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GROWTH THROUGH
MULTI-UNIT FRANCHISING

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I. INTRODUCTION

In today’s economy, corporate and consumer budgets seem to be tightening daily. The franchise industry is far from immune to this trend, and despite this – and in some cases, because of this – many franchisors are looking to expand into new markets to grow their brands both domestically and internationally. Regardless of the motivation behind this desire to expand, however, franchisors looking to grow their brands are looking to do so in the most cost-effective way possible.

While franchisors have traditionally used single unit franchising to expand their systems, alternative growth strategies are increasingly used by franchise systems. There are various strategies for growth available to today’s franchisors; from master franchising to joint ventures, franchisors have a myriad of factors to consider in determining which, if any, growth strategies may work for them at a particular point in time. Depending on the concept, the target market, the franchisors’ available resources and the growth strategies they have already employed in other markets, franchisors must carefully assess the various growth strategies available to them. The purpose of this paper is to provide franchisors looking to grow their concept with an overview of these available growth strategies and make them aware of some of the risks, benefits, contract and other legal considerations associated with each strategy.¹

II. OVERVIEW OF GROWTH STRATEGIES

A. Master Franchising

1. General Description and Agreements Involved

“Master Franchising” is a common expansion strategy used by franchisors both domestically and even more frequently, internationally, which involves three parties: a franchisor/master franchisor, a master franchisee/subfranchisor and one or more unit franchisees. Initially, it is important to note that the line between whether a relationship is a master franchise and area development arrangement (which is discussed in Section II.B. below) is often very fuzzy. Often, an arrangement using one of these two growth strategies will include characteristics from the other strategy.

Master franchising/sub franchising involves two interdependent contractual relationships: (i) the agreement between a franchisor and master franchisee (the “master franchise agreement”); and (ii) the agreement between the master franchisee and an individual franchisee (the “franchise agreement”). In most cases, the franchise agreement is entered into between the master franchisee and the franchisee. Unless the franchisor is a signatory to the franchise agreement, there is no direct contractual relationship between the franchisor and the franchisee.

Master franchise agreements grant the master franchisee a prescribed territory, and establish a development schedule within which the master franchisee is required to subfranchise outlets to third party unit franchisees. The master franchisee usually is responsible for unit level franchisee recruitment, site selection assistance, and construction and operational support, within the master franchisee’s prescribed territory. The master franchisee may also

¹ The authors wish to thank Andrea Rigobon, summer student at Cassels Brock & Blackwell LLP, for her valuable assistance with the preparation and review of this paper.
develop one or more units, whether or not required to do so by the franchisor, to showcase the franchise business that is for sale, to train new franchisee recruits and generally to gain valuable system experience. The franchisor often will train the master franchisee, both at the master and unit franchise levels and the master franchisee, in turn, will train the unit subfranchisees.

The benefits that can be derived from the relationship between franchisor and master franchisee are subject to the complexity of the relationship in general. The master franchisee will have to manage competing demands by conforming to the franchisor’s policies and procedures while finding ways to adapt them to local needs. The master franchisee will also have to address conflicting demands between the franchisor, the subfranchisees and other customers. In addition, the continued involvement and support of the franchisor is crucial to the success and growth of the master franchisee’s business.

2. **Sourcing Related Issues**

Unit franchise agreements often include a requirement for franchisees to purchase inventory, supplies, equipment and other products from the franchisor or the franchisor’s designated supplier. In a master franchise arrangement, the franchisor often delegates to the master franchisee the responsibility of supplying unit franchisees with inventory and other items. The master franchisee undoubtedly has a level of knowledge about the local market sufficient to either supply the items itself, or to find an appropriate alternate supplier. The franchisor is wise to closely monitor the inventory and other items being supplied by the master franchisee or its designated supplier in order to ensure that the franchisor’s standards of quality and consistency are being maintained.

The delegation of this responsibility is particularly relevant when dealing with the supply of goods that are subject to local quotas or some other type of industry regulation. Ideally, a master franchisee is aware of these local restrictions and regulations and thus, better able to efficiently arrange for the supply of inventory and other items to the unit franchisees.

3. **Financial Considerations and Fee Splitting**

Most master franchise agreements provide for the payment of a non-recurring fee (commonly referred to as a “master franchise fee”) that is typically payable by the master franchisee to the franchisor upon execution of the master franchise agreement. The amount of this fee varies significantly from deal to deal and is often negotiated by the parties. Payment terms for the master franchise fee may vary – a portion of the fee may be paid as a deposit or the fee may be paid in multiple instalments due over time (such as a portion due upon execution of the master franchise agreement and the remainder due in accordance with development). The master franchise fee serves as consideration for the rights granted to the master franchisee in the master franchise agreement as well as the franchisor’s lost or deferred opportunity to enter into a similar agreement with other parties during the development period. The master franchise fee is determined by the perceived value of the franchise and the size of the territory granted to the master franchisee. The fee sometimes includes consideration for start-up services which vary according to the degree of involvement by the franchisor in helping the master franchisee commence its operations.

In addition, most master franchise agreements require the master franchisee to pay to the franchisor a portion of certain fees paid by the unit level franchisees to the master franchisee. Each unit franchisee pays the master franchisee fees that may include an initial franchise fee, a royalty fee and an advertising fee. Then, the master franchisee remits to the
franchisor a percentage or flat fee portion of the fees payable or paid by the unit franchisee. Generally, the master franchisee retains one-half to two-thirds of the initial franchise fees and royalty fees, but regardless of the amount of the fees, it is important for a franchisor and master franchisee to ensure that the basis upon which payments are to be made (paid vs. payable) along with the timing of payments from the master franchisee to the franchisor are clearly set out in the master franchise agreement.\(^2\)

In determining an appropriate fee structure, the master franchisee will want to ensure that it has sufficient resources to undertake the expansion within the specified territory and make a reasonable profit. The franchisor will want to ensure that it is appropriately compensated for its investment and the expansion value of its system. The continuing costs of supporting the franchise system in the territory remain significant. During the initial few years when the franchise system is being established in the territory, the franchisor should be involved in assisting the master franchisee with the actions necessary to set up the franchise system. The continued involvement of the franchisor in the territory may be essential in order to ensure the viability of the franchise system. Often the royalties earned by the franchisor during this time period do not sufficiently compensate the franchisor for its efforts. To offset this burden, some franchisors have expanded their enterprises to include the manufacturing and sale of certain proprietary products to the master franchisee to be used in each unit franchise.

### 4. Unique Contract and Business Considerations

To guard against the risk of financial loss which could arise if the master franchise agreement is terminated or the master franchisee is unsuccessful in its efforts to subfranchise, the franchisor may want the agreement to provide for the franchisor’s or its designee’s option to assume the master franchisee’s obligations under the unit franchise agreements upon the termination of the master franchise agreement or material default of the master franchisee. As an alternative to such an option to assume, the franchisor may want the agreement to provide for the master franchisee’s assignment to the franchisor or a designated third party of all of the master franchisee’s rights, title, and interest in each individual franchise agreement. The master franchisee may try to avoid such an assignment provision because it allows the franchisor too much discretion in determining what constitutes a “trigger” event. These provisions should be carefully drafted and negotiated to ensure that the franchisor’s and the master franchisee’s rights are adequately protected. Courts have held that, absent a contractual obligation between the franchisor and the unit franchisee, the franchisor had no right to assume the rights and obligations of the master franchisee upon the termination of a master franchise agreement.\(^3\)

Further, a franchisor that is unsure of how its concept will fare in a new market may elect to open a franchisor-owned unit in that market prior to entering into a master franchise agreement.

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2. See *Mega Wraps B.C. Inc. v. Mega Wraps Holdings Inc.*, [2008] O.J. No. 2947 (C.A.) in which the Ontario Court of Appeal examined, among other things, the difference between franchise fees being paid by the franchisor by the master franchisee when the sale of the unit franchises ‘closed’ (i.e. when the unit franchisees paid the fees to the master franchisee), and franchise fees being paid at the time the unit franchisees opened their store locations. Ultimately, the Court of Appeal upheld the trial judge’s decision in finding that the portion of the fees payable by the master franchisee to the franchisor was not actually due to the franchisor until the unit franchisees had paid the fees to the master franchisee.

agreement. The degree of success experienced at the franchisor-owned unit can be the basis upon which the franchisor decides whether or not to enter into a master franchise agreement.

A significant challenge to master franchising is that the franchisor is one step removed from the training and control of the unit franchisees. To reduce the franchisor’s potential liability for the acts or omissions of the master franchisee and its unit franchisees, the franchisor should ensure that there are waiver and indemnity provisions in the master franchise and unit franchise agreements.

If a franchisor elects to require the master franchisee to operate a unit itself, a provision setting out that requirement must be included in the master franchise agreement. However, the franchisor should remember that the master franchisee’s operation of a unit franchise will prevent the master franchisee from devoting all of its time to developing the brand across its given territory by entering into unit franchise agreements with new franchisees. Providing the master franchisee with the option to open and operate a unit franchise can help to alleviate this concern by allowing the master franchisee to determine itself whether it has the capacity to wear the hats of both the unit franchisee and the master franchisee.

5. **Timeframe for Expansion**

By delegating responsibility for developing specified territories and recruiting franchisees within those territories to one or more master franchisees, a franchisor can achieve a more rapid rate of expansion through master franchising than would typically be accomplished by franchising on a unit-by-unit basis or by an area development arrangement (discussed below in Part II.B). This is particularly the case when the master franchisee brings valuable industry or geographic experience and contacts to its relationship with the franchisor. The master franchisee’s ability to navigate local laws and customs is an asset to a franchisor who would normally have to expend a great amount of time and money in order to establish a franchise in a market other than the franchisor’s primary market.

Master franchising typically attracts more sophisticated and experienced investors with greater access to capital than traditional unit franchisees. The experience, financial resources and market proximity of the master franchisee are beneficial to the franchisor since these factors will enable the franchisor to facilitate expansion into the market with greater ease. Further, because the master franchisee is able to focus its efforts and resources largely on establishing a management, recruiting and support structure, unit franchisees gain access to the tools they need to become successful operators, thus furthering the franchisor’s expansion objectives.

In a master franchise arrangement, the parties must also establish a realistic timetable for development. The development schedule is generally subject to much negotiation and the agreement between the parties must provide for appropriate remedies if the development fails to proceed as anticipated.

