The Soul of Franchising

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FRANCHISING TO LARGE AND SOPHISTICATED FRANCHISEES: A WHALE OF AN OPPORTUNITY OR THE ELEPHANT IN THE ROOM?

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Overview

• Recruiting Options
• Franchise Registration and Disclosure Considerations
• Drafting and Negotiation Considerations
• Hypotheticals (including Post-Signing Issues)
Recruiting Options

- Existing Franchisees
- Multi-Concept Operators
- Private Equity Firms
- EB-5 Immigration Program Participants
- Investment Groups
Existing Franchisees

**Pros**
- Inexpensive
- Existing history
- Requires less support and training
- Benefits from economies of scale

**Cons**
- Financial hurdles
- Existing history
Multi-Concept Operators

• Pros
  – Understand the franchise model
  – Skilled operators
  – Infrastructure

• Cons
  – Divided attention
  – Potential non-compete issues
  – Concessions related to creating efficiencies (i.e. suppliers, POS system, etc)
Private Equity Firms

• Pros
  – Access to capital
  – Sophisticated management team
  – Potential quick, financially healthy, development of units

• Cons
  – Potentially competing interest in PE Fund
  – For smaller franchisors, uneven distribution of power
EB-5 Immigration Program Participants

• Pros
  – Potential source of inexpensive but limited financing
  – Expanded franchisee base

• Cons
  – Must manage compliance (franchise and immigration)
  – Risk of litigation if business fails
  – May require investor to participating in managing a business in which the investor has limited experience
Investment Groups

• Pros
  – May have diverse experience actively involved in the group
  – Multiple sources of financial resource

• Cons
  – Similar to private equity franchisees
  – Similar to EB5
  – May have multiple passive investors with one “operator”
Franchise Registration and Disclosure Considerations

Federal vs. State

Federal
• Exemption from disclosure

State
• Exemption from registration
• Exemption from registration and disclosure
• Exclusion from definition of a franchise
Franchise Registration and Disclosure Considerations

Applicable State and Federal Exemptions

- **Large Investment Exemption**
  - Investment amount calculation

- **Sophisticated Franchisee Exemption**
  - Experience; Net Worth/Income; Substantial investment

- **Fractional Franchise**
  - Experience; Maximum sales threshold

- **Discretionary Exemption (States Only)**
  - If exemption is in the public interest
What if a franchisor wants to disclose more financial information to their sophisticated prospect?

- If in FTC Franchise Rule states only – can franchisor rely on an exemption?
  - If yes, Franchise Rule restrictions on financial reps will not apply. Beware state unfair and deceptive practices acts, misrepresentation and fraud claims, etc.
  - If no, bound by FTC Franchise Rule

- If in a registration state and no exemption from registration and disclosure applies – is a supplemental financial performance representation based on a variation appropriate?
Franchise Registration and Disclosure Considerations

Disclosing Negotiated Changes

- FTC Franchise Rule (Items 5 and 6)
- California – Notice of Negotiated Change
  - Applicable if transaction is exempt? Which exemptions?
- Virginia – 30 day period to void if franchisee was not afforded opportunity to negotiate.
Drafting and Negotiation Points

• Franchisor
  – Looking for a franchisee can execute quickly
  – Looking for a franchisee that can execute smoothly
  – Looking for a franchisee with relevant experience to take burden off of franchisor

• Whale
  – Looking to leverage experience
  – Looking to leverage existing enterprise
  – Looking to become a market mover
  – Looking to manage risk and protect investment
Structuring the Relationship

- Franchisor
  - show acceptance and evidence demand
  - collect fees
- Whale
  - test the waters
  - obtain exclusivity / expansion
Term and Renewal

• Franchisor
  – Ensure development over a defined term
  – Limit number of renewals

• Whale
  – Provide for extensive renewal rights to protect investment
  – Define contract terms / limit conditions / limit contract changes

• Solutions
  – Define and specify evergreen provisions
Supply Chain

• Franchisor
  – Wants the right to control substantially all ongoing purchases to maintain brand standards

• Whale
  – Wants to leverage knowledge and existing relationships that may not be designated or approved
  – Regulate pricing on products from franchisor

• Solutions
  – Agree to consider alternative suppliers
  – Consider alternatives for franchisor supplied products
Exit Strategy / Resale / Transactions

• Franchisor
  – Permit transfers by franchisor
  – Restrict transfers by Whale
  – Roll-up franchises

• Whale
  – Maintain flexibility in ownership structures
  – Allow permitted transfers

• Solutions
  – Allow for change of control or partial ownership changes
  – Limit franchisor’s right to purchase
  – Limit franchisor’s right arbitrage roll-ups in franchisor M&A
Defaults / Cure / Cross-Defaults

• Franchisor
  – Allow for rapid default and termination of non-performing or poor performing Whale
  – Provide for cross-defaults / cross-termination

• Whale
  – Protect investment by having long cure periods
  – Protect investment by having right to default in development as a result of non-development or closures

• Solutions
  – Narrow scope of defaults
  – Allow for cure
  – Eliminate cross-default as a result of development default; limit application of cross-default
Releases and Guarantees

• Franchisor
  – Looks to obtain releases at all inflection points
  – Looks to have unlimited, unconditional and irrevocable guarantees of payment and performance by all significate investors

• Whale
  – Eliminate releases; make mutual; restrict to known claims only
  – Eliminate personal liability for business failure

• Solutions
  – Limit scope of release; obtain release only at renewal
  – Limit liability under guarantee; limit duration of guarantee; limit persons responsible
  – Provide alternative sources of security.
Hypothetical #1

A multi-million dollar French pastry shop company has heard that “macarons are the new cupcake” in the U.S. and have decided to jump on this trend by becoming a multi-unit franchisee of an already-established U.S. franchisor. Their interest lies in developing units in New York, Connecticut, and Rhode Island.

Franchisor is not registered in New York, but wants to begin discussing the opportunity with the prospect immediately and sends them their then-current disclosure document.
Hypothetical #2

Franchisor has been approached by a developer looking to put one of the franchisor’s ice cream stores in Time Square. Franchisor is very excited about this opportunity, which will be a great showcase for the brand. Franchisor has five franchisees to choose from and must decide on which franchisee is best for this prime location. The first franchisee has been in the franchise system for three years and currently operates one unit. The second franchisee has no open units, but has 100 franchised units operating under a fast-food franchise system. The third franchisee is a private-equity group that is new to owning and operating franchised businesses, but has signed a Multi-Unit Development Agreement committing to develop 20 franchised units. The fourth franchisee (i) is an investment group made up of three EB-5 investors; (ii) has signed a Multi-Unit Development Agreement committing to open three franchised units; (iii) is new to owning and operating franchised businesses; and (iv) will have its franchised units managed by EB-5 Investing, Inc. which also served as the broker that put together the investment. The fifth franchisee is a group of physicians that have formed an investment group. This investment group had no open units, and none of the investors have any experience in the food industry.
Hypothetical #3

A new Franchisor is looking to grow with speed. They are talking to various investor groups to purchase geographic regions. The franchisor is approached by a private-equity franchise and multi-unit operators of another brand to acquire multi-unit development rights.

The franchisor begins to negotiate with each potential franchisee.
Franchising to Large and Sophisticated Franchisees: A Whale of an Opportunity or the Elephant in the Room?

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FRANCHISING TO LARGE AND SOPHISTICATED FRANCHISEES: A WHALE OF AN OPPORTUNITY OR THE ELEPHANT IN THE ROOM?

I. INTRODUCTION

In general, franchisors cannot deny the lure of the whale: a well-capitalized, sophisticated, party wishing to pay the franchisor for the opportunity to tenaciously grow that franchisor’s brand in a certain region. Nor are sophisticated investors ignorant of the benefits afforded to their top and bottom line by a well-established brand and its accompanying systems. The benefits to both parties can be significant if a mutually acceptable deal is reached and the partnership is a successful one.

Franchisors may view growth with larger franchisees as an opportunity to successfully penetrate new markets with less investment or capital demands on the system. While the franchisor is expecting, and expected, to provide assistance and training for the first units and during the initial growth period, this type of franchisee typically already has the operational infrastructure in place to then take over some of the franchisor’s responsibilities. With a well-capitalized investor also comes the added capability of supporting less well-performing units and the ability to tolerate greater than anticipated ramp-up periods. Franchisors may also look to leverage these well-capitalized and operationally self-sufficient businesses to grow at a faster pace than would otherwise be anticipated through single-unit sales and to attract other franchisees to the system.

The sophisticated investor, however, looks closely at the opportunity presented. With greater resources at its disposal, in addition to its own experience and acumen, they rely on advice from experienced counsel as well as financial and business advisors in evaluating a concept. With these added resources comes the ability to closely evaluate a concept and to negotiate a deal that is more advantageous than the standard offering. This is an investor who is looking for scalable concepts with multi-unit operational efficiencies that provides a solid return on investment—and if a franchisor is unable to deliver or the franchisee experiences difficulties, the once-hopeful relationship can begin to face large-scale, one might even say elephant-sized, challenges that cannot be ignored. To both the franchisor and the franchisee, however, with the appropriate due diligence performed on both ends, this is clearly a risk worth taking.

This paper explores how a franchisor might attract this whale of an opportunity and, once having captured it, keep it from morphing into the disruptive elephant in the room or, if necessary, practical considerations for dealing with those circumstances where, even despite a franchisor’s best efforts, the whale transfigures into the elephant.

II. RECRUITING OPTIONS

Recruiting franchisees is one of the most important and hardest challenges faced by franchisors. Whether a franchisor operates a small franchise system seeking to grow the system or an established brand looking to replace franchisees that are exiting the system, franchise recruitment is a critical part of the business. A successful recruitment strategy is essential for initial growth and the long-term sustainability of a franchise system. Most franchisors look to find candidates who: (i) will be good operators and follow the system, (ii) are sufficiently capitalized, (iii) will be attentive to managing the business, (iv) want to develop multiple units, and (v) will not be disruptive to the franchise system.
The competition for good franchisees has increased and it will continue to increase as the number of franchise opportunities grow. As the competition for franchisees continues to grow, most franchisors are seeking growth opportunities with both traditional franchisees and non-traditional franchisees as a means to grow the franchise system.

A. Recruit from Within

Recruiting franchisees from within the franchise system may be the cheapest and most effective recruitment strategy. The franchisor has the ability to evaluate: (i) the existing franchisee’s history as an existing franchisee, (ii) whether the franchisee is poised for developing additional units, and (iii) whether the franchisee is someone the franchisor desires to grow with. In addition to the benefit of knowing the history of an existing franchisee, existing franchisees know the franchise system and should: (a) require less support and training, (b) be capable of developing units faster than new franchisees, and (c) benefit from economies of scale. Existing franchisees can also partner with the franchisor to purchase underperforming units and/or units that are being closed by other franchisees.

