep in mind that, unless the in-house broker is otherwise tied to the franchisor (e.g., performs another company function for a salary or has an equity interest), this position can suffer tremendous turnover.

c. **Lead Generators or Lead Generation Networks**

Typically, lead generators or lead generation networks perform a very limited role in the franchise sales process: identifying prospects and providing the names to the franchisor. The relationship between a franchisor and a lead generator or a lead generation network is typically memorialized in a written agreement. Like traditional franchise brokers, lead generators and lead generation networks do not have the right to contract directly with franchisees, as this right is reserved exclusively to the franchisor, and also do not undertake any of the franchisor's post-sale obligations to franchisees. Moreover, lead generators and lead generation networks often work with several different franchisors simultaneously.
3. **Business Brokers**

Typically, franchisors do not hire business brokers to assist with the sale of new franchises. More frequently, franchisees hire business brokers to assist with the sale of existing franchised businesses. The fee paid to a business broker is usually comparable to the amount paid by a franchisor to a franchise broker or to a referral agent. Generally, there is no contract between the franchisor and business broker; accordingly, business brokers do not satisfy the 2007 Rule’s definition of a “third-party broker.”

4. **Other Referral Agents**

In addition to the area representation and brokerage options, over the years, franchisors have developed relationships with other third parties that result in the referral of prospects. These referrals can come from a variety of sources -- referral agents, consultants, business coaches, business advisors, realtors, existing franchisees, or Internet sites. The arrangement may or may not be reduced to a written agreement. While the role of these referral agents may vary, at a minimum the referral agent provides the names of viable leads to the franchisor’s sales department. There is no standard practice regarding the amount of the referral fee, but it may be in the range of hundreds of dollars to 10% or more of the franchise fee. The question of whether a particular “referral agent” satisfies the 2007 Rule’s definition of a “third-party broker” will need to be determined on a case-by-case basis, by applying the three part test described in Section IV.B. In many cases, the franchisor may pay a fee to the referral agent without being contractually required to do so. In those situations, the referral agent would not satisfy the 2007 Rule’s definition of “third-party broker.”

B. **Master Franchisors or Subfranchisors**

Master franchising, also known as subfranchising, involves two distinct, albeit interdependent, contractual relationships: (1) the agreement between a franchisor and subfranchisor (“master franchise agreement”); and (2) the agreement between the subfranchisor and an individual franchisee (“franchise agreement”). Pursuant to the master franchise agreement, the franchisor grants the subfranchisor the right to offer and sell the franchise in a defined territory, often in accordance with a development schedule. In turn, the subfranchisor, to a large extent, steps into the shoes of the franchisor with respect to individual franchisees in the territory, assuming responsibility for recruiting franchisees, site selection assistance, training, opening assistance, operational support, regional and local advertising and marketing, and enforcement of system standards. While the franchisor retains responsibility for services that affect the system as a whole, the subfranchisor undertakes those duties that are more local in nature.

Although the thrust of master franchising is the recruitment of new franchisees who will execute franchise agreements with the subfranchisor, a subfranchisor may be required to own and operate a certain minimum number of units itself under the terms of the master franchise agreement.

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21. See id.

22. See id.

23. See id.
In addition to the duties described above, subfranchisors typically collect the initial franchise fees and ongoing royalties payable under the franchise agreements and remit agreed upon portions to the franchisor. Generally, the subfranchisor retains one-half to two-thirds of the franchise and royalty fees. The franchisor may also charge the subfranchisor a separate initial fee, sometimes referred to as a “master license fee,” for the right to subfranchise.

As noted, subfranchisors do not receive compensation from the franchisor in connection with the sale of franchises. Accordingly, subfranchisors would not be considered a “third party broker” under the 2007 Rule’s definition.24

IV. LEGAL FRAMEWORK

A. Rationale for Regulation of Sales Intermediaries

Motivated by potential abuses arising from “overzealous independent commission agencies selling franchises without regard to the franchisee’s financial ability or adaptability to the particular franchise,”25 the FTC included in the 1979 and 2007 Rules provisions that placed express obligations and restrictions on sales intermediaries in connection with their dealings with prospective franchisees. Agreeing with the FTC’s assessment that regulation of the conduct of sales intermediaries was necessary to protect prospective franchisees, North American Securities Administrators Association (“NASAA”) also included provisions in the UFOC Guidelines designed to rein in renegade sales intermediaries, and certain states followed suit.

Generally, a franchisor’s use of a sales intermediary raises four basic legal issues under federal and state law: (1) compliance with disclosure obligations to prospective franchisees; (2) prohibited conduct by sales intermediaries; (3) required disclosures relating to the franchisor’s use of sales intermediaries; and (4) state registration and regulation of sales intermediaries. A franchisee’s resale of an existing franchised business presents unique legal considerations, which are discussed briefly at the end of this Section. (Please note that this Section generally refrains from using the catchall term “sales intermediary” and instead employs the precise legal term for a specific type of sales intermediary under the statute or regulation being discussed.)

B. Who Qualifies As a Broker?


The 1979 Rule defines a “franchise broker” as any person “besides the franchisor or the franchisee who sells, offers for sale, or arranges for the sale of a franchise.”26 Under the 1979 Rule, franchise brokers and franchisors are jointly and severally liable for preparing and providing prospective franchisees with the disclosure document.27 As discussed in further detail

24 See id.


27 Final Rule at 15,461.
below, the 2007 Rule removed these disclosure obligations from the franchise brokers’ shoulders and placed that responsibility solely on franchisors.\(^{28}\) In light of this change in the law, the FTC concluded that a separate definition of “franchise broker” was no longer necessary.\(^{29}\) Instead, the 2007 Rule includes the following definition of “franchise seller”:

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 franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.\(^{30}\)

Furthermore, the FTC has expressly stated that it intends the term “third-party broker” as used in the definition of “franchise seller” to refer to “a person who: (1) is under contract with the franchisor relating to the sale of franchises; (2) receives compensation from the franchisor related to the sale of franchises; and (3) arranges franchise sales by assisting prospective franchisees in the sales process.”\(^{31}\)

In drafting the 2007 Rule, the FTC expressly considered and rejected the argument that “middlemen or finders who just arrange for prospects to meet franchisors – but do not negotiate price or terms for the franchisor, or sign franchise agreements on behalf of a franchisor – should not be deemed brokers” as they do not “arrange” sales.\(^{32}\) Specifically, the FTC stated that “the term ‘arranges’ . . . include[s], for example, discussions with prospective franchisees about their specific business interests, pre-screening prospects through interest questionnaires, recommending specific franchise options, and assisting prospects in completing a franchisor’s application form.”\(^{33}\)


Five of the registration states – Hawaii, Illinois, New York, Virginia and Washington – expressly regulate the conduct of franchise brokers. Unlike the 1979 or 2007 Rules, none of these states’ definitions of a franchise broker includes persons who “arrange[] for the sale of a franchise.” While the states’ definitions of a franchise broker may arguably cast a narrower net than their FTC counterpart, at least Washington has liberally construed the meaning of “franchise broker.”

\(^{28}\) Id.

\(^{29}\) Id.

\(^{30}\) Id.

\(^{31}\) Id. at 15,462.

\(^{32}\) Id. at 15,461.

\(^{33}\) Id. at 15,461 n.167.
Hawaii, New York and Virginia include a fairly straightforward definition of franchise broker. 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. The New York Franchises Law, which uses the term “franchise sales agent” rather than “franchise broker,” defines “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. 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 and, unlike Hawaii’s and New York’s statutes, excludes that person if disclosed in Item 2 of the disclosure document.

In contrast, the Illinois Franchise Disclosure Act takes a more expansive approach to the definition of franchise broker. Illinois 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.

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 the definition franchisors, subfranchisors, and their respective officers, directors, and employees. Washington provides additional guidance in determining who is a franchise broker.