6. **Business and Legal Risks**

Master franchising involves the mitigation and allocation of risks between the parties involved. Probably the largest risk to the franchisor is the tarnishing of its brand, which can occur if the master franchisee does not adequately enforce the unit franchise agreement and operating manual. A unit franchise agreement within a master franchise structure may contain provisions that afford the franchisor certain rights to oversee the operation of the unit franchise,
with the objective of allowing the franchisor to protect its brand. However, if a unit franchisee fails to fully comply with the franchise agreement and operating manual, the franchisor has little or no direct recourse against the unit franchisee because the unit franchise agreement is between the master franchisee and the master franchisee.

To mitigate this risk, it may be possible in certain jurisdictions to name the franchisor as a third-party beneficiary in the agreement between the master franchisee and a unit franchisee.\(^4\) In addition, in certain limited circumstances it may be possible to include the franchisor as a party to the subfranchise agreement, which gives the franchisor the ability to enforce system standards on the unit franchisee in circumstances where the master franchisee is unwilling or unable to do so (as in the case of bankruptcy). The franchisor should also reserve the right to conduct audits and inspections of the master franchisee and its unit franchisees to confirm that its system standards are being upheld. It is important to note, however, that too much involvement by the franchisor in the unit franchise agreement could be inconsistent with the franchisor’s original purpose for choosing master franchising, namely, the allocation of responsibility and cost and can subject the franchisor to liability.\(^5\)

The reputation of the franchisor’s brand can be as important as the basic financials of the unit’s business model. Damage to the franchisor’s reputation can be severe and sometimes permanent. Even if there is only minimal reputational damage, it could inhibit the franchisor from attempting to re-enter that particular market for several years. Further, master franchising poses the risk of substantial financial loss if the master franchise agreement is terminated or the master franchisee is unsuccessful in its efforts to subfranchise the concept.

Local conditions may make a foreign market very different from other markets in which the franchise is successfully operated. As demographics, interests and consumption habits of consumers can vary by country, state, region, prefect, province, city and neighborhood, the familiarity of the master franchisee with local consumer demands and preferences is imperative to the success of the franchisor’s brand. Without the proper insight and adaptation of the brand to meet local needs, the franchisor risks a failed attempt at foreign expansion.

While it is important for a franchisor to contract with a master franchisee who is familiar with the local market, there are costs involved for the franchisor in dealing with a highly sophisticated master franchisee. Typically, a more sophisticated and experienced master franchisee will have higher expectations and greater demands, thus resulting in a more lengthy and costly process for the negotiation of the master franchise agreement. The franchisor must balance these costs against the benefits of working with a sophisticated master franchisee throughout the term of the master franchise agreement.

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4 The franchisor should carefully articulate its rights and responsibilities as a “third party beneficiary” under the master franchise agreement. For example, in *Collins v. Int’l Dairy Queen*, Bus. Franchise Guide (CCH) ¶11,368 (M.D. Ga. 1998), Dairy Queen was a third party beneficiary of the unit franchise agreement; however, the court found that Dairy Queen was not entitled to compel arbitration with the unit franchisees because the arbitration clause referred specifically to the master franchisee not the franchisor. The court opined that the unit franchisees unambiguously agreed to arbitration with the master franchisee and not the franchisor.

5 *O’Kocha V. Jani-King, Inc.*, Case No. C01-11688Z (W.D. Wa. 2002), which addresses questions relating to a franchisor’s liability for master franchisee’s actions. In each growth strategy, franchisors should assess these types of potential claims and carefully structure the relationship and draft contract provisions to address these concerns.
B. Area Development

1. General Description and Agreements Involved

An area development franchise can be viewed as a hybrid between the single unit and master franchise. Unlike the master franchise arrangement which involves three parties (the franchisor, master franchisee and unit franchisee), an area development arrangement typically involves two parties, the franchisor and the franchisee (area developer). An area development agreement involves the granting of rights by a franchisor to an area developer to develop, own and operate a prescribed number of franchises in a specific territory, in which the area developer may have exclusive, limited exclusive, or non-exclusive rights. An area developer must own or control all franchised units opened in its territory. The area developer must have the financial and human resources necessary to open up an agreed upon number of franchise units within the territory granted.

An area development arrangement is brought about through the use of an area development agreement, which sets out the territory for development, a development schedule and procedures for obtaining the franchisor’s approval to open each unit. Usually each franchise is the subject of an independent unit franchise agreement that is executed by the franchisor and the area developer, as unit franchisee. If the area developer fails to open units at the rate required by the development schedule, the franchisor may terminate the development agreement but allow the area developer (as unit franchisee) to continue operating any existing franchises.

Area development agreements provide all of the general advantages of multi-unit franchising, such as the potential for accelerated growth, with less investment or capital demands upon the franchisor. One of the principal advantages to the area development arrangement is that the franchisor contracts with and must train just one, likely sophisticated, franchisee. This individual is then often responsible for substantially all obligations leading to the establishment and operation of the franchised outlets in the target market. This arrangement is both time and cost effective for the franchisor.

2. Sourcing Related Issues

As the area development agreement is entered into directly between the franchisor and an area developer, the area developer will typically be required, at least initially, to purchase inventory, equipment and other supplies from the franchisor or the franchisor’s designated supplier. Eventually, the area developer may develop contacts and sufficient local expertise in its development territory to be able to source products comparable to those being supplied by the franchisor at better prices or from suppliers located closer to the area developer, thus requiring less transportation. The area development agreement will often include a provision allowing the area developer to present samples of such comparable products to the franchisor for the franchisor’s approval. If approved by the franchisor, the area developer may purchase the products from its chosen alternate supplier instead of the franchisor or the franchisor’s designated supplier.

3. Financial Considerations and Fee Splitting

The area development agreement will allocate an initial fee for the right to open a specified number of units (possibly with an option for more units if the developer achieves a particular quota during the term). Often this amount is a pre-payment of part of the initial fees
due for units opened by the area developer under the unit level franchise agreements; however, in some instances, this fee may be a separate additional fee that is not credited or set off against the initial fees for the unit opened. In this type of arrangement, the area developer will require access to considerably more capital than would be necessary to fund single-unit or master franchising. Since area developers develop and operate the units themselves, they do not earn income from the selling of individual franchises. The main source of income earned by area developers is the revenue earned from individual franchise locations. The area developer is responsible for financing every outlet as it opens and therefore, the area developer must make sure each unit is operated as efficiently as possible so that additional financing may be obtained as needed.

4. Unique Contract and Business Considerations

The franchisor must take great care in selecting an area developer. Often the qualifications for a successful area developer will be significantly different from those for a successful single unit franchisee. If the franchisor rushes into selecting an area developer without conducting proper due diligence and makes the wrong choice, the franchisor risks financial and other consequences, including damage to the franchisor's brand. This is particularly important for area development arrangements where the area developer alone is responsible not only for the expansion of the system in a particular territory, but usually for operating unit franchises as well. The franchisor may wish to conduct criminal background checks and credit checks against the area developer candidate if the candidate is an individual or against the candidate's principals if the candidate is a corporation. In many jurisdictions, the franchisor will be required to obtain the candidate's written consent prior to conducting such criminal and credit checks, but regardless of jurisdiction, it is prudent for the franchisor to obtain the candidate's written consent as part of the application process.4

5. Timeframe for Expansion

One of the principal differences between area development and master franchising is that the area developer must own or control all franchised units opened in its territory. Therefore, the speed at which an area developer may grow is more limited than a master franchisee, unless the area developer is well capitalized for expansion. Recognizing that limitation, the franchisor is likely to offer a smaller territory to an area developer than it would to a master franchisee. Another option may be to permit the area developer to form related or affiliated entities to act as the unit franchisees for franchised units developed and opened by the area developer. While the area developer will still need to fund the entities that are developing units, permitting the area developer have minority investors in the units may help accelerate growth.

The area developer has a dual role in the expansion of the franchise. At each location, the area developer is responsible for ensuring that each franchise begins to operate properly and that it is appropriately staffed. Concurrently, the developer will be considering where to develop and open the next franchise location. This dual responsibility provides another reason why franchise expansion under the area development strategy typically occurs at a slower pace

4 The necessity for background checks and criminal checks not limited to this growth strategy. Franchisors should carefully consider each applicant, regardless of the type of relationship to be established and conduct all necessary due diligence before proceeding.
than master franchising. Master franchising allows a quicker rate of expansion by allowing the master franchisee to delegate the responsibility of opening and operating each franchise onto a unit franchisee.

6. **Business and Legal Risks**

In comparison to master franchising, area development permits the franchisor to maintain more control over the unit franchisees. The area developer is required to operate the unit franchises, instead of granting third parties the right to do so. This arrangement results in a greater degree of direct control over the franchises by the franchisor. Some of the control retained by the franchisor in an area development agreement could potentially be lost if the area developer enters into a management agreement with an individual to operate one or more of the franchise locations. While the area developer may be well motivated to operate the franchisor’s system properly because of capital investment, the management of each unit franchise must be under a sufficient level of supervision to ensure success. To guard against this occurrence, the franchisor will want to include a provision in the area development agreement that requires the area developer to provide full-time, ongoing supervision of the franchises.

One of the most significant challenges applicable to area development is under-development. Development schedules often amount to lofty goals which may be difficult to achieve. It is in the best interests of the franchisor to grant smaller territories to area developers in order to better satisfy development goals.7

C. **Area Representation**

1. **General Description and Agreements Involved**

This growth strategy has various names including: “area representative,” “area director,” “development agent,” “master developer,” “area franchisee” or “regional developer/director.”8 For convenience, this paper refers to this strategy as area representation and the third party as an area representative. Typically, area representation involves: (i) three parties – the franchisor, the area representative and the unit franchisee; and (ii) two distinct agreements – an area representation agreement and the individual unit franchise agreements. In the area representation agreement, the franchisor grants the area representative the rights to undertake the following activities in a defined geographic area or territory that is usually exclusive: (i) the right to act as the franchisor’s sales agent with respect to the sale of individual franchised units; and (ii) the right to provide service and support to the franchisor’s franchisees. The area representative’s sales and development obligations may be subject to a development schedule.

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7 This potential challenge is also present for master franchising and area representation. Franchisors should carefully consider the development schedule, the territory granted and the true potential and ability of the other party (whether it be the master franchisee, area representative, or area developer) to meet the schedule. If the other party is failing to meet the schedule, the franchisor may lose market share to its competitors who are aggressively developing the territory.

8 For the sake of clarity, this section is not referring to a traditional area developer, which is referenced in Section B infra.
While the area representative may be “involved in” the selection of franchisees, typically, the franchisor retains the right to issue final approval of unit franchisees. Once the franchisor has approved the unit franchisee, the franchisor and the unit franchisee will enter into a unit franchise agreement. This arrangement looks somewhat similar to master franchising; however, unlike master franchising where the master franchisee enters into unit franchise agreements with the unit franchisees, the area representative does not contract directly with unit franchisees.