For some existing franchisees, financing can be a hurdle for developing additional units. To address this concern, franchisors may establish financing programs with third parties, offer direct financing, and/or guarantee loans for franchisees. Additionally, as an enticement to develop additional units and a means to offer additional development assistance to existing franchisees that develop additional units, franchisors may waive initial franchise fees, offer reduced royalties based on total sales for an initial or permanent period, and/or provide an exclusive development area for a certain period.

In discussing additional growth with existing franchisees, it is not uncommon for franchisors to hear these franchisees say they are not interested in the further development of units if it will subject them to being required to offer health care coverage required under the employer mandate of the Affordable Care Act. Prior to the employer mandate going into effect, many franchisors saw multi-unit franchisees selling units to escape coverage under the Affordable Care Act by lowering their employee count. To provide comfort to franchisees focused on this concern, franchisors can provide education, vendor recommendations and referrals to existing large franchisees effectively providing coverage under the Affordable Care Act.

B. Multi-Concept Operators

Multi-concept operators operate multiple businesses that may or may not be: (i) similar, and/or (ii) franchised. Multi-concept operators can be very experienced and skilled operators that understand franchising. Traditionally, many franchisors have prohibited their franchisee from owning or operating other businesses while the franchisee operates under their franchise system. These prohibitions have generally stemmed from the franchisor’s desire to have its franchisees devote full time and best efforts to the units operated under the franchisor’s franchise system (or, at a minimum, during the initial start-up phase). When evaluating multi-concept operators, a franchisor needs to be comfortable that the operator will not neglect developing and operating units under the franchisor’s system and focus on another business. When entering into an initial relationship with a multi-concept operator, the franchisor should make sure that the multi-concept operator’s other businesses are off the ground before the multi-concept operator embarks on developing initial units with the franchisor.
Similar to incentives for existing franchisees, a franchisor may offer reduced fees to multi-concept operators who make commitments to develop units. These reductions may not be as significant as the incentives given to existing franchisees who: (a) have an existing relationship and track record, and (b) are usually not as well-heeled as a multi-concept operator. Additionally, there are several accommodations that a private equity firm may request, which are discussed in the next subsection of this paper, and these accommodations may also be applicable to multi-concept operators that are large corporate entities.

Many multi-concept operators may seek to operate multiple concepts in the same industry. These multi-concept operators are generally looking for synergies in the concepts, including the ability to have their management teams use their experience across concepts. However, this desire may conflict with the franchisor’s in-term non-competition provisions. At the onset of the relationship or during the relationship, a franchisor working with a multi-concept operator may be asked to waive or narrow the in-term and post-term non-competition provisions. Franchisors must weigh the risks versus the benefits of working with the multi-concept operator.

Multi-concept operators can be harder to manage than traditional franchisees and they may have strong views on how units operating under the franchise system should operate based on their experience with other franchised or non-franchised businesses. To the extent that a franchisor is open to innovations, a multi-concept operator has the ability to bring innovation to a franchisor’s franchise system based on the multi-concept owner’s experience operating other businesses. This potential for the transfer of knowledge can be a double-edged sword. A franchisor may not only be a beneficiary of such knowledge transfer, but also a victim of such knowledge transfer, if a multi-concept owner transfers information related to the franchisor’s franchise system. Having a multi-concept operator in the system can be dangerous, if the multi-concept operator transfers any proprietary information, regardless of whether the information is transferred to businesses outside the franchisor’s industry.

A multi-concept operator may desire to have all of its concepts using the same computer system. Franchisors may or may not be willing to agree to allow the use of different computer systems within their franchise systems. Depending on the particular computer system and the potential disruption caused by using another system, many franchisors are willing to deal with minor inconveniences in order to work with multi-concept operators.

Within the last few years, the industry has seen an increasing number of initial public offerings by multi-concept operators. Franchisors that are concerned about franchisees that are public, or that prohibit franchisees from going public, may not be good candidates for franchising to multi-concept operators.

Additional concerns stem from a multi-concept operator’s financial situation. A multi-concept operator can become too leveraged as a result of having multiple businesses and/or the multi-concept operator’s other businesses can cause financial stress on the operator’s entire enterprise, including the those units operating under the franchisor’s franchise system.

C. Private Equity Firms

“Private equity” is essentially a pool of capital that is professionally managed for others and is invested in equity of private firms. A private equity firm can be formed by an individual, family office, or professional finance organization that raises money from wealthy individuals, trusts, institutional investors (e.g., public and private pension funds, foundations, endowments,
colleges and universities), and investment managers. Some of the greatest advantages to working with private equity firms is that they generally have access to capital, are usually not highly leveraged, and will not need the franchisor’s assistance in obtaining financing. Another advantage to working with private equity is that they will generally have a sophisticated management team that is active in the management of the business. The fund managers have an obligation to maximize the return to their investors, which keeps private equity focused on operating their business effectively and efficiently to maximize the return to the investors.

Private equity firms can have very complicated structures that will generally involve various different funds. Each fund will have different investors and each fund may focus on one or more specific industry and investment goal. Before entering into a relationship with a private equity firm, the franchisor should understand the structure of the private equity firm and how the franchisee entity fits within the structure.

Over the last 10 years, private equity firms have become increasingly interested in owning and operating franchised units. This has included purchasing underperforming units and/or obtaining rights to develop new units. Private equity had been attracted to franchising because of its growth potential, structured and proven model, consistent cash flows, and the various options to exit or obtain liquidity. Private equity is generally interested in becoming a franchisee of established brands with a proven track record. In situations where a private equity firm is interested in units of a small franchisor, the franchisor should consider whether it may be taking on a relationship with a franchisee that may have too much leverage because of its size. In general, the most significant factor that a private equity firm will consider in its decision to become a franchisee of a franchise system is the unit-level economic model.

Some private equity firms are solely focused on developing new units. This strategy may align with a strategy of investing in real estate from which the units will operate. Other private equity firms may be focused on purchasing underperforming units to turn around. In these situations, the private equity firm may be a great consolidator of units creating a healthier franchise system and an increased royalty stream for the franchisor. When a private equity firm acts as a consolidator, the consolidated units will also usually require less support than individual units.

When evaluating a potential relationship with a private equity firm, it is important for a franchisor to understand the private equity firm’s expectations for the return on the investment and timing of the return. The franchisor should be reasonably certain that the franchise system can meet the private equity firm’s expectations in these areas. In general, private equity firms tend to be more patient investors, but the franchisor will need to understand the fund’s time line (including the liquidation time frame). The liquidation strategy and time line can have a significant impact on the franchise system if the private equity firm owns a significant number of units.

Similar to multi-concept operators, private equity firms will generally request and need certain exceptions to the general requirements imposed on individual franchisees. Like the fee reductions offered to multi-concept operators, the franchisor may offer reduced fees to private equity firms that make commitments to develop units. Any fee reductions would typically be similar to the incentives given to multi-concept operators.

As discussed above, many franchise agreements require the owner to devote full-time and best efforts to operating the unit and this requirement is inconsistent with a multi-concept operator who has a professional management operations team. The franchisor may need to be
flexible in order for the private equity fund to attract, retrain and make reasonable changes to management. Additionally, the private equity fund may resist training requirements placed on management and seek to have all training requirements imposed on managers who are directly involved in working at units.

Franchisors may need to make accommodations to transfer and financing restrictions based on the ownership structure of the private equity fund. Transfers of minority interests in a private equity fund and organizational restructuring of a private equity fund may need to be excluded from all or certain transfer requirements. For many private equity firms, there will not be an individual who will sign a personal guaranty. In rare instances, the franchisor may be able to get someone with a significant financial interest to sign a guarantee, but often it will be necessary for the franchisor to get comfortable relying on the private equity firm’s financial situation or consider requesting a letter of credit. Similar to multi-concept operators, private equity firms may request, and need, certain adjustments to the non-compete to accommodate existing investments and/or planned investments.

D. EB-5

The EB-5 immigration program (the “Program”) allows permanent residency (i.e., a “green card”) to a qualified foreign national who invests $1,000,000 (or at least $500,000 in a targeted employment area (“TEA”), which is a high unemployment or rural area) in a new U.S. commercial enterprise that creates or preserves 10 full-time jobs for U.S. workers (excluding the foreign national and their immediate family). Initially, the foreign national is granted two years of conditional permanent residence for the foreign national and derivative family members. After the two-year conditional period, a petition must be filed to remove the conditions on the foreign national’s status. The conditions will be removed after the foreign national proves the requirements of the Program are satisfied and the foreign national will be granted a permanent green card. If the business fails prior to the end of the two-year conditional period or the conditions of the Program are not satisfied, the foreign national is not entitled to permanent resident status.

The Program dates back to 1992 when a pilot program was approved by Congress. In general, the use of the Program has been less than was originally anticipated. The Program was changed in 2011 to streamline the process. Under the Program, there are a maximum of 10,000 EB-5 visas permitted each year. In August 2014, the Program reached capacity for the first time in the Program’s history and the State Department put a hold on issuing EB-5 visas until the following fiscal year (which commenced in October 2014).

1 Immigration and Nationality Act § 203(b)(5) (8 U.S.C. § 1153(b)(5)).
2 Id.
Traditionally, foreign nationals have made EB-5 investments through regional centers approved by the United States Citizenship and Immigration Services. If a foreign national invests through a regional center, the foreign national will not need to participate in the operations or management of the business. The foreign national receives an equity interest in the new business entity developing the business or becomes a member of a limited partnership or limited liability company that will finance the business and get interest payments.

If a foreign national desires to be more involved in the investment which can lower the investment risks, investing in a franchise can be a more attractive option for a foreign national wanting to participate in the Program. With regard to investing in franchising, the foreign national's investment can be used to establish a franchise business that is (i) solely owned and operated by the franchisee, (ii) owned by the franchisee, but operated by the franchisor or a third-party, or (iii) a joint-venture between the franchisor and franchisee. Foreign nationals will usually make the investment in a franchise (i) directly through the franchisor, or (ii) through a broker that may or may not manage the development and/or operation of the salon. Regardless of the structure that a foreign national uses to participate in the Program, it is unlikely that the foreign national will have any financial exposure beyond the investment required under the Program and the foreign national will typically not be required to invest additional funds regardless of how the unit(s) performs. However, as a practical matter, a foreign national will likely invest whatever is required to keep the unit open during the two-year conditional period to satisfy the requirements of the Program and obtain permanent resident status.