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39 Illinois expressly exempts an “isolated transaction” from the state’s franchise broker registration requirements. Id. § 200.202(b), reprinted in Bus. Franchise Guide (CCH) ¶ 5130.17. 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. Id.
advertises, promotes, or identifies himself or herself as a broker.\textsuperscript{42} 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{43}

3. **Differences Between Federal and State Broker Definitions**

In addition to determining whether a sales intermediary satisfies the 2007 Rule’s definition of a “third party broker,” the franchisor must review any applicable state statutory “broker” definitions. A sales intermediary may satisfy both definitions, neither definition or one definition but not the other. Since the relationship between the 2007 Rule and the state franchise statutes remains uncertain, franchisors should carefully review these definitions before proceeding with any sales intermediary relationship.

C. **Compliance with Disclosure Obligations to Prospective Franchisees**

As noted above, under the 1979 Rule, franchisors and franchise brokers are jointly and severally liable for the failure to prepare the disclosure document and provide it to prospective franchisees.\textsuperscript{44} The 2007 Rule, however, places the obligation to provide timely disclosures to the prospective franchisee solely on the franchisor.\textsuperscript{45}

As noted below, NASAA has stated that it will update the Uniform Franchise Offering Circular Guidelines in response to the 2007 Rule. The revised UFOC Guidelines may require certain types of sales intermediaries to disclose prospective franchisees in states that adopt disclosure laws modeled on the updated UFOC Guidelines. Therefore, even if the 2007 Rule does not require sales intermediaries to disclose prospective franchisees, franchisors doing business in registration states should consider requiring their sales intermediaries to do so.

D. **Prohibited Conduct by Franchise Sellers Under the 2007 Rule**

While the 2007 Rule relieves franchise brokers of disclosure obligations, the Rule imposes several restrictions on franchise sellers, including franchise brokers.\textsuperscript{46} The 2007 Rule prohibits franchise sellers from, among other things: (1) making any claim or representation that contradicts the disclosure document; (2) misrepresenting that any person (a) purchased or operated a franchise of the type offered by the franchisor or (b) can provide an independent and reliable report regarding the franchise or the experiences of any current or former franchisees; (3) if requested by the prospective franchisee, failing to provide a copy of the disclosure document to a prospective franchisee earlier in the sales process than required by the 2007

\textsuperscript{42} WASH. REV. CODE § 19.100.010(11), Interpretive Statements No. FIS-6, reprinted in Bus. Franchise Guide (CCH) ¶ 5470.80.

\textsuperscript{43} Id.

\textsuperscript{44} 16 CFR § 436.1 (1979).

\textsuperscript{45} Final Rule at 15,461.

\textsuperscript{46} Final Rule at 15,560-61.

\textsuperscript{47} The 2007 Rule deems the enumerated acts unfair or deceptive acts or practices in violation of Section 5 of the Federal Trade Commission Act. Id.
Rule (i.e., 14 calendar days before any agreement is executed or any consideration is paid); (4) disseminating any financial performance representations to prospective franchisees unless the franchisor has a reasonable basis and written substantiation for the representation at the time made, and the representation is included in Item 19 of the disclosure document; (5) failing to make available to prospective franchisees written substantiation for any financial performance representations made in Item 19; (6) failing to provide a copy of the most recent disclosure document and any quarterly updates to a prospective franchisee, upon reasonable request, before the prospective franchisee signs a franchise agreement; (7) presenting 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 informs the prospective franchisee of the differences at least seven days before execution of the franchise agreement; (8) disclaiming or requiring a prospective franchisee to waive reliance on any representation made in the disclosure document, its exhibits or its amendments; and (9) failing to return any funds or deposits in accordance with any conditions in the disclosure document, franchise agreement or any related document.48

A number of states also expressly prohibit pre-contract misrepresentations to prospective franchisees. For example, the California Franchise Investment Law provides:

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communication 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 were made, not misleading.49

In addition, franchisors should bear in mind that, notwithstanding express (and fairly obvious) prohibitions on franchise brokers to refrain from making false statements or claims to prospective franchisees, franchisors may risk being held liable for their franchise brokers’ misrepresentations.

E. **Required Disclosure of Broker Information**

The 1979 Rule does not require the disclosure of broker information in the disclosure document. Although one of the objectives in revising the 1979 Rule was to make the Rule more closely track the UFOC Guidelines (which provide for the disclosure of broker information in, among others, Item 2 of the disclosure document), the FTC resisted this particular modification, and accordingly, the 2007 Rule does not require franchisors to include broker information in Item 2. Explaining its decision, the FTC noted that:

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

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48 Id.

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.50

However, under the 2007 Rule, the franchisor must include on the receipt pages of the disclosure document the name and contact information of any franchise seller dealing with the prospective franchisee.51 In addition, the 2007 Rule requires in Item 4 (Bankruptcy) the disclosure of specific bankruptcy matters in which, among others, any “individual who will have management responsibility relating to the sale or operation of franchises” has been or is involved.52 Accordingly, depending on the franchise broker’s role in the franchisor’s sales process, arguably, franchise broker information may be required in Item 4 of the disclosure document.

Notwithstanding the 2007 changes to the FTC Rule, as noted above, a franchisor desiring to use the UFOC format for its disclosure document, rather than the FTC format, must still include broker information in Item 2 (Business Experience).53 Specifically, Item 2 of the UFOC Guidelines requires, among other things, the disclosure of the name and five-year employment history of each franchise broker, a term which the UFOC Guidelines neglect to define. The inclusion of franchise brokers in Item 2 also triggers a disclosure requirement under Item 3 (Litigation). Item 3 of the UFOC Guidelines requires the franchisor to include, among other things, administrative, criminal, or material civil actions alleging violations of franchise, antitrust, or securities law, fraud, unfair or deceptive trade practices or comparable allegations, as well as any other significant litigation matters in which persons identified in Item 2 have been involved.54 Although the instructions accompanying Item 4 of the UFOC Guidelines are somewhat unclear as to whether the disclosure of broker information is required, to err on the side of caution, a franchisor may wish to disclose broker information in Item 4 as well.55 Like the 2007 Rule, the UFOC Guidelines also require the disclosure of the name, principal business address, and telephone number of the subfranchisor or franchise broker offering the franchise in

50 Final Rule at 15,476.
51 Id. at 15,514.
52 Id. § 15,547.
54 Id. ¶ 5755.
55 Id. ¶ 5756. NASAA subsequently clarified that while Item 4 does not require disclosure of bankruptcy information about every person listed in Item 2, it does require the disclosure of such information regarding, among others, "de facto" officers, "individuals who have management responsibility in connection with the operation of the franchisor's business relating to the franchises offered by the offering circular but whose title does not reflect the nature of the position." Commentary Dated July 21, 1994 on the Uniform Franchise Offering Circular, reprinted in Bus. Franchise Guide (CCH) ¶ 5800.
the state on the receipt pages of the disclosure document. In addition, in light of the recent overhaul of the FTC Rule, NASAA intends to adopt a replacement for the UFOC Guidelines and, until it does so, has drafted "Instructions for Filing a Uniform Franchise Registration Application Using the 'New FTC Franchise Rule' After July 1, 2007." These Instructions include the following disclosure relating to the franchisor's use of franchise brokers:

If applicable, state the following: ‘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.

For most registration states, in addition to disclosing broker information in Item 2 and, if applicable, Items 3 and 4 of the disclosure document, franchisors using the UFOC format must complete and file with the disclosure document a Sales Agent Disclosure Form for each person offering or selling franchises in the particular state. The Sales Agent Disclosure Form includes information similar to that required by Items 2 and 3 of the UFOC Guidelines, as well as personal information, such as the sales agent’s home address, home telephone number, birth date, and social security number. One should consult applicable state law to determine if the submission of the Form is necessary.

F. State Registration and Regulation of Franchise Brokers

While neither the FTC nor most registration states impose a registration requirement on franchise brokers, Illinois, New York, and Washington prohibit a franchise broker from offering or selling franchises in the respective state unless the broker registers with the state. The table below identifies the broker registration requirements for each of these states:

<table>
<thead>
<tr>
<th>State</th>
<th>Registration Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>$100 CHECK PAYABLE TO “State of Illinois”</td>
</tr>
<tr>
<td></td>
<td>FRANCHISE BROKER APPLICATION FACING PAGE</td>
</tr>
<tr>
<td></td>
<td>DISCLOSURE CERTIFICATION PAGE</td>
</tr>
<tr>
<td></td>
<td>SALES AGENT DISCLOSURE FORM</td>
</tr>
</tbody>
</table>

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58 Id. ¶ 5751.