With regard to the ongoing service and support of unit franchisees, the franchisor retains ultimate responsibility to the unit franchisees for these obligations under the franchise agreement; however, the franchisor delegates to the area representative many post-sale operational responsibilities. The area representative’s duties may, in addition to franchise sales, include site location assistance, training, consultations, advertising, inspections, and operational assistance to unit franchisees in the territory. Since the area representative is local and typically operates units in the territory, the area representative can respond to the needs and concerns of unit franchisees in the territory more efficiently than the franchisor, resulting in improved operational performance 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.

2. **Sourcing Related Issues**

In this arrangement, the franchisor is likely to select the area representative based upon his or her expertise and knowledge with regard to the local market conditions. By having an existing local presence in the territory, including the development of strong relationships with, among others, landlords, building contractors, vendors and 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 a key source of ideas as to how the sales process and the system can be tailored to achieve maximum success in the territory. In addition, the first-hand knowledge of the market is key in dealing with sourcing issues quickly and efficiently.\(^9\) Franchisors should carefully consider and take advantage of this knowledge when drafting the rights and duties of the area representative. Depending on the rights and duties the area representative takes on, the area representative may have an active role in assisting the unit franchisees with sourcing products and materials necessary for the operation of unit franchises. Given the unique knowledge of the local market, the area representative is undoubtedly in the best position to work with the unit franchisees to address supply chain issues. To protect the brand, the franchisor should closely monitor the inventory and other items supplied to ensure that they comply with the franchisor’s standards.

3. **Financial Considerations and Fee Splitting**

Typically, the area representative will pay the franchisor an initial, non-recurring fee for the right to become an area representative when the area representation agreement is signed.

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\(^9\) Master franchisees and area representatives will have similar local expertise. Franchisors should carefully consider the experience and knowledge of the local partner and ensure that the relationship is set up so that the parties get the maximum benefit from that experience and knowledge.
The amount of this fee may vary considerably and the parties may negotiate different payment terms.

One of the obvious drawbacks of an area representation arrangement for the franchisor is profit sharing with the area representative. Under this arrangement, the franchisor (not the unit franchisee) compensates the area representative for the franchise sales and ongoing services. Like traditional single unit franchising, the unit franchisee pays an initial franchise fee and ongoing royalty fees directly to the franchisor. Then, the franchisor pays the area representative a portion of the initial franchise fees as compensation for soliciting prospective franchisees, and a portion of the royalty fees as compensation for servicing and supporting franchisees. While these amounts are negotiated on a deal-by-deal basis and can vary considerably from system to system, often the area representative may receive 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.

While the compensation structure for area representation arrangements is very flexible, franchisors should keep in mind the various incentives created by the fee splitting. A franchisor may be tempted to provide the area representative a very small portion of the ongoing fees due to the franchisor from the unit franchisees, however, in doing so, the area representative will not be incentivized to support the unit franchisees and protect the brand. In successful area representation arrangements, 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 require that the area representative share in the costs associated with problem unit franchisees. For example, an area representative may be responsible for some portion of the legal fees and damages amassed through litigation or arbitration or rent arrearages where the franchisor would otherwise be liable.

Finally, the franchisor should develop a realistic financial assessment regarding area representation to ensure that the reduction in revenue to the franchisor resulting from the fee-splitting arrangement does not surpass the 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 growth strategy is not efficient.

4. Unique Contract and Business Considerations

The following issues should be addressed in an area representation agreement: grant of rights, exclusivity, development schedule, area representative ownership of franchised units, duties of the area representative, fees and compensation, initial and renewal term, transfer, grounds for default, the franchisor’s duties, and rights and obligations upon termination.\(^\text{10}\)

Franchisors may select an area representative from the existing, highly motivated franchisees in the territory and, in some circumstances, may permit the area representative to own and operate additional outlets. Even if area representatives are not selected from

\(^\text{10}\) These provisions are discussed in more detail in Part IV below.
franchisee ranks, in order to ensure that the area representative has some practical experience with the franchise system, the franchisor may require the area representative to have opened a franchised unit before commencing activities as an area representative. As an experienced operator who is familiar with all aspects of the business, the area representative knows what it takes to be a successful franchisee and, is therefore more qualified to screen applicants and service franchisees. In addition, maintaining the franchised unit in the area provides the obvious benefit of a built-in training facility.

5. **Timeframe For Expansion**

Area representation permits the franchisor to gain market presence without sacrificing control over the franchise system and use of trademarks. While retaining ultimate responsibility for the unit 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 franchisee candidates and providing operational support to existing and new unit 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 unit franchisees.

6. **Business and Legal Risks**

As with any other strategy, area representation has its risks. Because of the area representative’s direct involvement in franchise sales and operations, the franchisor may be held liable for the acts and representations of the area representative. The franchisor should develop and provide to the area representative clear guidelines and training on those guidelines.

Similar to master franchising, this arrangement involves three parties -- franchisor, area representative and franchisee. However, unlike master franchising, the franchisor controls both contractual relationships -- the area representation agreement and the franchise agreement. To reduce the risks associated with this strategy, the franchisor should carefully draft agreement provisions -- including the disclaimers and indemnification provisions. The franchisor should disclaim responsibility for any acts or statements made by the area representative that are contrary or in addition to the disclosure document, 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 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 disclosure document. These disclaimers should be included in the area representation agreement and in the franchise agreement with the unit franchisee. In addition, the franchisor should include a similar disclaimer in its compliance questionnaire.

The success of an area representation arrangement is highly contingent on the skills of the individual area representative. 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.).
In a perfect world, the area representative performs the continuing functions of the franchisor for the franchisees in a seamless manner. However, under the strategy, the franchisor necessarily loses some control of the oversight of the unit franchisees in the area representative’s territory. As most mature franchisors can attest, the success of the brand depends on maintaining positive relationships with the unit franchisees. By inserting an intermediary between the franchisor and the unit franchisee, this growth strategy can create attenuated franchise relationships. Notwithstanding the fact that the area representative may have a significant amount of contact with the unit franchisees, the franchisor should ensure that the unit franchisees have a bond to the franchisor and ultimately trust the franchisor.

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 and the franchise relationship may be irreparably harmed. 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 unit 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 unit franchisees in the territory despite the fact that the franchisor does not have an adequate infrastructure to do so. Additionally, in some instances, communications from the franchisor can get distorted or misinterpreted before they reach unit franchisees. Franchisors should retain the right to review communications between area representatives and unit franchisees.

D. Joint Venture Arrangements

1. General Description and Agreements Involved

As another alternative, a franchisor may create a jointly-owned entity with a local partner to develop the franchise system in the defined territory. Joint venture arrangements can be structured as corporations, partnerships, or other legal entities. Williston on Contracts notes that, typically, the following factors must be present in a joint venture arrangement:

“(a) A contribution by the parties of money, property, effort, knowledge, skill or other asset to a common undertaking;

(b) A joint property interest in the subject matter of the venture;

(c) A right of mutual control or management of the enterprise;

(d) Expectation of profit or the presence of “adventure”, as it is sometimes called;

(e) A right to participate in the profits;

(f) Most usually, limitation of the objective to a single undertaking or ad hoc enterprise.”11

Typically, this growth strategy involves two agreements: (i) the joint venture agreement between an entity formed by the franchisor and an entity formed by the local partner; and (ii) a traditional franchise agreement, master franchise agreement or development agreement between the franchisor and the joint venture entity. Outside of a few specific industries, such as the hotel industry, joint ventures are not very common in connection with franchising in the United States or elsewhere.

2. **Financial Considerations and Fee Splitting**

Under a joint venture arrangement, the franchisor has a greater potential for profit because the franchisor holds a direct interest in an entity whose value may appreciate. Of course, the franchisor should always consider the possibility that the joint venture will lose money or lose value. Some joint venture agreements provide the franchisor with an option to buy out the partner for a specific amount at a designated point in the future.

The franchisor must share the profits with a local partner. With this arrangement, the franchisor typically does not receive a set fee for the right to use the system and know-how. Instead, the franchisor’s compensation is contingent on its share of the profits and whether or not there is an agreement to reinvest profits.

3. **Unique Contract and Business Considerations**

Regardless of the form of entity created, the joint venture agreement should set forth the respective rights and duties of each party, including those activities which the joint venture is authorized to undertake, the amount of the capital and in-kind contributions to be made by each party, the manner in which the ownership interests and income will be distributed among the parties, allocation of control and decision-making authority, and the circumstances which trigger dissolution of the entity and the terms thereof. These arrangements are heavily negotiated and vary considerably. Typically, the franchisor contributes a license of its trademarks, know-how, and ongoing operational support to the joint venture, while the local partner contributes capital, human resources, and management skills.

If structured properly, joint ventures offer the franchisor, through equity ownership, greater control over the development of the franchise system in the territory and the use of its trademarks than it would have with other methods such as master franchising. Therefore, the franchisor is in a better position to enforce system standards and ensure the quality and uniformity of the franchising operation. Where the franchisor is not the majority owner of the joint venture, local corporate and partnership laws must be analyzed to determine the effect on the franchisor’s control.\(^\text{12}\)

The parties should carefully negotiate the termination provisions of the joint venture agreement. Termination of the joint venture arrangement will require the unwinding of a legal and business structure that has been set up to support the franchising efforts. Accordingly, if the franchisor is considering utilizing joint ventures for international transactions, the franchisor should keep in mind that some foreign jurisdictions have local ownership laws that must be taken into account. These laws may require a local citizen to own all or a portion of the ownership interests in any entity formed in, or operating a business in, the foreign jurisdiction. In international transactions, the franchisor should engage local counsel to review the joint venture structure and agreements.

\(^{12}\) If the franchisor is considering utilizing joint ventures for international transactions, the franchisor should keep in mind that some foreign jurisdictions have local ownership laws that must be taken into account. These laws may require a local citizen to own all or a portion of the ownership interests in any entity formed in, or operating a business in, the foreign jurisdiction. In international transactions, the franchisor should engage local counsel to review the joint venture structure and agreements.
these provisions are likely to be some of the most time consuming to negotiate and may be difficult to resolve. The actual implementation of the provisions is quite complex because of the interrelationship between the joint venture agreement, the master franchise or development agreement, and any supply agreements.