A franchisor seeking to recruit foreign nationals that will use the Program to develop units will need to evaluate how the required investment fits within their franchise program (e.g., will the initial investment for a unit exceed the investment level required under the Program or will the franchisee be able to develop multiple units with the investment level required under the Program). The business must also create the number of jobs required under the Program. When thinking about using the Program to grow units, a franchisor needs to be mindful that it can take six or more months just for the required approvals for the Program and additional time may be involved in connection with issues related to funding and the transfer of funds.

As discussed above, for the lower investment level, the commercial enterprises must be in a TEA. A TEA is an area that, at the time of investment, is a rural area (defined as any area outside a metropolitan statistical area as designated by the Office of Management and Budget) or outside the boundary of any city or town having a population of 20,000 or more (according to the decennial census) or an area experiencing unemployment of at least 150 percent of the national average rate (calculated by the Bureau of Labor Statistics). For foreign nationals looking to make the minimum investment, the TEA requirement may be a hurdle for locating a franchise, because some franchises may not be suited to be located in a TEA or perform well in a TEA.

As discussed above, a foreign national will need to retain an interest in the business during the two-year conditional period, but the foreign national is not required to retain the business after obtaining permanent resident status. For a foreign national investing in a

5 8 C.F.R. § 204.6 (m).
6 Id.
7 Immigration and Nationality Act § 203(b)(5) (8 U.S.C. § 1153(b)(5)).
partnership or membership in a limited partnership or limited liability company, respectively, such entities could have restrictions on how long the foreign national must keep an interest in the unit(s) and/or entity. If a large amount of units are developed around the same period through foreign nationals using the Program and all (or a substantial amount) of the foreign nationals seek to exit their investment around the same time, this could flood the market with units and negatively impact (i) the resale value of units and (ii) new franchise sales for units.

When evaluating foreign nationals seeking to develop and operate a unit directly, a franchisor will need to consider the significant challenges that the foreign national will face in learning how to do business in the U.S. and whether it is feasible for foreign nationals to develop units under their franchise system. In these situations, the franchisor may need to consider what additional assistance the franchisor may need to provide to the foreign national for the successful development and operation of a unit(s). Additionally, when working with a foreign national using the Program, a franchisor will need to consider the fact that the foreign national is not required to put additional capital into the unit above what is required under the Program and this could create future problems, if the unit does not have positive cash flow and/or the foreign national does not wish to put any profit back into the unit for things that are necessary to operate the unit in compliance with the requirements of the franchise system.

When franchise agreements are signed for units developed by foreign nationals under the Program, there may be situations where there will be no guarantor and this will create more risk for the franchisor which will not have any recourse against an individual(s) in the event of a default under the franchise agreement. Even if a foreign national signs a personal guaranty, it may be of speculative value, depending on where the foreign national lives when the franchisor seeks to enforce its rights under the guaranty. The lack of (i) a guarantor, (ii) a guarantor based in the U.S., and/or (iii) a guarantor with credit history will also be a concern for landlords. The franchisor will likely have to work with landlords to get them comfortable with leasing to foreign nationals developing units under the Program. Some landlords may ask the franchisor to guaranty the lease obligations for units developed by foreign nationals. Additionally, if down the road a significant number of foreign nationals walk away from units, this could damage the franchise system’s reputation with landlords. All of these issues have the potential to create situations that could cause significant harm to the franchisor’s brand and/or create exposure for the franchisor if these risks are not mitigated.

Establishing a program to attract foreign nationals to use the Program can be very complex. This is especially true if (a) the foreign national and franchisor connect through brokers, (b) a management entity will operate the unit for the foreign national, and/or (c) the management entity will operate multiple units owned by multiple foreign nationals. The more complicated transactions can involve (i) a broker/agent for the foreign national, (ii) a broker/agent for the investment entity that will manage the unit, and/or (iii) a broker/agent for the franchisor. Depending on how the arrangement is structured, an individual or entity may serve multiple roles for individuals and entities that have conflicting interests. Any conflicts will need to be addressed or properly disclosed and waived.

Marketing and/or establishing a program to attract foreign nationals has many legal risks. A franchisor embarking on working with foreign nationals using the Program will need to seek legal counsel experienced in working in this space and this may include immigration counsel and franchise counsel experienced in advising on disclosure issues related to the Program and franchise broker liability. The use of the Program in the franchise industry remains very new and it is unclear about the legal exposure related to units developed under the Program. However, claims related to (i) inadequate disclosures, (ii) misconduct, misstatements,
and/or conflicts by the broker(s) involved, and (iii) a conspiracy between the franchisor and broker(s) and/or manager(s) of the limited partnership or limited liability company that operates the unit(s) are foreseeable risks. These arrangements are new to franchising and this is not an exhaustive list of the claims that could be asserted by a foreign national. The structure and the complexity of the structure will factor into the potential claims that could be asserted.

E. Investment Groups

Investment groups can be less formal than a private equity firm and they are another source for developing units under a franchisor’s system. As discussed above, private equity funds generally come from wealthy individuals, trusts, institutional investors and investment managers. Investment group funds can come from any group of investors, despite income or investment experience. The issues related to developing with investment groups are similar to the issues involved in developing with (a) foreign nationals using the Program and (b) private equity firms.

III. FRANCHISE REGISTRATION AND DISCLOSURE LAW CONSIDERATIONS

A myriad of laws and regulations touch on a franchisor’s ability to negotiate and sell multi-unit franchises. These include both laws that affect pre-sale registration, disclosure, and negotiation activities as well as post-sale negotiations and agreement enforcement concerns. Familiarity with certain statutes, regulations, and case law in these areas are necessary for franchisors straying from the terms of their franchise offering. While this section will focus, in particular, on those laws and regulations that govern the pre-sale registration, disclosure, and negotiation of multi-unit franchise sales—including applicable registration and disclosure exemptions and disclosure laws pertaining to negotiated changes and multi-unit offerings—it also discusses, in brief, those post-sale laws which franchisors need to be aware of, such as anti-discrimination laws and covenants of good faith and fair dealing.

A. Federal and State Disclosure and Registration Exemptions

Both federal and state laws reduce legal and regulatory burdens on franchisors when they perceive that fraud and other similar abuses these laws were created to minimize are not likely to be present. As to larger, more sophisticated franchisees, both federal and most state regulating bodies view these prospective franchisees as the type who have the experience and resources to investigate an opportunity more thoroughly than a typical single-unit “mom and pop” franchise prospect. The various federal and state exemptions, as explained in greater detail below, are applicable to transactions involving sophisticated, multi-unit franchisees.

1. Large Investment Franchise

The first type of sale the FTC Franchise Rule (the “Franchise Rule”) exempts from disclosure requirements is one made to large investment franchises, where, in order to qualify for this exemption, a franchisee’s initial investment would have to meet or exceed $1,084,900 million.8 This minimum investment amount excludes the cost of unimproved land and any financing provided by the franchisor or any affiliate. The minimum investment amount is

8 16 C.F.R. §436.8(a)(5)(i); 16 C.F.R. §436.8(b). Note, also, that the minimum investment amount, which was first set in 2007 as $1,000,000, is subject to further adjustment as the Commission has reserved the right to adjust the threshold every four years based on the Consumer Price Index.
intended by the FTC to encompass those expenditures that would be set forth in Item 7 of a Franchise Disclosure Document prepared in accordance with the Franchise Rule, but need not be limited to a single unit.\footnote{Franchise Rule with Statement of Basis and Purpose, 72 Fed. Reg. 15,444, 15,526 (Mar. 30, 2007).} At least one owner must invest minimum required amount in the franchise venture in order for the exemption to apply. The franchisee must sign an acknowledgement that the franchise sale will exceed the investment threshold.\footnote{16 C.F.R. §436.8(a)(5)(i).} While the acknowledgement does not absolve the franchisor from liability if the investment does not meet the requirements of the exemption, it is a method by which a prospect will be alerted that the franchisor is relying on this exemption.\footnote{Franchise Rule with Statement of Basis and Purpose, 72 Fed. Reg. 15,444, 15,525 (Mar. 30, 2007).}

Illinois, Maryland, Minnesota, and South Dakota each have their own version of the large investment exemption, of which South Dakota is the closest in kind to the Franchise Rule.\footnote{Ill. Admin. Code tit. 14, § 200.201(c) (1999); Md. Code Regs. 02.02.08.10(E)(1); Minn. R. §§ 2860.8100-8300 (2007); S.D. Codified Laws § 37-5B-13(1) (2008).} To be eligible for the exemption in South Dakota, the franchisee must make an initial required investment of at least $1 million (excluding any unimproved land and financing from the franchisor) and must sign an acknowledgement which includes specific statutory language.\footnote{S.D. Codified Laws § 37-5B-13(1) (2008).} South Dakota’s exemption is the only state exemption for large investments which exempts the transaction from both registration and disclosure. The exemption in Illinois is unique and more difficult to satisfy in that the state examiners may approve or disapprove an application for an exemption from registration for the offer and sale of a single unit franchise where the minimum investment is in excess of $1 million.\footnote{Ill. Admin. Code tit. 14, § 200.201(c) (1999).} Maryland’s regulations, however, provide a more straightforward exemption from registration for the offer or sale of a franchise which requires an initial investment of more than $750,000. The franchisor’s Franchise Disclosure Document and other required accompanying forms must still be filed with the state at least 10 days before the offer or sale takes place.\footnote{Md. Code Regs. 02.02.08.10(E)(1).} Minnesota’s exemption by regulation applies to unfinanced investments of over $200,000, although franchisor’s financial statements and existing Minnesota franchisee information is required to be filed with the state.\footnote{Minn. R. §§ 2860.8100-8300 (2007).}

In reference to state exemptions generally, and applicable to those that follow, it is important when reviewing exemption language to pay particular attention to whether: 1) such exemption applies to registration, disclosure, or both; 2) an exemption-related filing needs to be submitted to the state, in what form, and when; 3) and whether any state-specific language or information must be disclosed.

\begin{itemize}
\item \textbf{10} 16 C.F.R. §436.8(a)(5)(i).
\item \textbf{12} Ill. Admin. Code tit. 14, § 200.201(c) (1999); Md. Code Regs. 02.02.08.10(E)(1); Minn. R. §§ 2860.8100-8300 (2007); S.D. Codified Laws § 37-5B-13(1) (2008).
\item \textbf{13} S.D. Codified Laws § 37-5B-13(1) (2008). The acknowledgement must state: “The franchise sale is for more than one million dollars, excluding the cost of unimproved land and any financing received from the franchisor or an affiliate.”
\item \textbf{14} Ill. Admin. Code tit. 14, § 200.201(c) (1999).
\item \textbf{15} Md. Code Regs. 02.02.08.10(E)(1).
\item \textbf{16} Minn. R. §§ 2860.8100-8300 (2007).
2. Sophisticated Franchisee Exemption

The Franchise Rule also allows for exemption from disclosure if the proposed franchise sale is to a large or, as oftentimes referred to, a “sophisticated” franchisee. The intent of the Franchise Rule is to cover franchisees with a net worth of at least $5,424,500 which have at least five years of prior business experience in any line of business—even if the franchisee has no prior experience in franchising specifically. Prior experience and the net worth of the franchisee’s affiliates and parents may be aggregated when determining whether the franchisee qualifies as a “sophisticated franchisee” under this exemption. This, of course, is extremely helpful to franchisees whose practice it may be to create new entities (whether for legal, tax, or business reasons) for various business interests. While the exemption does apply to individuals and business entities alike, most individuals who have the minimum required net worth and sufficient experience to meet the requirements of the exemption will be sufficiently sophisticated as to conduct business through a formal business entity.