59 Id. ¶ 5781.

<table>
<thead>
<tr>
<th>State</th>
<th>Registration Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>FRANCHISE BROKER CONSENT TO SERVICE OF PROCESS &amp; ACKNOWLEDGMENT</strong></td>
</tr>
<tr>
<td></td>
<td><strong>FRANCHISE BROKER AUTHORIZATION</strong> (A franchise broker authorization is required for each franchisor)</td>
</tr>
<tr>
<td></td>
<td><strong>IF BROKER WILL ACCEPT FUNDS FROM PROSPECTIVE FRANCHISEES ON BEHALF OF THE FRANCHISOR, THE FOLLOWING ALSO WILL BE NEEDED:</strong> (1) Unaudited balance sheet and income statement externally prepared by an independent CPA current within 120 days certifying the net worth of the franchise broker to be not less than $50,000; (2) Surety Bond in the amount of $50,000; or (3) Audited balance sheet and income statement of other entity (person, corporation or partnership) with a net worth of $50,000.</td>
</tr>
<tr>
<td></td>
<td><strong>Additional Documents Needed when using Financials of Other Entity:</strong> GUARANTY OF PERFORMANCE OF OTHER ENTITY, CORPORATE RESOLUTION &amp; SECRETARY’S CERTIFICATE OF OTHER ENTITY, CONSENT TO SERVICE OF PROCESS &amp; ACKNOWLEDGMENT OF OTHER ENTITY</td>
</tr>
<tr>
<td>New York</td>
<td><strong>YEARLY FILING REQUIREMENT</strong></td>
</tr>
<tr>
<td>New York</td>
<td><strong>$150 CHECK PAYABLE TO “New York State Department of Law”</strong></td>
</tr>
<tr>
<td>New York</td>
<td><strong>FRANCHISE SALES AGENT STATEMENT (Form NYF-3)</strong></td>
</tr>
<tr>
<td>New York</td>
<td><strong>PHOTOCOPY OF CONSENT TO SERVICE OF PROCESS (Form NYF-5)</strong></td>
</tr>
<tr>
<td>New York</td>
<td><strong>ORIGINAL CONSENT TO SERVICE MUST BE FILED WITH NEW YORK DEPARTMENT OF STATE IN ALBANY, NY ($35.00 CHECK PAYABLE TO “New York Department of State,” ORIGINAL CONSENT TO SERVICE OF PROCESS (Form NYF-5), and DEPARTMENT OF STATE FILING COVER PAGE)</strong></td>
</tr>
<tr>
<td>New York</td>
<td><strong>ONE TIME ONLY FILING</strong></td>
</tr>
<tr>
<td>New York</td>
<td><strong>NOTE: PERSONAL INFORMATION FOR SALES AGENT FORMS IS ONLY REQUIRED FOR THE OFFICERS, DIRECTORS AND PRINCIPALS OF THE FRANCHISE BROKER.</strong></td>
</tr>
<tr>
<td>Washington</td>
<td><strong>$50 CHECK PAYABLE TO “State of Washington - Treasurer”</strong></td>
</tr>
<tr>
<td>Washington</td>
<td><strong>APPLICATION FOR FRANCHISE BROKER LICENSE (Page 1)</strong></td>
</tr>
</tbody>
</table>

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Hawaii and Washington also impose specific recordkeeping requirements on franchise brokers. 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. Likewise, Washington requires franchise brokers to keep detailed sales records, including completing a separate registration card for each franchisee detailing the sale, keeping a copy of the receipt page executed by the franchisee, maintaining copies of all advertising used in selling the franchise, and maintaining records relating to the franchisee for six years. Interestingly, although Virginia’s Retail Franchising Act defines the term “franchise broker,” neither the Act nor the regulations promulgated thereunder impose registration, recordkeeping, or other obligations on franchise brokers.

G. Unique Legal Issues Related to Franchise Resale

With franchise resales, the disclosure obligations discussed above are greatly simplified. The 1979 and 2007 Rules and 13 of the 14 registration states provide an exemption from disclosure and/or registration for the sale or transfer of a franchise from one franchisee to another franchisee. Of the 14 registration states, only Virginia does not have such an exemption. To take advantage of this exemption, generally, the franchisor may not have any significant contact with the prospective transferee, and the sale may not be effected by or through the franchisor. In addition, the transferee cannot execute a new franchise agreement; instead, the existing agreement must be assigned to the transferee. Accordingly, in all states except Virginia, franchisee transfers are expressly permitted. The text of each exemption is set forth in the table below:

<table>
<thead>
<tr>
<th>State</th>
<th>Registration Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hawaii</td>
<td>FRANCHISE BROKER POWER OF ATTORNEY FOR CONSENT TO SERVE (Page 2)</td>
</tr>
<tr>
<td></td>
<td>FRANCHISE BROKER &amp; PRINCIPAL LITIGATION DISCLOSURE (Page 3)</td>
</tr>
<tr>
<td></td>
<td>FRANCHISE BROKER EMPLOYMENT HISTORY FOR PAST 5 YEARS (Page 4)</td>
</tr>
<tr>
<td></td>
<td>APPOINTMENT OF A FRANCHISE BROKER (Page 5)</td>
</tr>
<tr>
<td></td>
<td>(An appointment of franchise broker is required for each franchisor)</td>
</tr>
<tr>
<td></td>
<td>FRANCHISE BROKER BALANCE SHEET (Prepared in accordance with generally accepted accounting principles and as of a date within 90 days of the franchise broker registration application)</td>
</tr>
<tr>
<td></td>
<td>YEARLY FILING REQUIREMENT</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Jurisdiction &amp; Citation</th>
<th>Statutory Language</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979 Rule – Business Franchise Guide (CCH) ¶6220</td>
<td>A person who purchases an existing franchise directly from the franchisee who owns it, without significant contact with the franchisor, is not a prospective franchisee. A purchaser who purchases from an existing franchisee will not be deemed a prospective franchisee, therefore, merely because the franchisor has, and exercises, a right to approve or disapprove the purchaser, unless the franchisor's role in the sale is otherwise significant. Franchisors and franchise brokers must make required disclosures only to prospective franchisees.</td>
</tr>
<tr>
<td>2007 Rule – Section 436.1(t) - Business Franchise Guide (CCH) ¶ 6011</td>
<td>Sale of a franchise includes an agreement whereby a person obtains a franchise from a franchise seller for value by purchase, license, or otherwise. It does not include extending or renewing an existing franchise agreement where there has been no interruption in the franchisee's operation of the business, unless the new agreement contains terms and conditions that differ materially from the original agreement. It also does not include the transfer of a franchise by an existing franchisee where the franchisor has had no significant involvement with the prospective transferee. A franchisor's approval or disapproval of a transfer alone is not deemed to be significant involvement.</td>
</tr>
<tr>
<td>California – Section 31102</td>
<td>The offer or sale of a franchise by a franchisee for his own account is exempted from the provisions of Section 31110 if the sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee.</td>
</tr>
<tr>
<td>Hawaii -- Sec. 482E-4.(7)</td>
<td>The offer or sale of a franchise by a franchisee for the franchisee's own account, or the issuance of a new franchise agreement pursuant to a sale by a franchisee for the franchisee's own account, if the sale is an isolated sale and not part of a plan of distribution of franchises.</td>
</tr>
<tr>
<td>Illinois – Section 705/7</td>
<td>There shall be exempted from the registration requirements of this Act the offer or sale of a franchise by a franchisee for its own account if the sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee or requires payment of a reasonable transfer fee.</td>
</tr>
<tr>
<td>Indiana – Section 4</td>
<td>The offer of [or] sale of a franchise by a franchisee who is not an affiliate of the franchisor for his own account is exempt from registration if the offer or sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor if a franchisor is entitled to approve or disapprove a different franchisee.</td>
</tr>
<tr>
<td>Jurisdiction &amp; Citation</td>
<td>Statutory Language</td>
</tr>
<tr>
<td>-------------------------</td>
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</tr>
<tr>
<td>Maryland – Section 14-214(c)</td>
<td>The registration requirement of this section does not apply to the offer to sell or sale of a franchise by a franchisee for the franchisee's own account. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee.</td>
</tr>
<tr>
<td>Michigan – Section 445.1506 (f)</td>
<td>The offer or sale of a franchise by a franchisee for the franchisee's own account, if all of the following conditions are met: (i) the sale is an isolated sale, and not part of a plan of distribution of franchises; and (ii) the franchisee provides to the prospective purchaser full access to the books and records related to the franchise in actual or constructive possession of the franchisee.</td>
</tr>
<tr>
<td>Minnesota – Section 80C.03(a)</td>
<td>The offer or sale of a franchise owned by that franchisee if the sale is not effected by or through a franchisor; provided, however, that no person shall make more than one sale during any period of 12 consecutive months of a franchise or area franchise granted by a single franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee.</td>
</tr>
<tr>
<td>New York – Section 684.5</td>
<td>The offer or sale of a franchise by a franchisee for his own account is exempted from the registration provisions of section six hundred eighty-three of this article if: (a) the sale is an isolated sale and not part of a plan of distribution of franchises; and (b) the sale is not effected by or through a franchisor; and (c) the franchisee furnishes to the prospective purchaser, at least one week prior to the execution of any binding contract or purchase agreement, or at least one week prior to the receipt of any consideration, whichever occurs first, a copy of the offering prospectus of the franchisor (including amendments, if any) currently registered with the department of law.  A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee.</td>
</tr>
</tbody>
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Although the New York statute requires the franchisee to provide the currently registered offering circular to the transferee, we have discussed this requirement with the New York Attorney General’s Office. The franchise examiner informed us that the transferor should provide the most recent offering circular that the franchisor had registered or the offering circular that the transferor received when it purchased the franchisee, in that order of preference. If possible, the transferor should also provide updated financials to the transferee.
<table>
<thead>
<tr>
<th>Jurisdiction &amp; Citation</th>
<th>Statutory Language</th>
</tr>
</thead>
<tbody>
<tr>
<td>North Dakota – Section 51-19-04.2</td>
<td>The offer or sale of a franchise by a franchisee for his own account or the offer or sale of the entire area franchise owned by a subfranchisor for the subfranchisor’s own account is exempted from the provisions of section 51-19-03 if the sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee.</td>
</tr>
<tr>
<td>Rhode Island – Section 19-28.1-6(b)</td>
<td>The offer or sale of a franchise by a franchisee who is not an affiliate of the franchisor for the franchisee’s own account if the franchisee's entire franchise is sold and the sale is not effected by or through the franchisor. A sale is not effected by or through a franchisor merely because a franchisee signs agreements with terms which do not materially differ from the agreements with the existing franchisee or because a franchisor has a right to approve or disapprove the sale or requires payment of a reasonable transfer fee. This exemption applies to the offer or sale of a master franchise if the entire master franchise is sold.</td>
</tr>
<tr>
<td>South Dakota -- Section 37-5A-13</td>
<td>The registration requirement shall not apply to the offer or sale by a franchisee of a franchise owned by him if the sale is not effected by or through a franchisor; provided, however, that no person shall make more than one sale during any period of twelve consecutive months of a franchise. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee.</td>
</tr>
<tr>
<td>Washington – Section 19.100.030 (1)</td>
<td>The offer or sale or transfer of a franchise by a franchisee who is not an affiliate of the franchisor for the franchisee's own account if the franchisee's entire franchise is sold and the sale is not effected by or through the franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove the sale or requires payment of a reasonable transfer fee.</td>
</tr>
<tr>
<td>Wisconsin -- Section 553.23</td>
<td>The sale of a franchise by a franchisee for the franchisee's own account is exempted from registration if the sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee or because a franchisor imposes or has the right to impose a fee or charge to reimburse the franchisor for reasonable and actual expenses incurred in connection with the sale.</td>
</tr>
</tbody>
</table>

If, however, a franchisor or its agent is actively involved in the resale (including requiring the transferee to sign the then-current version of the franchise agreement), not only must the franchisor or its agent comply with the applicable disclosure requirements vis-à-vis the transferee, the franchisor also must navigate a number of state statutes that regulate the resale...
of existing businesses – franchised or otherwise. California, Colorado, Florida, Idaho, Michigan, Washington, and Wisconsin are among those states that have enacted this type of statute.66

Under the California statute, a person who “[s]ells or offers to sell, . . . solicits prospective sellers or purchasers of, solicits or obtains listings of, or negotiates the purchase, sale or exchange of real property or a business opportunity” is undertaking the duties of a real estate broker and must be licensed as such.67 A business opportunity is the “business and goodwill of an existing business enterprise or opportunity”68 – and this would encompass a resold franchise business, even one that does not require the franchisee to hold an interest (leasehold or otherwise) in real estate. Colorado, Florida, Idaho, Michigan, Washington, and Wisconsin have similar statutes.69 Colorado, Washington, and Wisconsin do not distinguish between a real estate broker and a “finder” for licensing purposes. Thus, in those three states, a finder, or one who merely introduces parties to a transaction but takes no part in any negotiation, is required to comply with the licensing requirements.

The case law in California illustrates the “finder’s” exception to the licensing requirement, under which “one who simply finds and introduces two parties . . . need not be licensed as a real estate broker.”70 As one California court explained, “[t]he distinction between the finder and the broker frequently turns upon whether the intermediary has been invested with authority or duties beyond merely bringing the parties together, usually the authority to participate in negotiations.”71 Furthermore, “[b]efore the finder’s exception may apply, it must appear that the activity is limited to arranging an introduction [between the parties] . . ., and the services performed in bringing the parties together cannot involve any role in negotiating the price or any of the other terms of the transaction. If the [intermediary] takes any part in the negotiations, no matter how slight, he is not a middleman but a broker.”72 For example, in Pawlak v. Cox, the court found that where a party told a seller that an offer was a “good deal” and gave advice “as to how to proceed in the negotiations if their first offer was rejected,” the party was a broker under California’s statute and not a mere finder.73

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68 Id. § 10030.
72 Id. (emphasis added) (internal citations omitted).
Another California court cited as evidence that a defendant was functioning as a broker: (1) defendant’s presentation of a package with description, location and other attributes for the property to prospective buyers; (2) defendant’s driving to the property when prospective buyers wanted to make an inspection; (3) defendant’s investigation of local ordinances applicable to the development and use of the property after prospects were interested; and (4) defendant’s assistance to the buyer in engaging a surveyor-engineer. The fact that this case did not involve the transfer of a franchised business does not negate its applicability to franchise resales.

The most obvious consequence of this California law is that a franchisor who seeks to offer through its employees or agents maximum help to a transferor-franchisee faces a choice. The franchisor, its employees or its agents must either: (A) be contractually labeled and act strictly as a “finder” with no need to become a licensed real estate broker; or (B) become a licensed real estate broker and undertake fiduciary duties on behalf of the transferor. However, because these California statutes were not drafted with franchise relationships foremost in mind, there are serious challenges presented by both choices – seemingly placing the franchisor between a rock and a hard place.

In addition, if the sale of a business includes personal property, certain states (such as Illinois) require the franchise seller to register with the state under the business broker statute and comply with certain other requirements. In other states (such as Kansas and Missouri), even if the sale involves real property and personal property, the franchise seller will be deemed to be a real estate broker rather than a business broker.

A franchisor that seeks to administer a nationwide franchise resale program using either a “broker” or “finder” must ascertain what triggers the application of each state’s statute. Some considerations include: (i) choice of governing law provision in the franchise agreement; (ii) location of the franchised business; (iii) location or state or organization of the franchisor; and (iv) location or state of organization of the franchisee. Similarly, how does a franchisor seeking to implement nationwide “broker” or “finder” duties, treat franchisees consistently from state to state, given the conflicting patchwork of statutes governing the resale of businesses? There are no easy answers here; franchisors must tread carefully.