Similar to master franchising, the local partner brings local market expertise relating to, among other things, knowledge of local customs and tastes and valuable business and political contacts. In addition, since the franchisor may not have the manpower to effectively manage the day-to-day operation of the outlets, the local partner typically handles these operations. Obviously, this results in reduced control by the franchisor over the operations.

4. **Business and Legal Risks**

Due to the direct ownership interest in the joint venture entity, the franchisor has direct liability for the actions of the joint venture entity. These risks can be allocated and minimized by a carefully drafted joint venture agreement. In addition, typically, the franchisor has invested capital or other resources into the joint venture. Since control of the joint venture entity does not rest solely with the franchisor, the franchisor is placing its assets at risk.

E. **Conversion Franchising**

1. **General Description and Agreements Involved**

This is a relatively straightforward growth strategy. The franchisor approaches a unit that is either independently owned or associated with another brand name and convinces that unit to convert to operate under the franchisor's flag. In the alternative, the franchisor may purchase an entire competing system and rebrand all of the units to the franchisor's system. The converting unit and the franchisor enter into the standard unit level franchise agreement.

Real estate, travel, and hotel chains were among the first to try this type of growth strategy by herding mom-and-pops into the franchise system. Today, franchisors in nearly every industry have implemented this growth strategy, including insurance brokerages, pharmacies, optical outlets, restaurants and financial services companies. Conversion franchising is more commonly used in the United States market than in the international arena.

Franchisors who desire to use this strategy should consider what is motivating the conversion. A number of factors, including changing economic, market, competitive and technological conditions, may precipitate the entry of conversion franchisees into a franchise system. For example, in periods of economic stress where it may be difficult to break-even, much less make a profit, independents view their alignment with an experienced franchisor that has achieved economies of scale in purchasing, advertising, and distribution as a potential solution to their financial ills. Conversion may be an attractive alternative for independents that are unable to meet the technological demands necessary to remain competitive. This scenario frequently arises in the lodging industry with respect to reservation systems. Increased competition with, and growing consumer demand for, brand names in a saturated market have also been driving forces behind conversions. With respect to converts from a competing system, these franchisees may have become disenchanted with their old brands because the previous franchisor failed to provide adequate marketing and operational support to its franchisees or a host of other reasons.
By subsuming independents operating the same or similar type of business and franchisees from competing systems, franchisors eliminate competitors who would otherwise take a share of revenues generated in the specific market. By replacing the competitor’s outlet with one of its own units, the franchisor strengthens its brand in that market and, conversely, diminishes its competitor’s brand.

2. Financial Considerations

From the franchisor’s perspective, since conversion franchisees typically open more quickly and have an existing customer base and associated goodwill, these franchisees are likely to achieve better sales levels, translating into higher royalties being paid to the franchisor than paid by a typical new franchisee.

In some cases, franchisors may offer incentive programs to lure converts into the system. Incentive packages may include a rebate or reduction of initial fees, signage costs, and other system fees; extended agreement terms; and the costs of renovation to bring the unit into system conformance. Occasionally, these kinds of incentive programs can generate dissension among existing franchisees. Consequently, it is important that existing franchisees understand the franchisor’s objectives in implementing a conversion program and that the majority of franchisees support the expansion and recognize the system-wide advantages that conversion can create.

3. Unique Contract and Business Considerations

Conversion franchising brings an experienced operator who, whether as an independent business or a franchisee for a competitor, has been operating a business that is similar to the system for some period of time. Based upon that experience, the costs incurred by the franchisor for training and support are likely to be reduced. There is a much higher probability that a conversion franchisee, with the right mix of brand name, renovation, and marketing, will be successful in repositioning the converted unit than the average new franchisee. The conversion franchisee’s knowledge of, and experience in, the industry collected during his/her operation as an independent or franchisee for a competing brand may also translate into system-wide benefits for the new franchisor’s brand. For example, the conversion franchisee may have developed concepts or processes which can be incorporated into the franchisor’s system to enhance the brand.

However, not all conversions go smoothly and some operators are difficult to re-train to the franchisor’s system. Some franchisees may discover that the transition from being an independent business owner to a member of a large franchise community is not as beneficial as anticipated. These franchisees may refuse to adhere to system rules or continuously attempt to negotiate fees and other obligations. Ultimately, such franchisees, who are likely to end up leaving the system either voluntarily or by force, conclude that surrendering control of their businesses was not worth the price of operating within a rigid franchise system.

If the franchisor is converting units in a market where franchised units already exist, the franchisor should carefully consider the reaction of the existing franchisees in the area. If the existing franchises have territorial rights, converting units is likely to raise claims of encroachment (unless otherwise expressly permitted in the existing franchise agreements). In such cases, a franchisor does not have the unlimited right to acquire and convert competing outlets but instead must comply with the terms of the pre-existing franchise agreement. If the franchisor fails to do so, a pre-existing franchisee with a protected territory may sue the...
franchisor for breach of contract for encroaching on the existing franchisee’s protected area. Even if the franchisor has not granted a protected area, franchisors need to be mindful of the damage that can be caused to its relationship with existing franchisees in the market if the conversion outlets cause a decline in sales at existing outlets.\(^{13}\)

4. **Timeframe for Expansion**

A key benefit of conversions, especially if the business is capital-intensive, is that it facilitates rapid market entry. Franchisors can achieve virtually instant presence in new markets, and circumvent time-consuming new construction. The construction of a new unit may take months, whereas a renovation can often be completed within a few weeks. The upside for the franchisor is that, when the franchisor opts for a conversion over a new-build therefore, the royalty stream will begin sooner.

Conversions provide franchisors an opportunity to infiltrate markets and quickly propel the brand forward. In some urban markets, the chief barrier-to-entry is often securing a location that works for the concept. Conversions can be the solution where land is difficult to find and new-build opportunities do not exist.

Even where sites can be found and where the franchisor would prefer to construct a new unit, new construction can be costly and timely obtaining building permits and financing has become increasingly difficult. In contrast, renovation is cheaper than a new-build; loans for renovations are likely to be easier to get approved, and permits (if required) can usually be obtained quicker for renovations. In addition, a lender may be more apt to lend money based on the converting franchisee’s ability to demonstrate the unit’s prior income stream. Strategic growth using converted units may be part of the answer to the current credit crunch facing franchisees trying to do new builds.

Unlike new units that must build a customer base, provided that the converting unit is not closed for an extended period of time for renovation, conversion franchisees enter the system with a solid existing customer base. As a going concern, newly converted franchisees generally have been successful in establishing and maintaining goodwill in their respective markets.

F. **Refranchising**

1. **General Description and Agreements Involved**

Put simply, refranchising is when a franchisor sells company owned units to franchisees. Similar to conversion franchising, the franchisor and the franchisee of the refranchised unit will enter into the standard unit level franchise agreement. Refranchising permits the franchisee to enter a market, or to expand its existing operations in a market, very quickly using established franchisor units that have hopefully already developed a customer base.

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\(^{13}\) Encroachment issues are particularly prevalent when a franchisor purchases a competing franchise system. In addition, the purchase and conversion of a competing franchise system raises a myriad of relationship issues for franchisors if franchisees object to the conversion program. In that event, the franchisor may be faced with managing two separate brands and franchise systems. Franchisees of both brands may object that they now have to compete with their franchisor and that the franchisor is not appropriately allocating resources for advertising and product development. A number of cases have raised issues arising from a franchisor’s purchase of competing systems or from competing units. See e.g., *Clark & Burney v. America’s Favorite Chicken Co.*, No. 96-30364 (5th Cir. 1997).
Franchisors engage in refranchising efforts for a variety of reasons. In some instances, if a franchisor is strapped for capital and confronted with the rising costs of business and the need to expand to remain competitive, the franchisor may incorporate a refranchising program into its strategic growth plan or the franchisor may simply need or want to raise capital. In addition, the franchisor may believe that the franchise purchaser can improve the performance of the units. The franchisor may also seek to exit a specific market where unified franchisee operations have a higher probability of high market penetration. Finally, the franchisor may desire to develop a specific market and offer company-owned units as an enticement.

A franchisor’s announcement of its plans to refranchise generates a great deal of buzz in the industry as such sales can present a tremendous opportunity for prospective purchasers to acquire and grow underperforming units. From the franchisee’s perspective, the acquisition of a company unit offers clear advantages, including compressed ramp-up time, possible franchisor financing, the availability of performance history as a basis for investment and operating decisions, and trained employees and management. Consequently, parties interested in taking advantage of this opportunity often aggressively court the franchisor.

The franchisor’s selection of capable partners, however, is vital to the success of any refranchising program. Refranchising franchisors use a variety of methods to select purchasers. For example, a franchisor may employ the services of an investment banking firm that competitively bids a multi-unit package. In this case, the investment banking firm will assemble a prospectus covering the units and solicit bids from interested parties. Upon receipt of the bids, the franchisor will identify a subset of potential buyers with whom it will continue to negotiate. Franchisors may also target a specific pool of candidates such as existing franchisees whom the franchisor has identified as successful operators. A franchisor may even attempt to use the sale of company-owned units to lure successful multi-unit operators from another concept into its system.

2. **Financial Considerations**

Selling off company units results in an injection of capital into the franchisor from the gains realized on the sale. In addition, depending on the nature of the transaction, the franchisor may also see a boost in rental and interest income. Although such capital may be used to fund other franchisor ventures, a franchisor will typically use the capital to reduce its debt.

Not only may a franchisor raise money through its refranchising efforts, the sale of company units frees up capital by reducing general and administrative expenses associated with the activities required for the capital- and labor-intensive business of company operations, including the day-to-day management of the units. Likewise, refranchising of company units also relieves the franchisor of restrictions with respect to real estate and human resources that might otherwise hinder the company in expanding its business at a rate sufficient to remain competitive. Further, the franchisor’s increased access to capital and/or debt reduction may also translate into system-wide benefits.

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14 16 C.F.R. §436.5(s)(4) (“If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with [Item 19 requirements], provided the information is given only to potential purchasers of that outlet.”)