California, Illinois, Rhode Island, South Dakota, and Wisconsin franchise laws provide for exemptions related to the offer and sale of franchises to “sophisticated franchisees.” As with the state exemptions for large investments described previously, each state’s requirements differ. California, for example, provides for two scenarios where the offer or sale to a certain type of sophisticated franchisee may be exempt from registration. The first exemption applies to prospective franchisees where one or more of the owners holding at least 50 percent of the interest in the prospect has, within the previous seven years, gained at least 24 months of experience with respect to a substantially similar business and is not controlled by the franchisor. The second California exemption applies to prospective franchisees which: 1) either a) are an entity with assets exceeding $5 million not formed specifically to purchase the franchise, b) an individual with a net worth of over $1 million (which may be joint with spouse, if any, but excludes certain exempt assets, such as place of residence), or c) an individual with gross income of $300,000 per year or, joint with spouse, exceeding $500,000 per year; 2) which the franchisor reasonably believes has the capacity to evaluate the merits and risks of the franchise; 3) the purchasers are purchasing for their own account; and 4) any initial cash payment required on the purchase of the franchise doesn’t exceed 10% of the purchaser’s net worth. The filing requirements also differ - for the first exemption, the franchisor must file the required notice with California’s Department of Business Oversight within 15 days after the sale of the franchise and, for the second exemption, the franchisor must file the required notice before the sale is made. For the Rhode Island exemption to apply, the franchisee must have a net worth of at least $1 million (which may be joint with a spouse, if any, but excludes certain exempt assets) or past income of at least $200,000 (which may also be joint with a spouse, and the prospect must have sufficient knowledge and experience in financial and business matters

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17 16 C.F.R. §436.8(a)(5)(ii); 16 C.F.R. §436.8(b). The minimum net worth amount, which was first set in 2007 as $5,000,000, is subject to further adjustment as the Commission has reserved the right to adjust the threshold every four years based on the Consumer Price Index.
20 Cal. Corp. Code § 31106(a)(1) and (b) (2015).
to be capable of evaluating the merits and risks of the franchise). 22 The Illinois and South Dakota exemptions, on the other hand, are much simpler, granting an exemption from registration for Illinois and from registration and disclosure for South Dakota, for the offer and sale of a franchise where the prospective franchisee (or its parents or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least $5 million. 23 Finally, Wisconsin’s exemption is unlike the others and provides for exemption from registration if the immediate cash payment required is at least $100,000 and does not exceed 20% of the franchisee’s net worth (excluding certain exempt assets), and the franchisor reasonably believes that the prospect has sufficient knowledge and experience to evaluate the merits and risks of the franchise investment. 24

3. Fractional Franchise

The federal fractional franchise exemption comes into play when the prospect already has an existing business interest which it would like to expand through the sale of additional product lines or services. In order for the fractional franchise exemption to apply to this expansion, however, the situation must meet two criteria. First, the franchisee or its principals must have more than two years of experience in the same line of business. Second, the parties must reasonably expect that the sales from the new line of business will not exceed 20% of the combined business operation’s total sales during the first year of operation. 25 The parties must also have a reasonable basis for relying on this exemption. 26 Beware, however, of the interpretation challenges this exemption presents. While the Interpretive Guides to the previous franchise rule explicitly stated that the two-year experience requirement could be met if the individual on whom the franchisee was relying had gained the experience at any time in the past, the new Franchise Rule is silent on the matter. 27 A franchisor must also determine when a franchisee’s prior business experience is in the “same line of business”, though limited guidance exists on how to make this determination. While the experience need not be in the identical line of business, the exemption may not apply if the previous experience is from the same general industry or selling complementary goods or services. 28

States deal with fractional franchises in two categorical ways. In Illinois, Indiana, and Virginia, fractional franchises are expressly excluded from the definition of a franchise. 29 In California, Michigan, Minnesota, New York, Oregon, South Dakota, and Wisconsin, laws and

25 16 C.F.R. § 436.1(g).
26 16 C.F.R. § 436.1(g)(2).
28 Statement of Basis and Purpose for the Amended FTC Rule, 72 Fed. Reg. 15,444, 15,458, Bus. Franchise Guide (CCH) ¶ 6060 (1979) (The Commission explains that prior business experience in a particular economic sector is not necessarily sufficient to operate a different franchise in the same sector. For example, operating a small fast-good kiosk in a mall does not necessarily mean that a franchisee understands the risks of operating a full-service sit down restaurant, although both are in the food service industry).
regulations provide for fractional franchise exemptions from the states’ registration and disclosure requirements. 30 There are, however, important differences between the state statutes and the Franchise Rule exemption. One of the most common differences between the Franchise Rule exemption and the related state statutes is how business experience is accounted for. While under the Franchise Rule this requirement may be satisfied with the experience of an officer or director of the franchisee, its affiliate, or parent, most states require that the individual with the requisite experience hold a position with the franchisee itself. Further restricting this requirement, the California and Illinois statutes require that the individual with the experience have held that position with the franchisee for at least twenty-four months prior to the execution of the franchise agreement. 31 On the other hand, Virginia’s definition of a fractional franchise excludes the two-year business experience requirement entirely. 32 Another example evidencing the difference between the Franchise Rule and state statutes includes California, Michigan, and New York’s requirement that the fractional franchise operate from the same location as the existing business. 33 These differing nuances in language under each state statute cannot be ignored and should be closely examined if a franchisor ultimately elects to rely on a fractional franchise exemption.

B. Statutes and Regulations Addressing Negotiated Changes

In any discussion regarding special concerns relating to sophisticated multi-unit franchisees, negotiated changes must undoubtedly be included. To this end, when negotiating, franchisors should bear in mind that both the Franchise Rule and certain state statutes address negotiated changes in a way that could impact disclosures provided to other prospective franchisees as well as create a requirement for amended filings with certain states.

1. Franchise Rule—Negotiated Changes

There is ample evidence in the text of the Franchise Rule itself, as well as in the discussions set forth in the Statement of Basis and Purpose, to make it clear that negotiated terms are an expected method of doing business and accounted for in franchise-related laws. For example, the seven calendar day waiting period franchisors must observe after providing a prospective franchisee with agreements which have been unilaterally and materially amended by the franchisor need not restart for negotiated changes initiated by the franchisee. 34 Also, while a franchisee is not permitted to waive reliance on any representation made in a franchisor’s disclosure document, the Franchise Rule does expressly state that “this provision is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms

30 Cal. Corp. Code § 31108; Mich. Comp. Laws § 445.1506(1)(h); Minn. Stat. §§ 80C.03(f) and 80C.01; N.Y. Comp. Codes R. & Regs. tit. 13, §200.10(2)(c); Or. Admin R. § 441-325-0030(1); S.D. Franchise Investment Act of 2008 § 1(10) and 12(3); Wisc. Franchise Investment Law § 553.22(1). California and New York also require that filings be made with the state in order to claim the exemption while the remaining states do not.


34 16 C.F.R. § 436.2(b).
and conditions set forth in his or her disclosure document during the course of franchise sale negotiations.\(^{35}\)

Franchisors should, however, take care to abide by the Franchise Rule’s disclosure obligations related to Item 5, which state that if the initial fees are not uniformly imposed, the franchisor must “disclose the range or formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount.”\(^{36}\) This might include disclosure language such as: “during our 2015 fiscal year, franchisees paid initial franchise fee amounts ranging from $0 to $45,000.” If the range of initial franchise fees paid in the past fiscal year, however, are a direct result of discounts or formulas already disclosed, franchisors need not disclose the actual range of amounts paid. Similar to the Item 5 disclosure requirement, a disclosure obligation under Item 6 requires that a franchisor state “whether the fees [listed in Item 6] are uniformly imposed.”\(^{37}\) A basic example of disclosure language for this Item 6 requirement would be: “franchisees in the system pay an ongoing royalty fee ranging from 5% to 7% of Gross Sales.” These disclosures would be included in the Franchise Disclosure Document at renewal.

Other than the foregoing, the Franchise Rule doesn’t require that franchisors disclose negotiated changes. However, if a franchisor routinely negotiates the terms of its agreements and, in particular, the franchisor routinely negotiates the same agreement terms, the question of whether the franchisor’s true offering to prospects is the one disclosed in its Franchise Disclosure Document arises.

2. California’s Notice of Negotiated Change

States, too, have laws and regulations governing negotiated changes, though none are more rigorous than California.\(^{38}\) In California, if a franchisor agrees to certain negotiated changes in its agreement with a California prospect that are different from the terms of its registered offering, it must abide by the filing and disclosure requirements set forth in the California Franchise Investment Law and California’s franchise regulations.\(^{39}\)

Under the statutory scheme, if the negotiated terms, on the whole, confer additional benefits to the franchisee, the franchisor is exempt from filing an amended registration reflecting the negotiated changes so long as, in pertinent part, the franchisor provides its prospective franchisee with a summary of each material term the franchisor negotiated for a California franchise during the 12 month period before the negotiated offer or sale was made, and the contact information of the representative of the franchisor from whom a copy of the negotiated changes could be obtained.

\(^{35}\) 16 C.F.R. § 436.9(h).

\(^{36}\) 16 C.F.R. § 463.5(e).

\(^{37}\) 16 C.F.R. § 463.5(f).