V. ADVANTAGES AND DISADVANTAGES OF USING SALES INTERMEDIARIES

Before deciding whether to use any form of sales intermediary and, if so, which form of relationship would be most advantageous under the particular facts and circumstances of its system, a franchisor should carefully consider the different advantages and disadvantages of each type of intermediary relationship. As noted earlier, the relative risks versus rewards of using sales intermediaries are likely to change during the life of a franchise system. To oversimplify, the disadvantages of using sales intermediaries tend to increase as a franchise system grows in size and maturity. An overview of specific advantages and disadvantages follows.

A. Area Representation

1. Advantages

Area representation permits the franchisor to gain market presence rapidly without sacrificing control over the franchise system and the use of the franchisor’s trademarks. While retaining ultimate responsibility for the franchisees’ operations, the franchisor nonetheless reduces its costs by delegating recruiting and operations duties to the area representative. The area representative bears the cost of maintaining a network of salespersons and field representatives who are dedicated to recruiting strong candidates and providing operational support to existing and new franchisees. Furthermore, sharing in the continuing fees, in addition to the initial franchise fees, incentivizes area representatives to go beyond merely selling the franchises and work to ensure the success of franchisees.

Franchisors may select an area representative from the ranks of existing, highly motivated franchisees in the territory and, in some circumstances, may permit the area representative to own and operate additional outlets. This can create other advantages. First, the area representative is an experienced operator who is familiar with all aspects of the business. The area representative, knowing what it takes to be a successful franchisee, is therefore in the best position to screen applicants and service franchisees. Second, by having an existing local presence in the territory, including the development of strong relationships with, among others, landlords, contractors, and building and other local officials, the area representative is a key resource with respect to local customs, consumer preferences, market conditions, prospective franchisees, and, in some cases, navigating local laws. Area representatives are therefore a key source of ideas as to how the sales process and the system can be tailored to achieve maximum success in the territory. Third, an area representative can respond to the needs and concerns of franchisees in his or her territory more efficiently than a franchisor. All of these factors translate into the possibility of improved operational performance in the territory.

By using an area representation arrangement and contracting with franchisees directly, a franchisor can frequently reduce its regulatory burden in complying with state and federal registration and disclosure laws. If the area representative is not required to pay the franchisor an initial franchise fee (which may include initial and ongoing fees) for the right to solicit and service franchisees in the territory, the arrangement typically will not constitute a franchise. Consequently, the franchisor will not have to register and disclose the area representative arrangement separately, although the franchisor must still register and disclose the offer and sale of the underlying franchise. Unlike the master franchising model (discussed below), the franchisor has increased control over, and a greater role in, the preparation and registration of the offering circular, which may reduce the franchisor’s liability exposure.

Even if the area representative arrangement does not constitute a separate franchise, the area representative will still likely be deemed a “third-party broker” under the 2007 Rule and a “franchise broker” under state franchise laws. Therefore, the area representative should comply with all applicable franchise broker registration and disclosure requirements. The offering circular should also disclose the scope of the area representative’s operational responsibilities to existing and new franchisees.

77 See supra Section IV.
2. Disadvantages

Despite its advantages, area representation has its problems. Because of the area representative’s direct involvement in franchise sales and operations, the franchisor may be held vicariously liable for the acts and representations of the area representative. To reduce these risks, a franchisor should disclaim responsibility for any acts or statements made by the area representative that are contrary or in addition to the offering circular, prohibit the area representative from making any representations of sales or profits to prospects (except to the extent those representations are consistent with any claims made in Item 19 of the disclosure document), specify the conduct in which the area representative is authorized to engage and that in which he or she is not, and disclose that the area representative is an independent contractor in the offering circular. Since the area representative is likely to be deemed a “third-party broker” under the 2007 Rule and a “franchise broker” under state franchise laws, the franchisor also risks joint and several liability when the area representative fails to comply with its obligations.

The success of an area representation arrangement is highly contingent on the skills of the individual area representative. Consequently, a franchisor’s utilization of this strategy may have varying results. To combat this concern, a franchisor must carefully select its area representative based on demonstrated expertise and motivation. In addition, the franchisor must carefully train the area representative to perform the tasks typically performed by the franchisor (i.e., soliciting franchise sales, training new franchisees, attending grand openings, providing continued support to franchisee, ensuring compliance with system standards, etc.).

If the arrangement meets the definition of a franchise – i.e., the area representative agreement requires the area representative to pay an initial franchise fee (since the other elements of a franchise are usually satisfied) – the sale of the area representation rights will constitute a separate franchise and will have to be registered and disclosed in the same manner as the offer and sale of subfranchising rights to a subfranchisor.

In a perfect world, the area representative performs the continuing functions of the franchisor for the franchisees in a seamless manner. However, this structure can have some unintended and unpleasant consequences. If a problem arises and the area representative does not inform the franchisor until the problem becomes serious, the window of opportunity to correct the issue may have closed.

Yet even where a franchisor succeeds in identifying a skilled area representative with whom it can work to expand the system, the franchisor may find that it is difficult to replace that area representative upon the termination of their relationship because the area representative will often have developed a relationship with franchisees in his or her territory, and these franchisees may be resistant to the introduction of a new area representative. If the franchisor cannot identify a replacement area representative, the franchisor may be obligated to service the franchisees in the territory despite the fact that the franchisor does not have an adequate infrastructure to do so.

One of the obvious drawbacks of an area representation arrangement for the franchisor is profit sharing with the area representative. Franchisors must share much of the revenue from franchise sales and continuing fees with the area representative. The franchisor should develop a realistic financial assessment regarding area representation to ensure that its reduction in revenue resulting from the fee-splitting arrangement does not eclipse its savings in administrative costs and increase in sales (generally and specifically, to what will hopefully be
high-quality, successful franchisees which the franchisor may not have recruited without the help of the area representative) to such an extent that this method of expansion loses its attraction.

B. Franchise Brokerage

1. Advantages

One of the biggest advantages offered by traditional franchise brokers, in-house brokers, and lead generators (which will be referred to in this Section as “brokers”) is that, unlike other sales intermediaries, the brokers’ efforts are dedicated to one task – the sale of franchises. Moreover, brokers are usually experienced salespersons having great familiarity with the franchise industry and, more specifically, the franchisors whose systems the broker is selling. Relying on their experience, brokers may identify and present prospects that the franchisor may not have otherwise considered. This can mean brisk sales for the franchisor. As a result of their on-the-ground sales experience, brokers also develop a keen understanding of market conditions in the area in which they are selling franchises. Accordingly, brokers are a resource on which franchisors can rely in refining their sales methods to make the franchise more attractive to prospects in the broker's territory.

In harnessing the efforts of brokers to sell franchises in a particular area, the franchisor also succeeds in shifting some of its administrative costs to the brokers. A franchisor accomplishes this by reducing or eliminating the need for an in-house sales force. Since brokers are paid on commission, any reduction in revenue stemming from the use of franchise brokers is offset by an increase in sales.

Because the franchise agreement is entered into between the franchisor and the franchisee directly, the franchisor retains control over the franchisees, the system, and the use of its trademarks. The franchisor is therefore in a position to grow, and enhance the image of, the brand through uniform enforcement of its operational standards.

2. Disadvantages

Despite these advantages, a franchisor’s use of brokers is not problem-free. The primary deficiencies of the brokerage arrangement derive from the fact that the payment structure fails to incentivize brokers sufficiently to identify high-quality, skilled, capable prospects. Instead, brokers’ compensation is almost exclusively tied to the number of prospects who execute agreements with the franchisor and pay the initial fee. Brokerage agreements fail to link compensation to post-sale performance as in the case of area representatives. Because brokers have no stake in the success of the prospect (except in the case where compensation is tied to royalty streams of the particular franchisee), the broker’s goal may be limited to signing up as many candidates as possible without regard to their potential for success in the system.