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The franchisor should carefully assess whether the buyer is overleveraging the acquisition of the company units and amassing unmanageable debt. If that occurs, in order to protect the brand, the franchisor may have no choice but to launch a costly bailout effort to aid these overleveraged franchisees, which may include loans or buybacks. Franchisors may also have to write-off franchise and license fee receivables. To avoid this pitfall, the franchisor should permit the purchaser to conduct due diligence commensurate with the scope and nature of the transaction. Although some franchisors do not permit wide-scale due diligence with respect to a single-unit sale, due diligence is common and in both parties’ best interests where a large, multi-unit transaction is contemplated. A franchisor’s success in achieving most of its refranchising goals is contingent on the success of the purchaser. If a franchisor sells units that are unprofitable or even barely profitable where it is clear that the units cannot be salvaged by franchisee or franchisor alike, the franchisee will fail and the franchisor will not realize the benefits of refranchising. Franchisors that refranchise negative cash flow units, should keep in mind that they may re-inherit the troubled unit at a later date or the troubled unit may create cash flow issues for the franchisee at the franchisee’s other profitable units. Refranchised units that ultimately fail or do not meet the business profit expectations can result in reputational damage to the franchisor and make it difficult to conduct large-scale refranchising programs in the future.

3. **Unique Contract and Legal Considerations**

Another benefit of refranchising, particularly where the units are sold to strong, experienced franchisees, is the potential improvement in performance of the units. Company units often gross less on average than franchised units. Franchisors believe that franchisees will operate those stores at higher sales volumes. This phenomenon explains why the sales price of a company unit may appear out of alignment with that unit’s sales history. Particularly under tight economic conditions, experienced franchisees are a company’s best bet because they are familiar with the business and already have the infrastructure to support this kind of expansion. Existing franchisees may secure loans more easily than new entrants into the system and given the operating experience of the unit that is transferred, lenders may be more willing to loan the necessary cash for the franchisee to take over the operations.

Even where a franchisor sells its units to new franchisees, the injection of new blood into the system is advantageous to both the franchisor and existing franchisees. By increasing the number of franchisees, the entire brand image can be enhanced, often resulting in improved sales averages for franchised units and the remaining company units. In addition, a franchisee typically will have a greater incentive than a company-employed manager to improve sales performance at the unit.

Refranchising establishes a unified approach to the market where the franchisor sells the company units to an existing franchisee who operates multiple units in that same market. The existence of a number of company units in the same market as franchised units can create intra-system competition. Some franchisors believe that such mixed ownership in one market retards growth and that they and their franchisees are better off dedicating these markets to one ownership or another in order to achieve top-line marketing benefits. The net effect is the creation of economies of scale for the franchisee. The implementation of such market dominance strategies also conveys the franchisor’s willingness, under some circumstances, to forego operating revenue in order to move each market forward. Over the long term, the revenue reduction associated with the sale of company units may be offset by increases in comparable sales and franchise royalties and development fees.
The resolution of personnel and operating issues that accompany the purchase of an existing business also can pose a challenge. An effective transfer requires a transition plan which focuses on reimaging, staff training, development and marketing and which clearly defines the roles of each party. Communication down to the unit level is also vital to the success of a refranchising program. To ensure a smooth transition, it is important that the parties provide employees of the unit a roadmap outlining anticipated changes and developments and the buyer’s expectations of the employees. In the absence of such communication, the purchaser may fail to garner the support it requires for successful operations, resulting in employee theft, employee turnover and declining cash flow and sales because of fear of the unknown.

The franchisor should carefully consider the legal issues and costs associated with the sale of the assets of the operating units to franchisees. These issues will include, among other things, the issues surrounding how to deal with interests in the real property. If the franchisor owns the real estate at the units to be refranchised, serious consideration should be given to whether the refranchising transaction will involve a lease to the franchisee or an outright sale of the real estate. There are obvious valuation, tax, pricing and financing aspects to consider here and they will often drive the decision to lease or to sell. If the franchisor subleases the real estate, that lease will probably require approval of the landlord to assign the lease or to enter into a sublease with the franchisee. In these transactions, franchisors should carefully assess any continuing liability that remains after the unit is sold or subleased to a franchisee and strategies to minimize exposure for such continuing liability.

Franchisors should always consider the non-financial “control” issues in this context as well. Refranchisings that involve sale of the real estate leave the franchisor in a much weaker position in relation to the franchisee if the relationship falls apart at some future date. Franchisors who want to terminate the franchise of a non-compliant franchisee will be left with the choice of letting a poor operator continue to operate the unit or losing the unit (or more likely numerous units) permanently. Leasing the real property to franchisees in a refranchising allows the franchisee to preserve the unit in the marketplace without having to compromise on standards.

4. **Timeframe for Expansion**

One of the primary benefits of selling company-operated units to qualified, well-capitalized franchisees is that it drives the development of additional units. Franchisors frequently offer company units as an incentive for a franchisee to develop a market. Accordingly, franchisees purchasing company units often execute an area development agreement, assuring the franchisor of future growth and increased revenue. Refranchising therefore acts as a seed program to attract new franchisees. This is particularly significant during periods of economic stress. When same stores sales are flat, franchisors generally rely on expansion to increase revenues. Even existing franchisees typically pledge to develop additional units as part of their participation in a refranchising program.

G. **Management Contracts**

1. **General Description and Agreements Involved**

A management contract is created when a business owner wants to outsource the day-to-day operation of his or her business. The owner will hire a third party, usually a professional management company (the “operator” or “manager”), to operate his or her business. This
arrangement is common in the hotel industry, where owners do not typically have the time or expertise to operate the business. A management contract can delegate a wide range of functions, such as the technical operation of a production facility, management of personnel, accounting, marketing services and training.

Management contracts can be employed in several different situations. For instance, a franchisor that has both franchised and corporate locations may use a management company to operate the corporate locations. Conversely, the owner-operator of a business could sell his or her business to a third party investor while retaining the management of the business. An area developer can also outsource the management of its franchises to a management company.

By partnering with an experienced and sophisticated operator, the owner can expand his or her business without the hassles associated with providing daily management or an administrative infrastructure for the business. In return, the management company benefits from the capital investment made by the owner. Therefore, a business owner who wishes to expand may utilize a management contract to avoid the inefficiencies associated with trying to own and operate a large number of outlets.

2. **Sourcing Related Issues**

The operator under a management contract is typically more attuned to inventory levels and the condition of the equipment used in the operation of the business than is the owner simply because the operator is more closely involved with the day-to-day operation of the business. Accordingly, the operator is generally responsible for placing orders for inventory and replacing or servicing equipment, and the owner is responsible for paying for those expenses. The owner will often designate suppliers, but it is not uncommon for an owner to be open to suggestions from its operator for alternate suppliers, if such alternate suppliers are able to maintain the level of quality required by the owner.

3. **Financial Considerations and Fee Splitting**

One of the main disadvantages to a management contract, when compared to a franchise arrangement, is that the business owner bears the sole financial responsibility for obtaining and constructing each business unit. This cost is substantial, as the owner will be financially responsible for acquiring the real estate, equipment and all assets required to operate the business.

The owner must also share revenue/profits with the operator. It is in the owner’s interests to allocate fees based on profits, instead of revenue, since a revenue-based fee structure may not sufficiently encourage the control of management expenses.

4. **Unique Contract and Business Considerations**

Owners have become aware of the potential risks associated with contracting out the operation of the business to a third party and thus, typically seek indemnity from operators for specified acts or events. For instance, if the owner is concerned about a certain risk, he or she could require the operator to fund a performance escrow. The operator may expose the owner to liability arising from carelessness, error and negligence. To mitigate these risks, the owner is wise to seek protection under a carefully drafted management contract that contains the right indemnity provisions.
From the owner’s perspective, it is important to include a provision in the management contract that ties the financial remuneration of the operator to the performance of each operated business. This type of contractual provision will help protect the owner from suffering financial loss by giving the management company an incentive to run the business effectively and efficiently.

5. **Timeframe for Expansion**

A management contract allows an owner to expand more quickly than it would be able to if it were operating the business itself. By appointing an operator, the owner is able to focus on expansion, rather than the day-to-day operation of the business. However, such expansion may be impeded by financial constraints because, as mentioned above, the owner bears the sole financial responsibility for obtaining and constructing each business unit.

6. **Business and Legal Risks**

By outsourcing the management and operation of his or her business, an owner necessarily cedes control. The amount of control relinquished by the owner is significant, since the operator will be responsible for selecting an on-site manager and other high-level employees. In exchange for this autonomy that the owner grants to the operator, performance levels may be higher since the management company usually has a high level of expertise in the industry, and is more familiar than the owner with the operation of the business.

On the other hand, the loss of control by the owner comes with a significant risk to his or her brand. Similar to a franchisee or licensee in a franchising or licensing arrangement, if the management company does not fulfill its obligations under the contract, the owner risks damage to the brand. It may be tempting, then, for the owner to become overly involved or “micro-manage” the management company’s operations of the business, despite provisions in the management contract granting control over the day-to-day operation of the business, without interference from the owner, to the management company. However, the British Columbia Court of Appeal confirmed in *Coast Hotels Ltd. v. Northwest Hotels Inc.* that interference by the hotel owner in the operation of the property, by way of giving instructions to, and otherwise communicating directly with, the hotel general manager and other staff, was a breach of the management contract and its provision allowing the management company to operate the hotel free of interference from the owner. It is therefore particularly important for the management contract to be carefully drafted to ensure it is clear to both parties what their respective rights and responsibilities are.

It is also important for the owner to expand his or her business at the appropriate pace because untimely and rapid expansion through the use of a poorly run management company could cause great harm to the owner’s brand. One way to minimize this risk, particularly from the perspective of a franchisor that has entered into, for example, an area development arrangement and the area developer has, in turn, engaged the services of a management company to operate some or all of its units, is to require the management company to enter into a form of confidentiality agreement with the franchisor. This agreement would require the

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16 *Ibid* at para. 7.
management company to maintain the confidentiality of the operations manual and other confidential information of the franchisor and to deidentify the business premises upon termination of its management contract with the area developer.

H. Licensing

1. General Description and Agreements Involved

A "license" is an arrangement in which the giver of the license (the "licensor") grants to the recipient of the license (the "licensee"), the right to do such things as manufacture, supply or distribute a product or service using the licensor’s patents, trademarks and/or know-how. It does not necessarily include the right to use the licensor's business format. Sometimes a license and a franchise can be confused since a franchise can be interpreted to be a form of a license, albeit a regulated one. The primary legal difference between a license agreement and franchise agreement is the degree of operational control the licensor has over the licensee’s system of operation. If there is no evidence of the licensor exercising control over the operation of the licensee’s business, the relationship between the licensor and licensee will not be regarded as a franchise and thus, the license agreement will not be subject to franchise regulation.17

2. Sourcing Related Issues

Sourcing and supply chain issues are not as prevalent in a licensing arrangement as they are in a typical franchisor/franchisee relationship. However, a trademark license agreement may include a provision requiring the licensee to obtain the licensor’s approval prior to using the trademark on any printed or other materials. This same provision may also require the licensee to purchase such printed and other materials bearing the licensor’s trade mark only from a supplier designated by the licensor.