\(^{39}\) Cal. Corp. Code § 31109.1 (2015); Cal. Admin. Code tit. 10 § 310.100.2. The language in the statute and in the regulations exempt from registration the sale of a franchise on terms that are different from a franchisor’s registered filing. Therefore, franchisors that are exempt from registration need not comply with the negotiated change requirement in California.
terms may be obtained. While neither a copy of the summary description nor the list of more specific negotiated terms are explicitly required to be filed with the state (under the statute), franchisors are required to certify in their application for renewal that they have complied with the requirements of this particular exemption.

However, the California regulations are broader in application, as they apply to any negotiated changes and not just those which, on the whole, confer additional benefits to the franchisee. In addition, the regulations state that a Notice of Negotiated Sale of Franchise, in the form included in the regulations, is to be filed no more than 15 business days after the negotiated sale is consummated. In fact, the regulations require that the franchisor amend its registered offer to disclose the specific items which franchisor negotiated with other franchisees before selling another franchise. The filing for the Notice is effective when filed.

Regardless of whether a franchisor relies on the statutory exemption or the regulatory exemption, however, the end result is the same with respect to disclosure. Negotiated terms agreed to between a franchisor and franchisee must be disclosed to that franchisor’s California prospective franchisees for a period of 12 months. This is true even if such negotiations occurred in connection with an offer and sale for which registration is exempt under another provision of the California Corporations Code.

3. Other State Statutes On Negotiated Changes

While no other state adopts as detailed a process as California as to negotiated changes, there are additional state statutes that address negotiated changes in other unique ways.

The Rhode Island and South Dakota statutes codify the typical practice in franchise registration states. These state statutes clarify that nothing in either act precludes the negotiation of terms of a franchise before it’s sold, nor do the acts require that a franchisor amend its disclosure document to negotiate with another prospective franchisee because of the previous change negotiated.

The Virginia Retail Franchising Act grants a franchisee a 30-day period in which to void its agreement with the franchisor if it “was not afforded the opportunity to negotiate with the franchisor on all provisions within the franchise, except that such negotiations shall not result in the impairment of the uniform image and quality standards of the franchise.”

41 Id, subsection (3).
43 Id., subsection (a)(4).
44 Id., subsection (a)(3).
45 Id.
Illinois’ franchise regulations reaffirm what the statute provides and states that “an amendment is not required when changes in the franchise agreement are made pursuant to negotiations between the franchisor and franchisee.” The text goes on to provide additional guidance, however, finding that in circumstances where “the same change is consistently made in additional consecutive franchise sales and it is a material change, it is considered to be a permanent change in the franchise agreement and an Amendment reflecting the change must be filed within the applicable time period.”

C. Financial Performance Representations

When recruiting more sophisticated prospects a franchisor may find itself wanting to disclose more information than may already be provided for in its Item 19 financial performance representation. If the franchisee and the location of the franchises to be developed are not within franchise registration states, the franchisor may wish to rely on one or more of the Franchise Rule exemptions discussed above and, therefore, not be confined solely to the financial information disclosed in its Item 19 representation. Although, in doing so, a franchisor must always be aware of other potential claims, including, misrepresentation and fraud claims and claims for violation of a state’s unfair and deceptive practice acts (commonly referred to as “Little FTC Acts”). To this end, a franchisor should still proceed with caution in ensuring that any financial representations made are not misleading, that they are representative of the type of franchises the prospective franchisee will operate, that there is a reasonable basis when made, and that there is written substantiation to the representations made.

If an exemption does not apply to the circumstance, however, or there is no exemption from disclosure in an applicable franchise registration state, the Franchise Rule does provide franchisors with the option of making supplemental financial performance representations based on variations. Such a variation might include, for example, multi-unit franchisee operations in the system or franchisees operating in the same or similar markets as those of the sophisticated prospective franchisee.

D. Additional Franchise Laws that May Impact a Franchisor’s Relationship With its Sophisticated Franchisees

The states of Hawaii, Illinois, Indiana, Minnesota, and Washington prohibit “discrimination” against “similarly-situated” franchisees. While it is true that cases asserting franchise discrimination claims are sparse, certain best practices have emerged and are followed by the cautious franchisor. First, franchisors should always operate under the assumption that any deal it makes with a franchisee will be discovered by others—even if such concessions are subject to confidentiality agreements. While it is true that a franchisee’s

49 16 C.F.R. § 463.5(s).
50 Id., subsection (s)(5). Any supplemental representation must be in writing; must explain the departure from the financial representation in the Franchise Disclosure Document; and be prepared in accordance with Item 19 requirements.
Various states also impose on franchisors a duty of good faith and fair dealing in their interactions with its franchisees. Whether a franchisee may rely on such implied covenants to bring a claim for disparate or discriminatory treatment—particularly where no statutory franchisee discrimination claim may be available—is not a settled area of law. However, they do provide franchisees with an additional possible cause of action to bring in circumstances where a franchisor showed more leniency, granted greater concessions to, or otherwise treated unequally certain system franchisees.

IV. KEY DRAFTING AND NEGOTIATION POINTS

The typical franchise relationship between the sophisticated franchisee (the “Whale”) and the franchisor will be focused on an eventual multi-unit relationship between the parties. The multi-unit relationship may come from standard multi-unit development, an area development relationship, or the acquisition of multiple single franchises. The Whale is looking to leverage its experience and resources to develop a critical number of units in one or more market areas. Its experience is generally as a multi-unit operator of a mature system that has a typical franchisor-oriented franchise agreement. The Whale’s experience with the mature system has colored its expectations as to the services and performance of a franchisor. It has also educated the Whale as to where points of tension can develop between a franchisor and franchisee—both contractual and operational. These experiences, together with the Whale’s desire to minimize its risk, protect its investment and maximize its upside, form the basis for the franchisee’s positions.

In this section we examine the key points of tension between the parties. These points of tension can guide a franchisor to prepare a set of documents that are more readily executable by a Whale or guide the franchisor through the negotiation of a new relationship with the Whale. We identify the franchisor’s position and the franchisee’s position and potential areas of compromise.

A. Structuring the Relationship

Franchisor: The franchisor is looking to show evidence of acceptance of the brand and demand for the concept through a Whale’s execution of a multi-unit or area development agreement and payment of up-front fees (notwithstanding that the fees may not be income for accounting purposes). This would allow the franchisor to evidence demand, acceptance and excitement for the brand by issuing a press release indicating that the Whale has signed a development agreement.

Whale: The Whale desires to “test the waters” with the brand. The Whale is looking to secure exclusivity to a defined territory and limit its financial commitment to develop and operate franchised units if the brand is not as successful as anticipated. At the extreme, the Whale may

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52 For purposes of this paper, this is an agreement where the Whale purchases the right to develop and operate multiple units without reference to territory.

53 For purposes of this paper, this is an agreement where the Whale purchases the right to develop and operate multiple units within a specified territory.
look to commit to develop units on a unit-by-unit basis without signing a multi-unit or area development agreement. Concurrently, the Whale will look to extract a commitment from the franchisor not to sell the Whale’s “territory” to a multi-unit or area developer.

**Solutions:** (1) Allow the Whale to develop on a single-unit basis with the franchisor agreeing not to enter into a multi-unit or area development agreement for a period of time. The franchisor may also grant the Whale a one-time right of first negotiation over development within a specified area or, although less favorable to the franchisor, a right of first refusal over development within that area.

(2) The Whale would sign a multi-unit or area development agreement requiring the development of the mutually agreed number of franchises and payment of fees. The agreement would allow for the Whale to terminate its commitment under multi-unit or area development agreement at certain intervals and/or upon the occurrence of certain objective facts, such as a certain number of units that have operated for a defined period failing to achieve an agreed economic objective. If the agreement is terminated, the franchisor would refund all or a portion of the development fee.

**B. Fees / Timing**

**Franchisor:** The franchisor is looking to collect its standard initial and ongoing fees from the Whale.

**Whale:** The Whale is looking to reduce its initial expenditures to enter into a relationship with the franchisor, lower or eliminate the initial fees payable over time, and fix fees and percentage rates that may vary over time.

**Solutions:** The franchisor may agree to reduce or allow multi-unit or area development fees to be paid over time. If the multi-unit or area development fee is in addition to individual unit fees, the franchisor may be more willing to reduce the amount of the fee or allow a portion to be paid upon signing and the remainder paid when individual units are opened. It may be more difficult to reduce initial fees that are payable upon signing a unit agreement. However, the franchisor may be willing to fix initial franchise fees that are payable when each franchise agreement is signed and agreed in order to make those fees payable upon opening rather than upon signing the franchise agreement. Further, the franchisor may be willing to fix the royalty rate, the maximum advertising fee payable, and other recurring fees.

**C. Development Schedules; Flexibility**

**Franchisor:** A standard multi-unit or area development agreement will require the Whale to develop, and thereafter operate, a specified number of outlets in accordance with an agreed schedule. In a highly competitive business landscape, obtaining prime real estate for franchised outlets is key to market development and penetration. Therefore, the franchisor wants the Whale to develop and operate as many units as possible, as quickly as possible. The franchisor’s development agreement will require the development of a specified number of units no less frequently than annually and, in many instances, require the Whale to obtain real estate more frequently. Thus, if the franchisor and the Whale were to enter into a development agreement for 10 outlets over 5 years, then the development schedule would specify, at a minimum, annual and cumulative numbers of outlets that the Whale would be required to develop and thereafter operate.
Whale: Again, the Whale is aiming to limit its risk, allow for maximum flexibility and the exercise of its judgment. The Whale will negotiate the development schedule so that the fewest number of units are required to be developed, if any, early and the greatest number of units are required at the end of the schedule, if not all of the required units. Thus, if the Whale is entering into a 10 outlet, 5 year development agreement, the Whale would first ask for all 10 units to be due at the end of the 5 year period and no interim development deadlines.

Solutions: A franchisor may allow development of certain units to be delayed. This may be accomplished through a “month bank” that allows the Whale to push back development deadlines for up to an agreed maximum number of months. The “month bank” may be used in single-month increments or all at once. If the Whale and franchisor have agreed that a certain number of units must be developed in sub-areas within a specified territory, the franchisor may allow some units to be moved from one sub-area to another. In cases where a Whale has a right (or right of first refusal) to develop units in non-traditional locations, the parties may agree that these locations, which are not typically counted toward the development schedule, count toward the development schedule. Whales may also want to have some flexibility to close units. If the franchisor and the Whale agree that the Whale may close units (whether because they are unprofitable or otherwise), then the franchisor may agree that closed units may count for a certain period of time following closure – this could be for a defined period of time or for the duration of the development schedule (particularly when the unit has been open for a number of years).