In addition, it might be difficult for the franchisor to determine if a lead is truly a “new lead” identified and developed by the brokers. The lead will need to be traced back to its origin to determine if it was identified by the brokers or by some other means. Any misrepresentations made by the brokers to a prospect during the sales process may also expose the franchisor to vicarious liability. A franchisor may alleviate some of these concerns by providing to the broker network the standards that the franchisor uses in screening applicants and conducting sales.
The expense involved in negotiating and drafting an agreement is another disadvantage of utilizing brokers. Because of the complex issues that must be addressed in the franchisor-broker relationship, the agreement is often as complicated as a franchise agreement. Since the broker is likely to meet the definition of a “third-party broker” under the 2007 Rule and a “franchise broker” under state franchise laws, brokerage also introduces the requirement to comply with federal and state registration and disclosure laws.

C. Master Franchising

1. Advantages

In the master franchising model, the franchisor delegates responsibility for developing a specified territory and recruiting and servicing franchisees within that territory to one or more subfranchisors, enabling the franchisor to recruit and service franchisees in a territory that might not otherwise be available to the franchisor. Typically, master franchisors are more sophisticated investors and have deeper pockets and greater business experience than a single unit franchisee. Some may even have prior franchising experience. The franchisor's alignment with such skilled, well-capitalized partners can further catalyze system recruitment efforts in new markets and increase the probability of success of the outlets opened.

If the expansion territory is remote, joining forces with a subfranchisor can dramatically ease market entry. The subfranchisor will have the requisite knowledge of local market, real estate, legal, and economic conditions essential to selecting suitable sites for outlets, marketing the franchisor's products and/or services, and tailoring the system, where permitted, to meet consumer demands and preferences. This subdivide and conquer approach also has the advantage of allocating some of the risks associated with franchising to the subfranchisor. Master franchising reduces the amount of financial and management resources that the franchisor would otherwise have to dedicate to recruit and expand into the remote market.

2. Disadvantages

While the franchisor's delegation of the establishment, supervision and control of franchised outlets in the territory, and licensing of the use of its trademarks to a subfranchisor is, on the one hand, advantageous because it frees up the franchisor's financial and management resources, the franchisor's diminished control frequently creates problems down the road for the franchisor. This loss of control stems from the absence of a contractual relationship between the franchisor and franchisees. By surrendering operational control, the franchisor will have to rely on the subfranchisor to ensure franchisees' compliance with the franchise agreements and operating manual. Ultimately, the franchisor may discover that the subfranchisor’s enforcement is lax, harming the brand in that territory, but the franchisor will have no real recourse because it is not a party to the franchise agreement. Depending upon the terms of the master franchise agreement, a franchisor may have the option to terminate the agreement; however, as discussed below, the franchisor's right to terminate may be illusory. A franchisor that chooses to subfranchise during the infancy of its system, particularly in the United States, may lament the loss of control once it reaches maturity. The master franchise agreement may be drafted, however, to mitigate the impact of that loss of control on the franchisor by, for example, naming the franchisor as a third-party beneficiary.

While franchisors can retain the right to review the franchise sales process set up by the subfranchisor, since the process is ultimately carried out by the subfranchisor, the franchisor will lose control over that process. Notwithstanding that loss of control, disgruntled prospects or
franchisees may attempt to hold the franchisor vicariously liable for any alleged misrepresentations made by the subfranchisor during the sales process.

The offering and sale of master franchises in the United States is further complicated by the need to comply with federal and state registration and disclosure laws. As discussed above, master franchising involves two separate contractual relationships – one between the franchisor and subfranchisor and another between the subfranchisor and an individual franchisee. Each contractual arrangement constitutes the sale of a separate franchise that must be disclosed and registered in franchise registration states. Generally, separate offering circulars are prepared for the master franchise offering and the franchise offering. While the franchisor is charged with the preparation and registration of the offering circular for the offering and sale to subfranchisors, the subfranchisor commonly handles the registration of the offering circular for the offering and sale to individual franchisees. The preparation of the latter offering circular is a feat requiring the coordinated efforts of both franchisor and subfranchisor for several reasons. First, the offering circular must include information about the franchisor and its arrangement with the subfranchisor. Second, the franchisor will often prepare some components of the offering circular or, at minimum, have the right to review the subfranchisor’s draft. As an aside, the master franchise agreement should address the manner in which disputes regarding the content of the subfranchisor’s offering circular are resolved between the franchisor and subfranchisor.

The splitting of initial franchise fees and continuing royalty fees between the franchisor and the subfranchisor is another disadvantage of master franchising because it inevitably results in a decrease in the franchisor’s return on its investment notwithstanding the allocation of costs between the two parties. The splitting of initial franchise fees and continuing royalty fees between the franchisor and the subfranchisor is another disadvantage of master franchising because it may result in a decrease in the franchisor’s return on its investment if the franchisor decides to use a subfranchisor; however, under this option, the franchisor’s initial and ongoing investment in the market is likely to be substantially less than if the franchisor attempted to build-out the market without using a subfranchisor. As discussed above, a franchisor typically receives a smaller percentage of the fees paid by subfranchisees than the subfranchisor. Whether or not the franchisor’s portion is sufficient compensation for the franchisor’s continuing support of the subfranchisor and the risks involved in master franchising poses a difficult question and is one whose answer is difficult to project. Where such financial projections fall short, an increase in the fees paid by individual franchisees does not present a quick fix because this kind of price hike will also serve to make the franchise less attractive to prospective franchisees.

Master franchising also poses the risk of substantial financial loss if the master agreement is terminated or the subfranchisor fails. It is axiomatic that the impact of the termination or failure of any multi-unit operator on the franchisor is directly tied to the number of units controlled by the operator. The franchisor may therefore be more willing to concede to the subfranchisor’s demands, to overlook the subfranchisor’s failure to comply with system standards, or to negotiate a workout of any defaults than in the case of a single unit operator. The franchisor’s failure to enforce the terms of the master franchise agreement may over time hurt the brand and send a negative message to the franchise community.

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78 Fifteen states have franchise registration and disclosure laws, which vary from state to state.
The termination or failure of the subfranchisor has the greatest impact on the individual franchisees who entered into franchise agreements with the subfranchisor but were not parties to the master franchise agreement. The failure to address the parties’ rights and obligations upon the termination or failure of the subfranchisor may be one of the biggest defects in a master franchise agreement. To limit the negative repercussions flowing from the subfranchisor’s termination or failure, the master franchise agreement should provide for the subfranchisor’s assignment to the franchisor or a designated third party of all of the subfranchisor’s rights, title, and interest in and to each individual franchise agreement and the franchisor’s or its designee’s assumption of the subfranchisor’s obligations under the franchise agreements upon the termination or failure of the subfranchisor. The subfranchisor may resist the inclusion of such an assignment provision, however, because it gives the franchisor too much control in determining what event will trigger an assignment of the franchise agreements. Moreover, the assignment may be more easily drafted than accomplished as the relationship between the franchisor and subfranchisor may have deteriorated by the time that the provision is triggered. Even where the assignment proceeds smoothly, the franchisor may not always have the financial resources to go it alone. Other contractual alternatives include provisions where the franchisor retains an option to purchase the individual franchise agreements or the franchisor retains an option to terminate them.

VI. AGREEMENTS WITH SALES INTERMEDIARIES

The use of sales intermediaries in the franchise sales process creates a number of business and legal risks for a franchisor, including: (1) unauthorized earnings claims by the sales intermediary; (2) potential conflicts of interest among the franchisor’s interest, the prospect’s interest, and the sales intermediary’s interest; (3) violations of “broker” registration and/or disclosure requirements; and (4) misrepresentations by the sales intermediary. Once a franchisor has made the decision to use a sales intermediary in the franchise sales process, there are several actions the franchisor can take in order to minimize the associated risks. First, the franchisor should carefully manage the relationship with the sales intermediary. Second, the franchisor should establish, among other things, a training program for the intermediary and a detailed set of guidelines for the intermediary to follow in the sales process. Such guidelines would include criteria for qualifying prospects, identification of the types of promotional materials that can be used, and a summary of the relevant franchise laws. Most important, the relationship between the franchisor and the sales intermediary should be set forth in a carefully drafted agreement that reflects the parties’ rights and obligations and anticipates events that might affect the parties in the future.