3. Financial Considerations and Fee Splitting

One of the primary benefits to licensing is that it is substantially less expensive and quicker than franchising. Licenses usually have a lower purchase price and are generally easier to create thus requiring the licensor to pay less in legal fees. Generally, the licensee will be required to make a payment, directly or indirectly, in exchange for the right to engage in business. In exchange, the licensor will grant the licensee the right to sell or distribute goods or services associated with the licensor’s mark/brand. Specifically, similar to the fee structure set out in a franchise agreement, a license agreement can include (i) an initial base fee, (ii) continuing royalties, and (iii) a monthly license fee during the term of the agreement. Franchisors should carefully assess these arrangements to avoid falling into the definition of a franchise.

4. **Unique Contract and Business Considerations**

There is no standard form license as every license arrangement is unique and has its own special requirements, aims and objectives. However, one of the primary risks associated with the granting of licenses lies in the vulnerability of the licensor having its brand tarnished by licensees. To maintain the licensor's reputation, the license agreement should thoroughly set out all terms, conditions and requirements that bind the licensee, with careful consideration to the kinds of control that might push the license over the line to a franchise.

5. **Timeframe for Expansion**

Granting licenses has become an integral part of developing a brand. It helps expand the brand’s reach to cover a wider range of goods and services while mitigating the financial risks normally associated with entering new markets. The owner of a trade mark for instance, can rely on the expertise of the licensee in a particular industry or trade, to implement its brand successfully. This way, a company that owns a strong trade mark can expand into new territories and industries and maximize the financial advantages of the mark’s strength.

6. **Business and Legal Risks**

There is little or no government regulation related directly to licensing; however, licensors should be aware that certain laws, such as business opportunity laws, may apply to the relationship. In many jurisdictions by contrast, there is substantial and complex government regulation related to franchising. Despite this distinction, there is risk involved when creating a license arrangement, since it could be held to constitute a franchise agreement, depending on how it is drafted. If the license agreement is subsequently held to fall within the provisions of applicable franchise legislation, the licensor can be held liable for not complying with certain provisions of the legislation and the disclosure requirements in particular.

A license may be purchased for a particular product by the owner of an existing business to allow the owner of the business to test for a period of time the popularity of the product. From the licensee's perspective, this reduces, in part, the risk of acquiring the license for a longer term since the licensee can maintain its existing business operations while testing the product. If the addition of the licensed product to the business is unsuccessful, the licensee still has the pre-existing products/services to sustain its business.

I. **Franchisee to Franchisee Transfers (“F-to-F’s”)**

1. **General Description and Agreements Involved**

Most franchise agreements have detailed provisions governing how a franchisee can sell the franchised unit or assign the franchise agreement to a different franchisee, with the franchisor’s approval, of course. These transfer provisions are normally seen as an important provision for the franchisee because the provisions set forth the roadmap for the franchisee’s potential exit strategy should the franchisee want to convert the equity it has built up over a number of years into cash. These provisions are also seen as beneficial for the franchisor’s long-term control of the brand because of the conditions on transfer that the franchisor will normally place in the transfer provisions. A right of first refusal is often included in such transfer provisions. These conditions on transfer can also be seen as part of the growth strategy of a
franchisor using a typical franchise or master franchise model. Strategic use of these transfer provisions can result in greater and faster growth of the system in several ways.

Franchisees that are poor operators can provide the franchisor with an opportunity to grow the system. Whether the operator is poor due to its inability to deliver the brand in accordance with operations standards or due to its inability or unwillingness to pay royalties and other fees on time, a poorly operated franchise presents the franchisor with some options. Rather than defaulting and terminating the franchisee’s franchise agreement, the franchisor could explain the situation to the franchisee and strongly suggest that the franchisee should investigate their options to sell the business to another franchisee or back to the franchisor. This could result in a mutually agreeable F-to-F sale pursuant to which the franchisor can require a development commitment from the buying franchisee. Also, if the franchisor buys the units, they can be sold (or the purchase contract assigned) to a buyer who commits to further growth via development of new units.

The franchisor can get control of a critical mass of existing franchised units by exercising on its right of first refusal in an F-to-F deal and then assigning that right of first refusal to a franchisee that is willing to execute a long-term development agreement committing to growth.

Franchisors need not wait until a non-compliant franchisee situation presents itself. Some franchisors are more proactive in this area and try to combine geographically close units into one deal by negotiating purchase options on units owned by various franchisees in one market. A franchisor can acquire a purchase option (the right, but not the obligation, to buy the franchisee’s unit at a set price for a set period of time) on numerous units, combine all the options into one deal and assign the option contracts to a prospective buyer with a condition that a multi-year, multi-unit development agreement also be purchased. Using this strategy a franchisor can take a fractured and stagnant market and turn it into a cohesive, efficient and growing market without having to invest significant capital.

2. Financial Considerations and Fee Splitting

Most franchise agreements have provisions that require a selling franchisee to pay an assignment fee if the franchisee chooses to sell the unit and assign the franchise agreement. These fees range from nominal amounts of a few hundred dollars in some systems to tens of thousands of dollars in others. In addition to, or instead of, an assignment fee, a franchise agreement may require a buying franchisee to pay the full amount of the initial franchise fee prescribed in the franchise agreement on the completion of the purchase and/or to enter into a new form of franchise agreement rather than simply take an assignment of the existing franchise agreement. However, since the larger goal of these transfers is unit growth, franchisors are often willing to waive some or all of these assignment or initial fees if the franchisor is the driving force behind the transfer. For most franchisors, a long-term development agreement is much more valuable than a one-time fee.

3. Unique Contract and Business Considerations

Some franchisees may feel that they can get a better price for their units if they sell directly to another franchisee rather than selling or optioning to the franchisor. Buyers that are new to the system may have a tendency to overpay for the business and justify the premium they are paying as the “price of admission” to the system. Franchisors can find ways to make their offers more competitive than the other prospective buyers. For example, the franchisor can offer to waive the transfer fees required to be paid under a typical F-to-F sale. Also, some
franchise agreements require that the selling franchisee remain jointly and severally liable for financial defaults of the buyer for years after an F-to-F sale. Franchisors can offer to release the seller from that liability immediately if the existing franchisee sells to a franchisee of the franchisor’s choosing or sells directly back to the franchisor.

4. **Timeframe for Expansion**

These methods of growth can be time consuming, are complicated and must be managed carefully with legal counsel but they can ramp up the pace of development very quickly. New franchisees entering a weak or moribund market need positive cash flow from existing operations to fund or finance new development. The new franchisee that is offered existing units in conjunction with a development commitment is much more likely to ramp up new unit development.

5. **Business and Legal Risks**

These methods of acquiring control or rights to control franchisees units to use as sweeteners in a development deal are not without risks, however. There are numerous state relationship laws that govern how the default, termination, transfer and non-renewal process can work in a franchised system. Any franchisor using the F-to-F as a growth strategy is advised to work closely with legal counsel on designing any program and on each individual transaction.

### III. FRANCHISE REGISTRATION AND DISCLOSURE OBLIGATIONS

Regardless of the particular strategy or structure a franchisor employs for expansion, a franchisor must determine if the rights granted under the applicable agreement meet the definition of a “franchise” under applicable law. A business relationship generally qualifies as a “franchise” if three criteria are met: (i) the franchisee pays a franchise fee to the franchisor; (ii) the franchisor grants a trademark license to the franchisee, or the operation of the franchisee’s business is substantially associated with the franchisor’s trademark; and (iii) the franchisor exerts significant control over, or provides significant assistance in, the franchisee’s business. Although the regulatory requirements that govern franchisors are similar across the United States and other jurisdictions, exactly what constitutes a “franchise” in each jurisdiction varies. In determining whether a “franchise” has been created, the parties’ intention and

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18 Some states and territories use the term “dealership” rather than “franchise.” See, e.g., Wisconsin Fair Dealership Law, Wis. Stat. § 135.01 et seq., BFG ¶ 4,490.01.

19 The Amended Rule and most state franchise statutes provide a minimum threshold for the franchise fee element, generally ranging from $100 to $500. See, e.g., Rhode Island Franchise Investment Act, § 19-28.1-3(vii)(1)(b), BFG ¶ 3,390.03.

20 See, e.g., 16 C.F.R. § 436.1(viii). There also must be some form of agreement between the parties. Some state statutes require a written agreement, while others, such as Connecticut’s, also permit an oral agreement.

21 15 states have franchise registration and disclosure laws, which vary from state to state. The registration states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Some foreign countries also have registration and/or disclosure laws that must be taken into account in international master franchise relationships. These laws should be considered when analyzing the structure that a franchise relationship will take in any jurisdiction.
characterization of the relationship is irrelevant.\textsuperscript{22} It is essential to consider the applicability of each jurisdiction’s franchise registration / disclosure laws and franchise relationship laws, as well as industry-specific laws, to any commercial arrangement where one party offers, sells, or distributes to another party goods or services identified by the former’s trademarks.\textsuperscript{23} Unless an exemption or exclusion is available, if a relationship is a “franchise” under the various definitions, the franchisor must prepare, and in some instances register with various states, a franchise disclosure document. The franchisor should keep in mind that a copy of all proposed agreements between the relevant parties must be included in the disclosure document.\textsuperscript{24} In addition to the ultimate franchisor, other parties may also be required to provide disclosure depending on the particular growth strategy that the franchisor employs.

A. Master Franchising

Generally speaking, the disclosure requirements under the franchise disclosure laws of most jurisdictions apply equally to franchise and master franchise arrangements alike. In the context of a master franchise arrangement, the franchisor is responsible for providing a disclosure document to the master franchisee and the master franchisee, in turn, is responsible for providing a disclosure document to each unit franchisee.\textsuperscript{25} The master franchise agreement should require the master franchisee to provide to the franchisor all information necessary for the franchisor to complete the franchisor’s disclosure document and the franchisor should reserve the right to review the disclosure document prepared by the master franchisee. As an added expense, the master franchisee may be required, depending on the jurisdiction, to prepare (or arrange to have prepared) audited financial statements for inclusion in the disclosure document.