D. Term / Renewal

Franchisor: A standard multi-unit or area development agreement will specify that the agreement is for a term of years and may allow the Whale to renew the agreement for an additional term if a development schedule for the renewal term can be agreed upon. Similarly, a standard franchise agreement will be for a specified term and provide that it may be renewed for one or more additional terms. In both cases renewal will be subject to the satisfaction of a number of conditions, including execution of then-current forms of agreement, upgrades and updates to the outlets, execution of a general release in favor of the franchisor, and payment of a renewal fee.

Whale: The Whale is looking to maximize and protect its long-term investment. Some Whales request perpetual renewals and negotiate to limit or eliminate potentially problematic renewal conditions such as the requirement to deliver a general release.

Solutions: The parties may agree to extend renewal terms, though a perpetual renewal is not advisable. The parties may also agree that if a renewal term for a multi-unit development or area development agreement is not agreed upon, the franchisor may not enter into an agreement with a third party for a specified number of years that provides for the development of a fewer number of units. The Whale will also look to eliminate or limit the conditions to renewal, such as requirements that the Whale not have defaulted (or defaulted multiple times), deliver a general release, or an unlimited remodeling or re-fresh requirement.

E. Forms of Agreement / Locking in Terms

Franchisor: The standard forms of agreement (whether multi-unit, area development or unit franchise) will require the Whale to sign the then-current form of applicable agreement at each inflection point – renewal of a multi-unit or area development agreement; execution of a new franchise agreement; and renewal of an existing franchise agreement.
Whale: The Whale will want to eliminate the requirement to sign then-current forms of agreement at renewal or upon execution of a unit franchise agreement; this will solidify the forms of agreement and the Whale’s negotiated changes for the course of the relationship.

Solutions: In order to bridge the gap between the franchisor’s position and the Whale’s position, the franchisor and Whale may agree to preserve or require certain terms to be included in the agreements that will be signed in the future, notwithstanding that the parties sign the then-current forms of agreement.

F. Territory / Exclusivity

Franchisor: The standard forms of agreement (whether multi-unit, area development or unit franchise) will provide a narrow grant of rights to the Whale and reserve all rights not granted to the Whale. The franchisor will agree not to develop an identical business within the Whale’s protected territory. The franchisor usually reserves the right to operate and franchise a competitive business at any location, sell products into or through other channels of distribution, operate and franchise the same business at specified categories or types of locations (such as airports, stadiums, etc.), and operate or conduct all other businesses not specifically prohibited in the agreement. Some franchisors that have multiple formats of the same brand (for example, a full-service pizza restaurant and a to-go version only) will reserve the right to operate the other format in the Whale’s territory.

Whale: The Whale will look to prohibit the franchisor from operating or franchising any other business in the Whale’s territory. Depending on the type of franchise (e.g., an ice cream shop), the Whale may also seek to prohibit the franchisor from also selling into alternative channels of distribution in the Whale’s territory.

Solutions: The franchisor may offer the Whale any of the following: (a) a right of first refusal to obtain franchises for non-traditional locations, (b) a right to distribute products in the Whale’s territory in certain alternative channels of distribution, or (c) a right to share in the franchisor’s revenue from sales into alternative channels of distribution in the Whale’s territory.

G. Supply Chain

Franchisor: The standard form of unit franchise agreement will allow the franchisor to control substantially all of the material ongoing purchases by the Whale to operate the franchise. The franchisor will require this to maintain brand consistency. The franchisor may also be the sole supplier of certain items to the Whale.

Whale: A Whale that has an existing complementary business will want to leverage that experience for the new brand. The Whale will want to have flexibility with its suppliers such that the Whale is not compelled to purchase product from the franchisor’s supplier at a price that is higher than what the Whale can obtain for the same or similar product through its own supplier. If the franchise system is one where franchisees must purchase goods from the franchisor or its affiliate, a Whale will want to establish the pricing schedule for those products. The Whale does not want to purchase product from the franchisor or its affiliate at a significant mark-up and pay a royalty on gross sales of that product – this leads to the franchisor “double dipping.”

Solutions: An early-stage franchisor can easily address the Whale’s concerns over the system’s supply chain. Such a franchisor would agree to reasonably consider the Whale’s proposed suppliers and their products. Later-stage franchisors may have more difficulty
addressing the Whale’s concerns over the supply chain, because of agreements for national distribution with the suppliers. However, flexibility may be available for specialty products or products that may be available locally at a lower cost. Similarly, the franchisor and Whale can agree in advance regarding pricing – including non-discrimination, limitations on price increases that are disproportionate to cost increases, and rights to use alternative products, if the franchisor cannot supply products or the costs are increased in a way that is materially greater than the increase in costs.

H. Development/Construction

Franchisor: The standard forms of agreement (whether multi-unit, area development or unit franchise) will provide that the Whale must develop its outlets at locations approved by the franchisor and in accordance with the franchisor’s specifications. The unit franchise agreements will also require periodic updating, remodeling and “refreshing” of the franchised outlet. The franchisor will also require the Whale to maintain the outlet in accordance with standards. The agreements will also require the Whale to obtain the approval of the franchisor for various third-party consultants, contractors and suppliers used to locate, construct and remodel the franchised outlet.

Whale: The Whale will look to curtail and influence (and to some extent override) the franchisor’s contractual controls over development and construction because of its perceived or actual superior knowledge and resources. The Whale will also look for agreements to limit or eliminate provisions that result in a deemed rejection of a submission by the Whale. Likewise, the Whale will look to eliminate provisions that allow the franchisor to use its sole discretion. Whales will also look to have flexibility to use its contractors and third-party advisors for development and construction rather than the franchisor’s designated or pre-approved suppliers. On an ongoing basis, the Whale will look to limit its expenses for capital improvements, remodeling, and “refreshing.”

Solutions: If the Whale is an experienced multi-unit developer, including reasonableness provisions regarding site selection, selection of professionals, and selection of contractors and other vendors may satisfy the Whale’s concerns. The franchisor may also be willing to allay a Whale’s concerns over open-ended agreements to upgrade, remodel, or refresh franchised outlets by placing cost and/or frequency limitations on these requirements. The franchisor may also agree to further limit capital expenditures separately from other upgrading or remodeling requirements.

I. Rebates

Franchisor: The franchisor will reserve the right to obtain rebates or other benefits based on system performance or purchases.

Whale: The Whale does not want its purchases to be a profit center for the franchisor or allow the franchisor to obtain other benefits based on franchisee purchases – all of which are ostensibly obtained at the Whale’s and other franchisees’ costs.

Solutions: The franchisor can agree that cash rebates will be contributed to the marketing or advertising fund or otherwise used for the system as a whole.
J. Menus / Product Offering and System Change

Franchisor: A franchise agreement usually gives the franchisor complete control over menu and product offerings and can change menu and product offerings at its discretion. Similarly, the agreements usually allow the franchisor to implement other aspects of system change at its discretion. The franchisor may impose changes to systems and menus without testing for market acceptance.

Whale: The Whale’s goal to protect its investment and maximize profitability will lead to the Whale demanding flexibility to change offerings to adapt to local customs and tastes. The Whale will also resist a franchisor’s right to unilaterally impose changes to product offerings and systems, and will further resist having to adopt untested new product offerings and system changes or product offerings and system changes that have not been adopted by the franchisor and its affiliates for its corporate stores and by the franchise system.

Solutions: The franchisor may be amenable to relaxing its unilateral rights to set and change menu and product offerings for the well-entrenched and experienced Whale. The franchisor may want to agree to a reasonableness standard for rejecting Whale-suggested changes to the menu or particular menu items (e.g., recipe changes). The franchisor may also permit the Whale to add or remove menu items that appeal to the local consumer. With respect to system change, the franchisor is unlikely to agree to only impose system change on the Whale if the change has been tested and adopted by the franchisor and/or some minimum number of units. The more likely solution is that the franchisor will not impose system change only against the Whale.

K. Staffing and Operational Issues

Franchisor: The franchisor’s standards will usually identify the required staffing for the franchised outlet. Many franchisors also require certain managerial (and higher-level) staff to be dedicated to the franchised brand and possibly to a certain number of franchised units. Franchisors may also require certain managerial-level staff to own an equity interest in the franchisee.

Whale: The Whale will negotiate for flexibility in its staffing of franchised outlets. The Whale will not want the franchisor to require specified levels of staffing or managerial involvement. The Whale will also negotiate for flexibility in granting or not granting managerial or more senior employees an equity interest in the franchise. As noted below, where the Whale operates the franchised outlet in close proximity to another of its businesses it may look to share staff or managers.

Solutions: The franchisor will likely eliminate all requirements that the unit-level staff own an equity interest in the Whale or franchise operation. The franchisor may allow certain management to be shared among the Whale’s other brands if an appropriate level of supervision may be provided by the shared management.

L. Cobranding / Joint Branding

Franchisor: The standard forms of agreement (whether multi-unit, area development or unit franchise) will prohibit the Whale from developing the franchised unit with another franchised or non-franchised brand.
**Whale:** The Whale is looking for maximum flexibility to take advantage of opportunities that are presented to it without having to obtain the franchisor's consent. These opportunities may include constructing two or more complementary concepts under the Whale’s control in neighboring premises or within the same premises. The Whale may also look to share staff among franchised outlets under its control, whether those outlets are within the same premises or adjacent to one another.

**Solutions:** A franchisor may relax its discretionary approval process and impose a reasonableness standard on approvals of joint, yet separate, development of concepts franchised and operated by a Whale. Typically, the franchisor will prohibit a joining or cobranding of the two separate concepts.

### M. Exit Strategy / Resale / Permitted Transactions

**Franchisor:** The standard forms of agreement (whether multi-unit, area development or unit franchise) generally restrict transfers by the franchisee. The restricted transfers are broad and require the franchisor’s consent before being concluded. Without the franchisor’s consent, a franchisee is not permitted to directly or indirectly sell, assign, or encumber the franchise or the business entity that owns the franchise. In some instances, transfers of less than a certain percentage (e.g., majority or less) of the equity will not be a “transfer” under the franchise documents. Transfers are subject to the franchisor imposing numerous conditions, including the payment of fees and the delivery of general releases.

The franchisor may also include a “roll-up” or right to purchase the franchised business on the occurrence of certain events. The pricing for the “roll-up” may be subject to negotiation, but is typically a multiple of EBITDA. This right to purchase the franchise will be in addition to the franchisor’s right of first refusal that is triggered on a transfer by the franchisee and a right to purchase the franchise on expiration or termination.