While no two agreements will be identical, most agreements between a franchisor and sales intermediary will cover similar concepts such as the parties’ obligations, payment of commissions or other compensation, any exclusivity granted, default, termination, and post-termination obligations. Despite these commonalities, a franchisor should avoid the temptation to use a form agreement as these agreements should be drafted to take into account the specifics of the relationship. In addition, if the sales intermediary provides a form of contract, the franchisor should carefully review, among others, the indemnification provision. The agreement is likely to be heavily negotiated, with the relative bargaining power of the parties playing a critical role in the final terms of the agreement.

The following is a checklist of the key legal and business issues that should be considered in connection with any contract with a sales intermediary. In addition, many of these issues should be considered by a selling franchisee in connection with any contract with a finder or broker regarding a resale.
A. Duties of the Sales Intermediary

The franchisor and the sales intermediary should have a general sense of the basic role and duties that the sales intermediary will perform during the relationship. Despite that understanding, the role and duties should be carefully identified and specified. Depending on the type of sales intermediary, the duties may include, among others: (1) obtaining confidential and/or proprietary material from the franchisor to be used in the sales process; (2) identifying prospects; (3) providing general information regarding the franchised system to the prospect; (4) obtaining information such as a completed franchise application, financial statements, and a business plan from the prospect; (5) interviewing the prospect; (6) qualifying the prospect; (7) providing disclosure to the prospect; and/or (8) referring the prospect to the franchisor. If the franchisor intends to retain exclusive control over any aspect of the franchise sales process, the agreement should expressly identify that aspect. Depending on the type of sales intermediary, the franchisor may not permit the sales intermediary to approve or disapprove prospects, notify prospects of approval or disapproval, or collect money.

If the sales intermediary provides disclosure to the prospect, he or she should be required to maintain a list of, among other information, the name of the individual or entity to whom disclosure has been provided, which form of the disclosure document was provided, when the disclosure was sent, when the signed acknowledgement of receipt was received, and the date the receipt was signed. Since the signed acknowledgement of receipt provides evidence of compliance with disclosure obligations, all signed receipts received by the sales intermediary should be provided to the franchisor. Once the sales intermediary qualifies and refers the prospect to the franchisor, the sales intermediary should be required to send written notice to the prospect stating that the prospect has been referred to the franchisor but that such referral does not constitute approval.

B. Franchise Sales Process

The franchisor and the sales intermediary should agree to and detail in express terms the scope of the sales intermediary’s dealings with the prospects. As an initial matter, the sales intermediary should be required to review and become familiar with the franchise sales and promotional materials, including, most importantly, the disclosure document and the agreements. Since most questions from prospects are likely to relate to the nature of the business, fees, investment costs, services provided by the franchisor, and earnings-related issues, the sales intermediary should focus on Items 1, 5, 6, 7, 11, and 19 in the disclosure document and the corresponding sections in the agreements. The information provided by the sales intermediary to prospects must be consistent with these materials. If a question from a prospect goes beyond the scope of the materials provided by the franchisor, the sales intermediary should refer the prospect to the franchisor.

In order for the sales intermediary to sell the franchisor’s concept effectively and to answer questions from prospects, before the intermediary begins offering the franchise for sale, the franchisor should provide training on the salient representations contained in the disclosure document and the franchise agreements. The franchisor should also retain the right to require the sales intermediary to attend additional training to explain any changes to the franchised system. The specifics regarding the training, including when training will be required, where the training is conducted, the medium for the training, the length of the training, and the frequency of the training, should be included in the agreement.
With regard to promotional materials and sales brochures used by the sales intermediary, the franchisor should specify that only those materials provided or approved by the franchisor can be used by the sales intermediary. In addition, the franchisor should reserve the right to specify the medium and/or format used in connection with the dissemination of any promotional materials. For each promotion or advertisement placed, the sales intermediary should retain a copy of the promotion or advertisement and a record of where and when each promotion or advertisement was published. Each promotion or advertisement must include any disclaimers required by the franchisor. A franchisor should keep in mind that any advertising published by the sales intermediary is subject to filing requirements on franchise sales advertising.79

Developing a franchise sales compliance program and carefully communicating that program to the sales intermediary is key to minimizing the legal and business risks. A franchise sales compliance program is a formalized set of internal rules, procedures, processes, and training programs developed by a franchisor to address how the franchisor, its employees, and any sales intermediary will handle the sale of a franchise, from the initial contact to the execution of a franchise agreement. In addition to addressing the nuts and bolts of the sales process, this program should specifically address: (1) an overview of the franchise sales and relationship laws; (2) the content of the disclosure document; (3) the delivery requirements for the disclosure document and the franchise agreement; and (4) a summary of the agreement provisions.

Once developed, the franchise sales compliance program should be explained in detail to the in-house sales staff and any sales intermediary. In addition, a summary of this program could be included as an exhibit to the agreement with the sales intermediary. If the sales intermediary is required to use and/or provide forms or agreements to prospects, to use specific reporting formats, and/or to provide other information to the franchisor, the parties should specify that obligation, including what materials can or should be used and the format of the materials (e.g., written or electronic).

As part of the sales compliance process, the franchisor should consider requiring new franchisees to execute a "compliance questionnaire." The purpose of this document is to confirm that, in connection with the execution of the franchise agreement, the prospect is not relying on any representations – including those from the sales intermediary – that were inconsistent with the disclosure document or the franchise agreement.

C. Term, Renewal, Termination

The term and renewal rights under contracts with sales intermediaries vary. For example, the term could be for a set period of time, such as one year or two years, or it could be a continuous term, such as one-year terms that renew automatically unless the parties terminate the agreement. Instead of providing specific renewal terms (e.g., two five-year renewal terms), the agreement may provide that the term is renewable by the mutual consent of the parties. The main concern for the franchisor will be to ensure that the agreement is consistent with the timing and other objectives of the franchisor's expansion plan. Unlike franchise agreements, there are no statutes that regulate termination of agreements with sales intermediaries. Accordingly, either party may terminate the agreement at any time with or without cause. In most instances, the agreement will only require that the party that desires to terminate give the other party notice of the termination.

D. Territory and Market

The efforts of a sales intermediary may be focused in a number of ways. If, for example, the franchisor wants to expand to a remote area or the sales intermediary has specialized knowledge of a particular area, a franchisor may engage a sales intermediary to identify prospects in a specific geographical territory. The size of the territory is likely to depend on the experience and resources of the sales intermediary and may be as small as a city or county or as large as the entire United States. In addition, the franchisor may require the sales intermediary to sell only to prospects domiciled in certain states.

E. Exclusivity

The issues surrounding exclusivity are very similar to those in the franchise relationship. If the franchisor grants the sales intermediary an exclusive territory (i.e., the sales intermediary is the only sales intermediary that the franchisor will use in "X" geographic area), the contract should state any limitations on that exclusivity. In addition, to protect the franchisor from potential non-performance by the sales intermediary, the agreement should establish minimum sales performance criteria (e.g., "X" applications or "X" franchise sales sourced within a given period of time) for the sales intermediary to maintain the exclusivity. Failure to meet the minimum sales performance criteria typically will result in the loss of exclusivity, reduction in the size of the territory, or termination of the agreement. The agreement should provide a mechanism to modify the exclusivity and the minimum criteria to reflect changes such as the opening of additional company units or significant growth in the relevant population base.

F. Compensation

The amount of the commission (or other compensation), the timing of the payment of the commission (i.e., what triggers the payment obligation), the method of payment, and other issues related to compensation are not uniform. These terms should be negotiated based upon the specific relationship, the services rendered, and the duties of the sales intermediary.
With regard to the amount of the fee to be paid, there are two basic compensation or commission options: (1) a flat or fixed amount; or (2) a percentage amount. Percentage-based compensation is typically computed as a portion of one or both of the following fees paid by the prospect: the initial franchise fee or the royalty fee for a set period of time. In some circumstances, commissions may be subject to “floors” and/or “ceilings” and may vary depending upon how many prospects are identified either: (a) without regard to timing; or (b) depending upon how many franchises are sold within a given period of time. The commission may be reduced (or eliminated) if the prospect does not meet certain criteria such as net worth, liquid assets, or credit scores. While franchisors should be familiar with the typical fees and the range of fees charged by the relevant type of sales intermediary, the amount of the fee should not be based upon those amounts without further consideration of the specific relationship.