B. Area Development

In most circumstances, the franchisor in an area development arrangement will have to comply with all local disclosure laws, the majority of which will require the franchisor to provide the area developer with a disclosure document relating to the area development business. With regard to franchised units developed and opened by the area developer, the franchisor may not be required to provide disclosure for the new units if (i) the franchise agreement for the new unit is substantially similar to the franchise agreement included in the original disclosure document, and (ii) there have been no material changes to the disclosures included in the disclosure document provided to the area developer.\textsuperscript{26}

\textsuperscript{22} 16 C.F.R. § 436.1(viii) (Franchise means any relationship that satisfies the definition, \textit{whatever it may be called.})

\textsuperscript{23} For a more detailed discussion of these issues, see From License Agreement to Regulated Relationship: The Accidental Franchise, Kenneth Costello, Beata Krakus and Kristy Zastrow, 32nd Annual Form on Franchising, October 14 – 16, 2009; The Accidental Franchise, Mark Kirsch and Rochelle B. Spandorf, 24th Annual Forum on Franchising, October 10-12, 2001.

\textsuperscript{24} 16 C.F.R. § 436.1(v).

\textsuperscript{25} See e.g., Ill Reg. §14-A-200.702, Bus. Franchise Guide (CCH) ¶5130.52.

\textsuperscript{26} See Bus. Franchise Guide §6219.2 (“Franchisees who exercise a right under their franchise agreement to establish new outlets for themselves (as opposed to selling outlets to others) . . . need not be furnished with the
C. Area Representation

Generally speaking, if the franchisor does require the area representative to pay an initial fee for the area representation rights, this arrangement typically satisfies the definition of a “franchise.” Accordingly, the franchisor must comply with federal and state registration and disclosure laws before granting the area representation rights.

In addition, with regard to the sale of individual franchised units, the franchisor is responsible for registration of the disclosure document in the various states and for providing disclosure to the individual unit franchisees. Unlike the master franchising model (discussed above), the franchisor retains complete control over this process. Given the significant differences between the area representation franchise offering and the individual franchise offering, in most instances, franchisors prepare two separate disclosure documents, thus increasing the franchise law compliance costs. 27

D. Joint Venture Arrangements

When a franchisor sets up a joint venture arrangement with the local partner, that agreement is not likely to be considered the sale of a franchise. Accordingly, the franchisor would not need to comply with the franchise registration and disclosure laws. However, in the second step of the relationship when the franchisor is granting rights to the joint venture entity, a joint venture entity is treated no differently from any other entity and, if the sale of the rights constitutes the sale of a franchise, the franchisor must comply with the franchise registration and disclosure laws.

E. Conversion Franchising

The franchisor’s franchise registration and disclosure obligations with this strategy are identical to the franchisor’s obligations of traditional single unit franchising.

F. Refranchising

The franchisor’s franchise registration and disclosure obligations with this strategy are identical to the franchisor’s obligations of traditional single unit franchising; however, if the franchisor has a concerted plan to sell off units, the franchisor should consider adding the terms of the refranchise program to the relevant items in the disclosure document. For example, the asset purchase agreement should be attached as an exhibit to the disclosure document and the disclosure required for prospective franchisees unless the new relationship is under terms and conditions materially different from their present agreement. In interpreting whether disclosure is required in such circumstances the Commission will employ a flexible standard based upon the extent to which the disclosure will materially assist the franchisees in making an informed decision.

27 The franchisor also must consider whether the area representative is a “franchise seller” under the FTC Rule. A “franchise seller” is: 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, master franchisees, and third-party brokers who are involved in franchise sales activities. Since most area representatives will satisfy the definition of a franchise seller, for each franchise sale the area representative is involved in, the franchisor will need to identify the area representative as a franchise seller on the receipt pages of the disclosure document.
disclosure document might describe the refranchising program in Item 1 and information regarding the additional or different start up costs might be included in Item 7.

G. Management Contract

Typically, the management company does not pay the franchisor an initial fee (instead the franchisor compensates the management company for its services) and the franchisor does not grant the management company the right to use the franchisor’s trademarks. If structured properly to avoid at least one of the elements of the franchise definition, a management contract will not fall within the ambit of a franchisee-franchisor arrangement and, therefore, disclosure would not be required.

H. Licensing

Notwithstanding that it is not the intention of the parties to the license agreement to create a “franchise”, caution must be exercised by the licensor to ensure that the legal arrangement does not create obligations under various jurisdictions’ franchise legislation. The licensor should conduct the appropriate analysis based on the legal components of a franchise for its particular jurisdiction, and as outlined generally above, to determine whether the rights granted under the applicable agreement meet the definition of a “franchise.” If so, the licensor will be required to provide a disclosure document to each prospective licensee.

I. F-to-F’s

Generally speaking, the FTC Rule and all of the state franchise laws include an exemption that permits existing franchisees to sell their franchised businesses to third party purchasers. The exemptions vary from jurisdiction to jurisdiction, however, the exemptions do include some common restrictions. For example, the sale cannot be “effected by or through” the franchisor. In most states, merely approving or disapproving a transfer does not constitute sufficient control for the transfer to be considered “effected by or through” the franchisor. However, the more involved the franchisor becomes in the transfer process, the more likely that the line will be crossed. Consider the following activities that might push the franchisor over the threshold and make the transfer one that has been “effected by or through” the franchisor: (i) matching buyers and sellers; (ii) advising the parties on the financial terms; (iii) facilitating or identifying financing; or (iv) requiring the purchaser to sign a new franchise agreement.

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29 In North Dakota, if the franchisor approves the transfer, the exemption is only available if the franchisor obtains the commissioner’s approval.

30 E.g., Little Caesar Enterprises, Inc. v. OPPCO, LLC, 219 F.3d 547 (6th Cir. 2000).

IV. TYPICAL PROVISIONS FOR AGREEMENTS

While no two agreements will be identical, most agreements for these growth strategies 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. Each 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. While the agreement is often heavily negotiated, the franchisor’s form of agreement, which serves as a starting point from which the negotiations can begin, must be attached to the franchise disclosure document. However, it should be noted that under Canadian franchise laws, for example, the franchisor is required to attach the negotiated form of agreement, if the franchisor waits to disclose the prospect until after the negotiations on the form of agreement have concluded.

The following is a checklist of the key legal and business issues that should be considered in connection with preparing the agreements to document the relationships for each growth strategy.

A. Duties of the Other Party

The franchisor and the other party (or parties) should have a general sense of the basic role and duties that each party will perform during the relationship and those roles and duties should be carefully identified and specified. The other party’s duties will need to be tailored to the growth strategy. For example, for master franchising or area representation, the other party’s duties are likely to include, among others: (i) obtaining confidential and/or proprietary material from the franchisor to be used in the sales process; (ii) assistance with the franchise sales process (including obligation to become familiar with any guidelines issued by the franchisor); (iii) providing disclosure to the prospect (which should include maintaining records of disclosure); (iv) referring the prospect to the franchisor for approval; (v) providing site selection, construction and opening assistance; (vi) providing post-opening support and assistance (such as training, inspections, audits, reviewing new suppliers); and (vii) collecting fees and remitting a portion to the franchisor. In most instances, the franchisor will want to retain a final approval right for certain actions such as new franchisees, new locations and advertising materials to be used.

B. Term, Renewal, Termination

The term and renewal rights under contracts will vary based on the type of growth strategy, the number of units to be opened, the size of the territory and the amount of time required to do so. 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.

32 16 C.F.R. § 436.1(v); Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3 (the “Ontario Act”), s. 5(4)(iii).

unless the parties terminate the agreement. Typically, the term of a master franchise agreement will be very lengthy (i.e., until all subfranchise agreements have expired, which may be as long as 20 to 30 years) while area development agreements and area representation agreements typically include a term that covers the length of time the other party needs to develop or build out the territory granted (i.e., three to five years depending on the size of the territory granted and the number of units to be developed).

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 term could also be tied to the development schedule obligations. 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. The franchisor should be aware that certain state statutes may limit the franchisor's right to terminate the agreements or refuse to renew the agreements.\(^{34}\) Regardless of jurisdiction, typically, the franchisor will need to have good cause to terminate or refuse to renew and will need to provide the other party statutorily required notice.

With respect to master franchise, area development and area representation arrangements, which involve two sets of agreements, the termination of the agreement between the franchisor and the master franchisee, area developer or area representative does not necessarily result in a termination of the unit franchise agreements. For example, a master franchise agreement will usually include a provision granting the franchisor the option to either assume the master franchisee’s rights under the unit franchise agreements or, more frequently, terminate the unit agreements. Similarly, in the event of the termination of an area development agreement, the area developer will lose all rights flowing from the area development agreement, but typically at the option of the franchisor, each unit franchise agreement between the area developer (as unit franchisee) and the franchisor may continue in force until it expires or is terminated in accordance with its own provisions. Finally, the termination of an area representation agreement generally will have no impact on the unit franchise agreements between the franchisor and the unit franchisees.

### C. Territory and Market

The efforts for a growth strategy may be focused in a number of ways. If, for example, the franchisor wants to expand to a remote area or the other party has specialized knowledge of a particular area, a franchisor may engage the other party for that specific territory. The size of the territory is likely to depend on the experience and resources of the other party and may be as small as a city or county or as large as an entire country. The scope of the territory or market may also need to be limited based upon whether the franchisor and the other party have complied with various state franchise registration or other state franchise law requirements. The franchisor should always consider whether the other party has sufficient resources to build out the territory in a timely manner.

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\(^{34}\) *E.g.*, Cal. Bus. & Prof. Code, Div. 8, Chap. 5.5, Sections 20020, 20021, 20025, 20026; Hawaii Rev. Stats. Chap. 482E-6(H); Ind. Code, Title 23, Art. 2, Chap. 2.7, Sections 1(7) and (8).
D. Exclusivity and Development Quotas

The issues surrounding exclusivity are very similar to those in the franchise relationship. If the franchisor grants the other party an exclusive territory (i.e., the subfranchisor is the only subfranchisor 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 other party, the agreement should establish minimum sales performance criteria (e.g., “X” franchise sales sourced within a given period of time, “X” units opened by a specific date) for the other party 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.

E. Compensation to Other Party

Perhaps the terms that are likely to vary the most among these various growth strategies are the monetary terms including the fees due the franchisor and compensation provided to the other party. The amount of the compensation, the timing of the payment (i.e., what triggers the payment obligation), the method of payment, and other issues related to compensation are not uniform. These terms are negotiated based upon the specific relationship, the services rendered and the specific obligations that the other party undertakes.

With regard to the amount of the fees to be paid, there are two basic compensation or commission options: (i) a flat or fixed amount; or (ii) 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. Franchisors should carefully consider related terms such as whether the compensation should be subject to a “floor” and/or “ceiling” and any circumstances when the franchisor is not obligated to pay the compensation. Franchisors should be familiar with the structure of fees used by other systems; however, franchisors should carefully consider whether the fee structure fits their specific concept in light of the actual growth strategy used.