**Whale:** The Whale will want flexibility in its ownership structure and to maintain the ability to finance its venture as it deems appropriate. Similarly, the Whale will want flexibility to engage in “permitted transfers” – transfers among owners of the franchise entity, transfers to employees, and transfers (pledges or encumbrances) for debt financing purposes. The Whale will also negotiate to eliminate rights to purchase the franchise during the term or upon termination or expiration.

**Solutions:** (1) Whales that are institutional owners (e.g., large foodservice companies) may be permitted to experience a “change of control” that does not trigger the assignment provisions of the franchise documents. (2) Whales that are not institutional owners may be permitted to transfer partial ownership, but not control, of the franchise entity for estate planning purposes, provided that the applicable principals remain in control of the franchise entity. (3) Depending on the franchisor’s system, the franchisor may be willing to provide that its right to purchase the franchise business at expiration or termination will be based on an adjusted fair market value basis rather than book value or other valuation methodology that could result in a less than fair market value purchase price. (4) Some systems are designed for the likely franchise buyer to be the franchisor, or the system is designed such that the franchisor may “roll up” the franchisees to allow for a liquidity event for the franchise system. In the circumstance where the franchisor is “rolling up” the franchised outlets, the franchisor could base the purchase price on a multiple of EBITDA that is less than the franchisor’s multiple in its liquidity event, but equal to or more than what the Whale could sell the unit for on the open market.
N. Financing / Inter-Creditor Agreements

Franchisor: As between the franchisor and Whale, the franchisor is not involved in the Whale’s financing plans or arrangements. Moreover, a typical franchise agreement prohibits the Whale from using the franchise as security for repayment of the loan.

Whale: The Whale is looking to obtain financing at the lowest available cost. Depending on the size of the financing and the nature of the relationship between the Whale and the lender, the lender may desire to secure the Whale’s debt with the franchise – thus adding collateral for the lender to seek. A lender may also look to enter into a contractual relationship with the franchisor whereby the franchisor will provide notice to the lender of any defaults by the Whale.

Solutions: A franchisor may be able to get comfortable with the Whale using the franchise agreement as security for the Whale’s financing, if the franchisor and lender enter into an agreement – sometimes called an intercreditor agreement or comfort letter – that will govern the circumstances surrounding the Whale’s default of the loan documents and the lender’s exercise of its security interest. The franchisor will want to obtain notice of the Whale’s default of the loan documents and, similarly, the lender will want notice of a default of the franchise agreement and an opportunity to cure the default. The lender and franchisor may also be able to negotiate a relationship where, among other things, the franchisor will manage the franchise for the lender for a fee, the franchisor will asset the lender to sell the franchise, and the lender will be responsible for curing defaults.

O. Owner Involvement / Management

Franchisor: Many franchisors require personal involvement and management of the franchise by an owner of the franchise. In some instances, the franchisor may require the franchise manager to have a minority equity interest in the unit(s) that the manager supervises.

Whale: The Whale is looking for flexibility in its equity arrangements and to avoid any requirement that a certain minimum amount of equity must be held by a manager or other person(s) in management.

Solutions: A franchisor may agree to reduce or eliminate equity requirements for unit managers and allow for the Whale to have greater flexibility in its equity relationships.

P. Defaults / Cure / Cross-Default

Franchisor: The typical multi-unit development and area development agreements and franchise agreements will contain numerous provisions that result in specific defaults. Some of those provisions will provide that the franchisor may terminate the agreement without giving the franchisee an opportunity to cure and immediately with or without notice (depending upon the circumstance). The franchise documents may also provide a limited number of defaults (usually payment and operational) where the Whale will have the opportunity to cure the default. Frequently, all of the franchise agreements will include cross-default and cross-termination provisions such that a default of one agreement is a default of all of the agreements and if one agreement is terminated all of the agreements may be terminated. In some instances, franchisors provide that a development default under an area development or multi-unit development agreement is not a default that would trigger a cross-default.
**Whale:** The Whale will want the opportunity to cure virtually all defaults in order to protect its investment. The Whale will strongly resist cross-defaults and cross-termination provisions because these provisions allow a franchisor to terminate, or at least threaten to terminate, the Whale’s entire operation. Thus, potentially causing the loss of the Whale’s entire investment.

**Solutions:** The franchisor should review the defaults in its documents closely, looking at the nature of the default, evaluating its materiality and whether it can be cured, and the potential duration of the cure period required to effectuate the cure. In some instances, language can be added that will allow for an extended cure period if the Whale is diligently prosecuting the cure. In many instances, the franchisor will remove the cross-default and cross-termination provisions in their entirety or severely limit the application of such clauses to only egregious and repeated defaults.

Q. **Indemnification**

**Franchisor:** The area development and multi-unit development agreements and franchise agreements typically require full indemnification by the Whale for claims relating to the operation of the franchised business. Franchise agreements may also provide limited indemnification in favor of the Whale if the Whale, while using the franchisor’s trademarks as authorized, is accused of trademark infringement.

**Whale:** The Whale will ask for reciprocal indemnification by the franchisor, which may include protection from damage to the brand, and full and unconditional indemnification from trademark infringement.

**Solutions:** The franchisor is unlikely to provide broad reciprocal indemnification. However, in many instances the Whale’s request may be satisfied by excluding the franchisor’s gross negligence from the Whale’s indemnification obligation.

R. **Non-Competition Covenants**

**Franchisor:** The franchisor will provide that neither the Whale nor any of its affiliates or related parties can compete with the franchised business, directly or indirectly, during the term and for a period of years following the term.

**Whale:** The Whale’s objective is two-fold. First, the Whale must ensure that its existing business operations do not cause an immediate breach of the new franchise documents. Second, the Whale will want to ensure flexibility so that its existing and future businesses do not conflict with the new franchise documents.

**Solutions:** As further discussed in Section V.A. of this paper, the parties may be able to agree to modifications to the non-compete so that the core of the franchisor’s business is protected but that the Whales pre-existing operations do not violate the non-compete. For example, the franchisor and Whale may agree that the Whale’s existing concepts are specifically permitted (or excluded from the coverage of the non-compete). In addition, the franchisor and Whale may agree to limit the definition of competitive activities, such that only businesses that feature the core business are covered by the non-competition provisions. For example, a coffee franchise may provide that a business that generates more than 33% of its revenue from the sale of coffee will be covered by the non-compete. Accordingly, if the Whale
had existing restaurants, those restaurants, even if they serve coffee, would not be covered by the non-compete.

S. Dispute Resolution

Franchisor: Disputes are resolved either in court or by arbitration proceeding. The decision of the forum for resolving disputes is complex. Typically, the franchisor will not negotiate its choice of forum. Frequently, the franchisor will include provisions that are one-sided, such as the franchisor’s right to seek and obtain attorneys’ fees if it prevails, and the ability for the franchisor to seek and obtain injunctive or other provisional relief. The franchisor may also include a shortened limitations period for bringing claims.

Whale: The Whale is looking to preserve its investment and protect itself from one-sided provisions that favor the franchisor or put the Whale at a disadvantage. Because potential franchise law violations and other pre-signing inaccuracies may only reveal themselves after operating the franchise for some time, the Whale will also want to ensure that the contractual limitations period is long enough that it will have time to bring claims after it has operated the franchise for some time.

Solutions: In order to avoid costly litigation, the franchisor and the Whale may agree to mediate disputes prior to either party bringing a claim. The Whale will also require mutuality of provisions, such as availability of provisional remedies and attorneys’ fees being awarded to the prevailing party. Further, the Whale will require the elimination of contractual elimination periods or extending those beyond a short period following execution of the franchise documents.

T. Guaranties / Security

Franchisor: The franchisor wants to keep the franchisee’s principal(s) “up at night.” The franchisor will typically require full guarantees of payment and performance by the Whale’s principals and the affiliates of the franchisee entity. In some instances the franchisor will ask for an alternative method of security, such as a letter of credit.

Whale: Again the Whale is looking to limit its downside and risk. The Whale will ask to eliminate the guarantee in its entirety or reduce the liability over time.

Solutions: The franchisor may be willing to limit the guaranty in various respects. The franchisor may limit the guaranty to monetary matters only (e.g., no guaranty for operational defaults). The monetary aspects of the guaranty may also be limited by imposing a cap, a cap that declines over time, or by allowing the guaranty to expire after there is confidence that the Whale can operate successfully and has sufficient other resources to support the franchise.

V. SPECIAL ISSUES: POST-SIGNING

A. Multi-Concept Issues/Competition Considerations

As discussed above in Sections II.B. and IV.R. discussing multi-concept operators and private equity firms, these types of franchisees are likely to desire to operate franchises or businesses in the same industry that may be competitive. Depending on the exception being requested and the franchisor’s level of sensitivity to modifying non-competition provisions, it may be necessary to limit the non-competition provisions or create carve outs for the non-
competition provisions. The carve outs could include certain geographic areas or business segments. In these situations, the franchisors will need to weigh the risks. There are real risks that multi-concept operators and private equity firms that operate businesses in the same space as the franchisor’s franchise system will transfer knowledge from the franchise system to other businesses.

There may also be requests to modify the confidentiality provisions in the franchise agreement. Adjustments are likely necessary if all investors will need to sign confidentiality agreements. With those changes, the franchise agreement should be modified to restrict confidential information from being provided to investors that are not signatories to the franchise agreement or not directly involved in the business.

### B. Influence on System and Brand Development and Influence on the Culture of the Franchisor

Whales in a franchise system will generally have significant influence with the franchisor. Franchisors will often have whales sit on councils, committees and boards for the franchise system and whales are often tapped to do trials or tests before products, services or equipment are rolled out to the franchise system. Marketing decisions are another area where whales can have a significant amount of influence within a franchise system. Franchisors need to be mindful that whales have certain economies of scale and other advantages over individual or small franchisees (e.g., flexibility to adjust inventory and staff between units based on market conditions). Decisions for the franchise system should take into consideration both large and small franchisees who do not have the advantages of whales. If a franchisor anticipates potential issues related to a multi-unit franchisee’s influence on councils and committees, it may structure voting rights to equalize franchisee input.