In addition to addressing the amount of the fee, the agreement should also include payment-related terms such as what events trigger the payment of the fee and the timing for making the payment. The agreement should identify the circumstances under which the fee is due the sales intermediary. Typically, the fee will be due once the sales intermediary has complied with its obligations for a specific prospect.

Since the franchisor likely will not want to pay the commission until after the franchisor actually receives the payment from the prospect, most agreements provide for payment of the commission within a certain number of days after the franchisor’s receipt of payment from the prospect (e.g., 30 days or 45 days). In addition, the franchisor should not be obligated to pay the commission unless the fee paid by the prospect has been “earned.” Usually, that fee is not earned until the franchisor, for its own internal accounting purposes, can consider the new franchise sold or the fee paid by the prospect “booked.” The fees will be considered “booked” when all initial fees are paid to the franchisor, all initial agreements, including the franchise agreement and all ancillary legal documents, are fully executed, and in most instances, the franchisor has performed all pre-opening obligations.

In connection with the compensation-related provisions, the franchisor should consider the following questions and, if necessary, address them in the agreement:

- Does the sales intermediary earn the commission only when the sales intermediary initially identified (or “sourced”) the prospect?
- If the sales intermediary must source the prospect to earn a commission, how is that proven?
- What if the prospect already knew about the franchisor before he/she contacted the sales intermediary?
- What if the franchisor identifies a prospect and asks the sales intermediary to assist with qualification?
- What if the prospect is a current or former franchisee of the franchisor or its affiliates?

The agreement also should address issues such as whether the commission, or any portion of it, must be refunded if, within a prescribed period of time (e.g., 60 or 90 days after sale), the franchisor terminates or rescinds the franchise agreement. This issue can be addressed in a number of ways, including making only a portion of the commission payable
when the prospect signs the franchise agreement and the remainder payable when the prospect opens the unit.

G. Costs and Expenses

In addition to commissions, the franchisor may agree that other compensation will be paid to the sales intermediary or the sales intermediary will be reimbursed for certain costs and expenses. For example, the franchisor may agree to pay the sales intermediary a flat administrative fee for expenses such as maintaining telephone service, conducting background checks, verifying financial information, and preparing and distributing promotional mailings. In addition, if there are costs that can be specifically attributed to a prospect (such as postage, photocopying, overnight delivery, telephone charges, travel costs), the parties may agree that the franchisor will reimburse the sales intermediary for those costs.

H. In-Term Noncompete

In order to reduce the conflicts of interest, the franchisor may wish to bind the sales intermediary to an non-competition covenant during the term of the contract. These provisions will prohibit the sales intermediary from working with the franchisor’s direct competitors. The competitors can be described (i.e., all quick service restaurants that sell roast beef sandwiches) or identified by name.

I. Post-Term Obligations

Upon the expiration or termination of the agreement, the parties will have certain obligations to each other. The sales intermediary’s obligations to the franchisor may include: (1) providing to the franchisor information relating to any prospects in the pipeline; (2) returning to the franchisor any confidential and/or proprietary materials; (3) complying with all confidentiality restrictions; (4) observing any non-disparagement clauses; (5) complying with any non-competition restrictions for the period specified in the agreement; and (6) remaining liable to the franchisor under any indemnification obligations. Depending on the compensation structure, if the sales intermediary refers a prospect to the franchisor before termination or expiration and the sale is completed after termination or expiration, the franchisor may be required to pay the sales intermediary a commission on that sale. The payment obligation for such sales typically runs for a limited period of time after the termination or expiration of the agreement. However, if the agreement is terminated based upon a default by the sales intermediary (such as a misrepresentation), the payment obligation should not survive.

J. Compliance with Laws

The sales intermediary should be required to comply and cooperate with the franchisor in complying with all applicable laws, including any state broker filing requirements (as discussed earlier) and any federal or state franchise disclosure obligations. If the franchisor provides updated disclosure or sales materials to the sales intermediary, those updated materials must be used in place of any prior versions of such materials. If the franchise offering has not been registered in all registration states, the franchisor should provide to the sales intermediary a list of the states in which the registration is not effective.

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80 The registration states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.
K. **Legal Description of Relationship**

The contract should specifically state that the sales intermediary is an independent contractor, not an employee of the franchisor. Unless the duties of the sales intermediary require otherwise, the franchisor should specify that the sales intermediary has no authority to enter into any agreements or to make any binding commitments on behalf of the franchisor.

L. **Indemnification**

Perhaps one of the most important provisions in the agreement will be the indemnification provision. The sales intermediary should indemnify the franchisor with respect to all claims, demands, damages (including attorneys’ fees), liabilities, and costs caused by, resulting from, or pertaining to the performance of the sales intermediary’s duties under the agreement. The indemnification provision should cover claims asserting that the sales intermediary: (1) negligently or intentionally deceived the prospect; (2) made misrepresentations or untrue statements; or (3) made unauthorized representations such as an unauthorized earnings claim. The sales intermediary may request that the franchisor indemnify the sales intermediary with respect to third party damages arising out of the franchisor’s uncured breach of the agreement and any violation of the franchise sales laws. The indemnification provisions of the agreement should survive termination or expiration.

M. **Surveillance**

In order for the franchisor to monitor the sales intermediary’s compliance, the franchisor may reserve the right to send people posing as prospects to the sales intermediary. These mystery shoppers will evaluate whether the sales intermediary is complying with its obligations. In the alternative, the franchisor may reserve the right to, among other things, be present during phone or in-person communications between the prospective franchisee and the sales intermediary.

N. **Miscellaneous Provisions**

The contracts should also include “boilerplate” provisions to deal with issues such as: (1) transfer; (2) integration and the requirement that amendments be in writing and signed by both parties; (3) choice of forum; (4) choice of law; (5) mediation or arbitration (if desired); (6) minimum insurance requirements for the sales intermediary; and (7) notice.

VII. **CONCLUSION**

There are significant advantages associated with using sales intermediaries in the sale of new franchises and the resale of existing franchises. However, a franchisor should carefully evaluate its own needs and goals both when deciding whether to use sales intermediaries and in choosing which type of sales intermediary would best accomplish the franchisor’s objectives. When selecting sales intermediaries, the franchisor should carefully investigate the sales intermediaries’ past performance and future prospects to determine whether those particular sales intermediaries will “go to bat” for the franchisor and act in the franchisor’s best interests or will instead pursue their own agendas. To limit the business and legal risks of using sales intermediaries, the franchisor should negotiate comprehensive agreements, specific to each sales intermediary, that address the franchisor’s concerns unique to each particular sales intermediary. Although it will be impossible to eliminate entirely the risks associated with using
sales intermediaries, by aligning the franchisor’s goals with suitable sales intermediaries, the franchisor can maximize the potential for success of its future franchisees.
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As a franchise expert witness, he brings to bear over 25 years experience as a franchisee, franchisor, business founder, consultant, counselor and author. He has published numerous articles, was the host of AOL’s franchise forum for six years, and is quoted by popular websites and publications regarding franchise development issues.

Prior to embracing the franchise industry, he was employed by ITT Corporation where he was an operations analyst and reached the Director level at age 29. Before corporate life he was an officer in the U.S. Marine Corps and completed a tour of duty in Vietnam.

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Leslie has spoken and conducted roundtables at numerous franchise legal and business conferences and seminars. She is an active member of the American Bar Association’s Forum on Franchising, serving as the Young Lawyers Division Liaison to the Governing Committee. In addition, in past years, Leslie has helped to plan the annual community service event for the American Bar Association Forum on Franchising. For the 2006 ABA Forum, Leslie was the Co-Chair of that event. She is also a member of the International Franchise Association. Leslie received a Bachelor of Arts degree from Elizabethtown College and graduated magna cum laude from University of Pittsburgh School of Law, where she served as research editor for the University of Pittsburgh Law Review.
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