Franchisor may refer leads to the area representative, master franchisee or area developer in the territory and the parties should determine up front whether the franchisor will be compensated for such referrals, and if so, how such compensation will be calculated.

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. Finally, the agreement also should address issues such as whether the compensation is refundable and, if so, under what circumstances.

F. Advertising and Promotion

For certain system-wide promotional programs, the franchisor will typically create and produce advertising materials, and require the other party and franchisees to use those exact materials. The franchisor will often delegate to the other party the responsibility associated with more regional or local advertising and promotional programs. The other party will be responsible for creating the advertising and promotional materials, and the costs associated
with doing so. However, it is not uncommon in those situations for the franchisor to retain the right to approve all such materials prior to use.

**G. In-Term Non-Compete**

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

**H. Post-Term Obligations**

Upon the expiration or termination of the agreement, the parties will have certain obligations to each other. The other party’s obligations to the franchisor may include: (i) returning to the franchisor any confidential and/or proprietary materials; (ii) complying with all confidentiality restrictions; (iii) observing any non-disparagement clauses; (iv) complying with any non-competition restrictions for the reasonable period specified in the agreement, in a reasonably limited geographical area; and (v) remaining liable to the franchisor under any indemnification obligations.

**I. Compliance with Laws**

The other party should be required to comply and cooperate with the franchisor in complying with all applicable laws, including any state broker filing requirements and any federal or state franchise disclosure obligations. If the franchisor updates disclosure or sales materials, those 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 other party should not undertake any activities that would violate the state laws.

**J. Legal Description of Relationship**

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

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35 For more detailed analysis of in term and post term covenants against competition in franchise agreements, see Covenants Against Competition in Franchise Agreements (Peter J. Klarfeld ed., 2004). To ensure enforceability, covenants against competition should be carefully scrutinized in light of the ever-shifting legal framework. See e.g., Atlanta Bread Co. Int’l v. Lupton Smith, Bus. Franchise Guide (CCH) ¶13,911 (Ga. App. May 14, 2009) (holding that in term and post term covenants against competition in a franchise agreement were unreasonable and unenforceable).

36 See supra note 7.
K. Indemnification

Perhaps one of the most important provisions in the agreement will be the indemnification provision. The other party should indemnify the franchisor with respect to all claims, demands, damages (including attorneys’ fees), liabilities, and costs caused by, resulting from, or pertaining to that party’s performance of duties under the agreement. The indemnification provision should cover claims asserting that the other party: (i) negligently or intentionally deceived any prospect; (ii) made misrepresentations or untrue statements; (iii) made unauthorized representations such as an unauthorized earnings claim; and (iv) violated any state franchise disclosure or relationship statute. These indemnification provisions of the agreement should survive termination or expiration. Generally speaking, franchisors will not agree to include mutual indemnification provisions.

L. Choice of Forum, Choice of Law and Dispute Resolution

Regardless of the growth strategy employed by a franchisor, all parties involved in the franchise relationship will want to avoid negative publicity arising out of disputes between the franchisor and the other party, which could harshly impact ongoing business. In addition, franchisors should be mindful that certain disputes will need to be disclosed in the disclosure document.

The jurisdiction in which franchise disputes are resolved is significant for a number of reasons. The franchisor may want all disputes to be resolved in its home jurisdiction, thereby shifting travel-related costs to the other party. However, enforcing decisions against the other party in the franchisor’s home jurisdiction if the other party is from another jurisdiction may require considerably more time and money than simply arguing the dispute and obtaining relief in the other party's territory. If possible, it would be beneficial to the franchisor to have disputes resolved with the other party in a state that does not require registration and/or that has a less onerous franchise disclosure law. However, the franchise laws of certain jurisdictions prohibit this type of “jurisdiction-shopping” and require that disputes are resolved in that particular jurisdiction.37

If desired, parties may include a provision in their agreement describing the dispute resolution mechanism which the parties have agreed to use in case of a dispute between them. Before deciding which alternative dispute resolution method to employ, the parties must consider that the efficiency of a particular dispute resolution method can vary by jurisdiction. For instance, in certain jurisdictions, arbitration is more efficient and cost-effective than litigation. In other jurisdictions, the delay and costs that are characteristic of the litigation system are similarly experienced by individuals who choose arbitration as their preferred dispute resolution method.

M. Miscellaneous Provisions

The contracts should also include “boilerplate” provisions to deal with issues such as: (i) use of trademarks; (ii) transfer; (iii) integration and the requirement that amendments be in writing and signed by both parties; (iv) minimum insurance requirements; and (v) notice.

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37 See e.g., Ill. Reg. § 200.608, Bus. Franchise Guide (CCH) ¶5130.50; Ontario Act, s. 10.
V. CONCLUSION

The increasing popularity of various franchise system growth strategies over the past several years has changed the face of the franchise industry dramatically. Whether due to, or in spite of, tightening budgets in franchisors’ home markets, franchisors are looking to grow their brands into new domestic and international markets, and in many cases are looking for alternatives to the traditional unit franchising model in order to do so in a cost effective manner. Although this paper has surveyed many growth strategies available to franchisors, it is important for wary franchisors to note that certain of these growth strategies can be combined to tailor a strategy that meets the needs of particular franchise systems. However, prior to making any decisions on a particular growth strategy (or combination of strategies), franchisors should conduct a thorough assessment of each strategy and develop a plan for growth in order to increase the chances for a successful expansion.
Leslie Curran is a Partner in the law firm Plave Koch PLC in Reston, Virginia. She has practiced in the field of franchise law for over 10 years. Leslie represents a broad range of clients in domestic and international franchising, licensing and distribution matters, across diverse industries, including restaurants and food service, dry cleaners, waste disposal, hotels, retail, health care, business services and product distribution. She has extensive experience in structuring franchise and distribution systems, compliance with state and federal regulatory issues, developing licensing and distribution arrangements and compliance with state relationship laws.

Leslie has a BA in Political Science from the Elizabethtown College. She received her JD (*magna cum laude*) from University of Pittsburgh School of Law, where she was a Research Editor for the *Law Review for the University of Pittsburgh School of Law*.

Leslie has spoken on panels and conducted roundtables on numerous legal and business issues related to franchising. In 2009 and 2009, she conducted roundtables on topics including: Managing Multi-State Disclosure Process; Termination Issues; and Best Practices for Dealing with a Franchisee Who Doesn’t Fit the System. In 2007, she co-presented a paper titled Pros and Cons of Using Brokers, Development Agents and Other Referral Sources at the annual ABA Forum on Franchising meeting. In addition, Leslie has published a variety of articles and papers on franchise topics. Most recently, for the Spring 2009 *Franchise Law Journal*, Leslie co-authored Exemption Based Franchising: Are You Playing in a Minefield?

Leslie is an active member of the ABA Forum on Franchising. She has helped organize Community Service Events sponsored jointly by the Women’s Caucus and Corporate Counsel Division. Since 2004, Leslie has served on the Technology Committee. From June 2007 to June 2009, she served as the Young Lawyers Division Liaison to the Governing Committee. In August 2009, Leslie authored Understanding Franchise Law in *The Young Lawyer*.

Outside of franchising, Leslie is active with other boards and organizations. Leslie serves on the board of the Greater DC Chapter of the National Association of Women Business Owners. For 2009 to 2010, she will be the President-Elect and then, for 2010 to 2011, she will be the President. Since February 2009, Leslie has served on the Steering Committee for the CPR Institute, Franchise Mediation Program. In 2008, Leslie was asked to join the steering committee for the Women Executive Leadership Network in Montgomery County, Maryland. She also serves on advisory boards for various start-up companies that are considering franchising as a possible expansion method.

Leslie enjoys hiking, running, riding motorcycles, traveling, reading fiction and amateur photography.
CRAIG S. PRUSHER

Craig S. Prusher is Vice President, Assistant General Counsel for Burger King Corporation. In this position, he is responsible for all legal issues relating to franchising and real estate in the U.S. and Canada, and the Corporation’s government and industry relations worldwide.

Prior to this position, Prusher was Senior Director, Associate General Counsel, Franchising in North America. Prior to that Prusher was Division Counsel for Burger King Corporation’s Asia/Pacific Region and prior to that he was a Senior Attorney, Marketing and Promotions. He joined Burger King Corporation in 1993 as a Senior Attorney, Franchising.

Previously, he was an associate in the corporate department of two Boston law firms, Warner & Stackpole and Nutter, McClennen & Fish. He is a 1985 graduate of Boston University’s College of Liberal Arts where he received his B.A. magna cum laude with distinction and a 1988 graduate of Boston University School of Law where he received his Juris Doctor and served as an editor of the Boston University Law Review.

Prusher is currently on the Board of Directors of the National Council of Chain Restaurants. He is also a member of the American Bar Association’s Forum on Franchising, the International Franchise Association and the Association of Corporate Counsel. He is a frequent speaker at legal seminars regarding franchise law issues.

Craig S. Prusher was born in New York, New York. He resides in Miami, Florida with his wife and three children.
JAYNE WESTLAKE

Jayne Westlake is an associate with the Toronto, Canada law firm of Cassels Brock & Blackwell LLP. Jayne practices in the area of franchise law and represents clients ranging from small Canadian companies interested in exploring franchising for the first time, to large international corporations looking to expand their franchise network into Canada. Through her practice, Jayne has developed a sound understanding of Canadian provincial franchise laws and the various options available to clients structuring their franchise or distribution system.

Jayne received a Bachelor of Arts (Hons) degree in Political Studies from Queen’s University in Kingston, Canada and a Bachelor of Laws degree from the University of Windsor, where she was active member of her law school community as, among other things, the Public Relations Editor of the Windsor Review of Legal and Social Issues.

Jayne is also actively involved in the franchise community. She is a member of the Canadian Franchise Association’s Award of Excellence Committee and is a co-founder and co-chair of the Toronto chapter of the International Franchise Association’s and Canadian Franchise Association’s Women’s Franchise Network. She is also a member of the ABA Forum on Franchising’s International Franchise and Distribution steering committee.

Jayne has spoken at events for the Canadian Franchise Association trade shows and the Ontario Bar Association’s Franchise Subcommittee. Jayne has conducted roundtable discussions at Canadian and international franchise conventions and legal symposia and is a regular contributor to the Federated Press Franchise and Distribution newsletter. Earlier this year, Jayne co-authored an article for ABA’s The Franchise Lawyer entitled, “So What’s the Worst That Can Happen? Franchise Law Compliance In Tough Economic Times”.

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