If a franchise system is small and a whale(s) makes up a significant part of the franchise system, it is not uncommon for such a whale(s) to expect to have substantial input in how the franchise system operates. Whales may concede that the franchisor owns the franchise system, but whales will assert that have invested in the system and have the most to lose. The small franchisor will need to make sure the desire for input by a whale does not turn into a desire to control the franchise system. Even if a franchise system consists of one or more whales that make up a significant part of the franchise system, the franchisor needs to retain the ultimate right to control the franchise system and do what is in the best interest of the franchise system. It is important for a franchisor to establish boundaries early on in the relationship with whales so that it is understood that any input and advice that is solicited by the franchisor will be considered but the ultimate decision will rest with the franchisor.

### C. Extraction of Ongoing Concessions

Most whales will seek to use their status in the system to obtain preferential treatment from the franchisor. This may include preferential treatment like the development incentives discussed above and other things like (i) permission to close or relocate units, (ii) granting exclusive areas, (iii) approving units in desirable development areas, (iv) providing favorable payment terms, (v) approving franchise agreement terms contained in prior versions of the franchise agreement, (vi) offering positions on councils and boards for the franchise system, and (vii) approving develop schedule extensions.

Groups of whales may also look to extract concessions or preferential treatment from the franchisor. These may include (i) agreements on the form of the agreement, (ii) length of the
then-current term of the franchise and any renewal terms; (iii) restrictions or limitations on obligations to refresh or remodel the franchised business. There are risks to the franchise system if broad based concessions are made to the entire system or groups of Whales. For example, if Whales extract cost or adoption limitations on remodels or refreshes of the franchised (e.g., that the Whale must only remodel or refresh if a certain percentage of the system or the franchisor-owned units have already performed the remodel or refresh), then the franchisor will be forced to require some groups of franchisees to adopt the change where others are not required to do so until the early groups adopt the change. This can create timing issues and undue strains in the franchisee community and between the franchisor and its franchisees.

D. Defaulting or Terminating a Large Franchisee

If a single whale holds a large number of units, a franchisor may be reluctant to enforce policies and agreements against that whale. If the whale refuses to comply with franchisor’s policies or agreements, franchisor may not be willing or even able to terminate and would therefore be placed in an uncomfortable position. If a franchisor is unwilling to formallydefault a whale, in certain circumstances, it may elect to use other incentives to encourage compliance. The decision to ultimately terminate a large whale, however, is riddled with special issues, including: a) the potential loss of an entire market, b) the possibility that the terminated whale may sell its assets to a competitor, thus turning over the market to a competitor, c) a lawsuit brought by a party who can bankroll a substantial suit, and d) the whale’s ability to break away from the system and operate as an independent, particularly in those jurisdictions where franchisors are not able to enforce post-term non-competition provisions.

E. Consolidation of System into Large Franchisees

A franchisor with a franchise system made primarily of whales has benefits and risks. Operating the franchise system can be easier with these type of franchisees. Generally, a whale (i) requires less support and guidance, (ii) takes more responsibility for cascading training within their organization, (iii) is better capitalized, (iv) is unlikely to become complacent and satisfied with not improving performance, and (v) will bring strong financial and business skills to the table.

Although there are many reasons why whale consolidation is good for a franchise system, there are several drawbacks to dealing with whales. Whales will generally have the resources to litigate with a franchisor in the event of disputes. Having an ongoing litigation dispute with a whale that makes up a large percentage of the franchise system can be as disruptive as having a class action with a significant portion of a traditional franchise system consisting of smaller franchisees. Also, events like a bankruptcy of a whale will have a significant impact on the franchise system if the large franchisee represents a significant portion of the franchise system. The loss of a whale with a significant number of units through bankruptcy or some other exit from the franchise system can have a negative impact on the entire franchise system. Such a loss can (i) significantly decrease the overall size of the franchise system (impacting the franchise system’s market presence, market share and ability to get volume discounts); (ii) hinder franchise sales; (iii) decrease unit resale values; (iv) decrease the advertising funds’ budget; and (v) decrease the franchisor’s royalty stream. Accordingly, the health and welfare of the franchise system can be tied to a whale(s) in the franchise system. A franchisor relying on a whale(s) needs to be prepared to deal with contingencies that may result from the loss of a whale(s).
When considering whether to issue a default notice to a whale (even for payment defaults), the franchisor must carefully evaluate and weigh the options because of the potential impact. Usually, franchisors are more patient and tolerant of defaults committed by whales. It is unclear how serious a default and how long such default would have to continue before most franchisors would terminate a whale whose units consist of a major portion of the franchise system.

In the case of a whale that is a private equity firm, it is possible for the private equity firm to become focused on gobbling up the franchise system through the acquisition of units from small franchisees. This situation could be hard to prevent without specific language in the franchisor’s franchise agreement. The franchisor may have a right of first refusal but this may be of limited value if (i) the franchisor does not desire to operate units, (ii) does not have the capital to match the private equity fund’s acquisition appetite, and/or (iii) does not wish to match the purchase price premiums that the private equity fund is willing to pay small franchisees.

A franchisor may seek to develop a policy related to how much of the franchise system can be owed by a whale(s). This type of policy may be easy to enforce if the whales are focused on developing new units that require the franchisor to grant new franchise rights. However, when a whale seeks to grow through acquiring units from other franchisees, it is more difficult to control the whale’s growth and it would generally be done through denials of transfer requests. Although beyond the scope of this paper, the most common standard for approving or denying consent to a transfer is that the franchisor must be reasonable.54 It can be difficult finding reasonable grounds to deny a transfer to an existing franchisee, unless the existing franchisee is in default, has operational issues or does not meet the financial qualifications. A franchisor seeking to limit the growth of whales through transfers should include very specific transfer language in its franchise agreement that (i) gives the franchisor sole and unlimited discretion in approving or denying transfers; and (ii) permits the denial of a transfer to a franchisee who has a certain size within the franchise system.

VI. CONCLUSION

Growing a franchise system through franchising to Whales has substantial benefits and we believe that franchising to Whales will continue to be an important source of growth for franchise systems seeking fast and substantial growth. The various types of Whales that are interested in becoming franchisees has expanded and will likely continue to expand as franchising becomes even more popular. However, franchisors growing through Whales need to be mindful of the risks and challenges of working with Whales and how Whales can impact the franchise system. Entering into franchise relationships with Whales should be done with full awareness of the risks and challenges. When Whales are present in a franchise system, franchisors must be prepared and dedicated to managing these relationships if the Whales make up a significant portion of the franchise system.

When a franchisor seeks to recruit Whales, the franchisor will need to be prepared to (i) sell to a more sophisticated prospective franchisee, and (ii) negotiate and/or make agreement changes to address concerns particular to Whales. In these negotiations, the franchisor must not focus solely on the growth opportunity to the exclusion of maintaining a balance of power so that the franchisor retains necessary controls to lead the franchise system. There are a myriad

of legal and business issues raised in connection with franchising to Whales and all of these issues need proper consideration before embarking on a franchise relationship that will last many years.
MARAL KILEJIAN

Maral Kilejian is counsel at Haynes and Boone, LLP. Prior to joining Haynes and Boone, Maral was a partner in a franchise law firm in Dallas, Texas named Mullin Russ Kilejian PC. Her practice focuses on franchise and distribution law, trademark law, and advertising and promotional law. Maral routinely represents franchisors and multi-unit franchisees across various industries.

Maral provides practical counsel and legal support to franchisors in the structuring and operation of domestic franchise programs and international expansion, franchise regulatory compliance, non-traditional venues, alternative distribution channels, managing franchisee relationships, crisis management, operations manuals, marketing-related legal issues, development and implementation of social media policies and guidelines, trademark matters, and nation-wide and international sweepstakes and contests.

Maral is an active member of the American Bar Association’s Forum on Franchising, a Topics and Articles Editor for the Franchise Law Journal, and from 2013 to 2015 served on the Forum’s Diversity Caucus’s Steering Committee. Maral has given presentations at conferences held by the International Franchise Association, and has spoken and written regularly on franchise issues at both local and national venues.

Maral holds a J.D./M.B.A from the University of Houston Law Center and Bauer School of Business and also speaks French and Armenian.

GERALD WELLS

Gerald Wells is General Counsel, Secretary and Director for the Dessange Group North America, Inc. and its subsidiaries (including the franchise brands Dessange Paris salons and spas, Camille Albane salons and Fantastic Sams salons). Mr. Wells was previously a partner in the Washington office of Quarles & Brady and a partner in the Atlanta office of DLA Piper LLP (US). Mr. Wells has also worked in the legal departments of Hewlett-Packard Company and US Office Products Company, where he served as Senior Corporate Counsel. US Office Products Company was the parent company for several companies, including two franchise companies. He has been recognized in the Best Lawyers in America®, the International Who’s Who in Franchise Law, and as a Legal Eagle” by Franchise Times. Mr. Wells has written articles and spoken on franchise law at various venues.

Mr. Wells received his B.A. degree from the University of Maryland, and his J.D. degree from the College of William and Mary. He served as a law clerk to the Honorable Hart T. Mankin of the United States Court of Appeals for Veterans Claims. Mr. Wells is admitted to practice in the District of Columbia, Georgia, and Maryland. He is a member of (i) the Maryland State Bar Association Committee on Franchising and Distribution Law (1995 to present, and its Secretary 1999 to 2000), (ii) the State Bar of Georgia Franchise and Distribution Law Section (2008 to present, and served most recently as Vice Chair) and (iii) the Steering Committee for the Forum's Corporate Counsel Division (2015 to present).
TONY MARKS

Tony Marks is certified by the California State Bar Board of Legal Specialization as a Franchise and Distribution law specialist. Tony counsels clients in the spectrum of franchise and distribution law, including structuring new domestic and international franchise and licensing programs, franchise registration and disclosure matters, terminating and renewing franchise relationships, negotiating complex multi-unit transactions and transfers, and assessing the applicability of federal and state franchise and business opportunity laws.

Tony also counsels start-up and growth businesses in a broad range of transactional matters, including initial formation and capitalization, licensing, venture capital financing, debt financing, intellectual property protection and licensing, stock and asset acquisitions and divestitures, and strategic transactions. He regularly acts as outside general counsel for clients in connection with a broad range of day-to-day corporate and commercial transactions.

Tony has authored and co-authored, or contributed to, articles and seminar materials on numerous franchising and corporate matters. He has spoken at the International Franchise Association’s Annual Legal Symposium and Annual Convention, and other franchise law-related meetings and training sessions. He is also a former Commissioner of the Franchise Law Advisory Committee of the California Bar’s Department of Legal Specialization and a former co-chair of the California Bar Association franchise law committee. Tony was named as a “Best Lawyer in America” for franchise in 2013-2015, a 2006-2011 Southern California “Rising Star” by Law & Politics, and a 2013-2015 Southern California Super Lawyer by Law and Politics.