Issues in Growth by Multi-Unit Franchising

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In this article, we explore the main issues in growth by multi-unit franchising, including the unique contours of the main types of multi-unit franchising and the main challenges we see in this area. After discussing what multi-unit franchising is in Section I, we explore why it is attractive to franchisors and franchisees in Section II. We delve into typical issues and challenges faced by franchisors engaging in multi-unit franchising in Section III, and then look at various issues from the multi-unit franchisee's perspective in Section IV, before concluding in Section V.

I. What Is Multi-Unit Franchising?

Multi-unit franchising as a method of growing a franchise system can take many forms. The three most common forms of multi-unit franchising are (1) multi-unit development (also known as area development, and in which the franchisee is often referred to as the multi-unit developer, area franchisee, or regional developer); (2) master franchising (also known as sub-franchising); and (3) area representative franchising (where the franchisor contracts with an "area representative," also known as a development agent).[1] As these three forms and their permutations have already been described in

1. To be clear, these possibilities are not the only types of multi-unit franchising, but, based on a review of the existing literature and the authors' experience practicing in this field, are certainly the most common. We do not discuss here certain other forms of franchising growth strategies that may or may not involve multiple units, such as joint ventures, bulk conversions of franchisees from other franchise systems, refranchising, or management contracts. We also do not discuss here multi-brand franchising. For discussion of these alternatives, *see*, *e.g.*, Leslie Curran, Craig S. Prusher & Jayne Westlake, *Growth Through Multi-Unit Franchising*, ABA 32nd Ann. Forum on Franchising, at 16–22 (W-5) (Oct. 14–16, 2009).

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the existing literature[2] at length, we will only briefly define them here before getting into the particular issues that they involve.

The North American Securities Administrators Association (NASAA) describes each of these types of multi-unit franchising as follows:

- Multi-unit development (area development) "involves a person that is granted, for consideration paid to the franchisor, the right to open and operate multiple unit franchises, generally within a delineated geographic area."
- Master franchising (subfranchising) "involves a person that is granted, for consideration paid to the franchisor, rights related to granting unit franchises to third parties, generally within a delineated geographic area."
- Area representation "involves a person that is granted, for consideration paid to the franchisor, the right to solicit or recruit third parties to enter into unit franchise agreements with the franchisor, and/or to provide support services to third parties entering into unit franchise arrangements with the franchisor."[3]

II. The Trend Toward Multi-Unit Franchising: Why Is It So Attractive?

Single unit franchising has historically been the face and the bedrock of the franchising industry since its inception. Under the standard single unit franchise model, a franchisor grants a franchisee the right to open and operate one franchised outlet at a specific location, using the franchisor's trademarks and operating system to offer and sell the franchisor's products and/or services to customers located within a defined territory. However, according to a recent study, 76% of the nearly 13,000 top brand franchised outlets are

2. Various published research and writing about multi-unit franchising, both in the franchise legal literature and elsewhere, goes back decades. *See*, *e.g.*, Dan Monaghan, Fraser Clarke & Andrae Marrocco, *Multi-Unit and Multi-Brand: The New Trend in Franchising*, Canadian Franchise Ass'n CFA Annual Law Day (Sept. 27, 2018); Harris Chernow, Edward Levitt & Tom Wells, *Have Multi-Unit and Multi-Brand Franchisees Set a New Standard for Franchisors?*, Int'l Franchise Assoc. 51st Ann. Legal Symposium (May 6–8, 2018); Jason Daley, *The Unique Challenges and Benefits of Multi-Unit Franchising*, Entrepreneur, July 19, 2013, https://www.entrepreneur.com/article/226763; Lane Fisher & Max Staplin, *Planning Ahead: Creating and Enforcing Mandatory Development Schedules in Area Development, Area Representative, and Master Franchise Relationships*, 33 Franchise L.J. 49, 70 (2013); Will K. Woods & Sarah Yatchak, *Fundamentals 201: The Art and Science of Drafting Multi-Unit Development Agreements*, ABA 35th Ann. Forum on Franchising, (Oct. 3–5, 2012); Leslie Curran, Craig S. Prusher & Jayne Westlake, *Growth Through Multi-Unit Franchising*, ABA 32nd Ann. Forum on Franchising (W-5) (Oct. 14–16, 2009); Brian H. Cole & L. Seth Stadfeld, *Representing and Dealing with Multi-Unit Franchisees: Does Size Really Matter?*, ABA 31st Ann. Forum on Franchising (W-23) (Oct. 15-17, 2008).

3. N. Am. Secs. Admins., Multi-Unit Commentary (Sept. 16, 2014) [hereinafter NASAA Multi-Unit Commentary], http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf.

owned by multi-unit franchisees.[4] Clearly, the multi-unit franchising model has been a growing phenomenon over the last couple of decades. But why?

A. *Advantages of Multi-Unit Franchising from the Franchisor's Perspective*

1. Accelerated Unit Growth with Limited Number of Franchisees

One of the foremost—if not the foremost—reason why the multi-unit franchising model has become more attractive to franchisors is the possibility of aggressive, accelerated unit growth with a limited number of franchisees and, more importantly, with limited franchisor investment. With an increase in multi-unit franchisees, a franchisor can penetrate markets at a faster pace while curtailing the number of franchise relationships that it must manage.

However, the different forms of multi-unit franchising each support growth in a different way and to a different extent. For franchisors that offer and sell master franchise opportunities, the rate of brand expansion is likely to be faster than through multi-unit development arrangements. Under master franchise arrangements, the responsibilities of recruiting, training, and supporting franchisees are delegated to the master franchisee that may (or may not) also have the obligation to develop and operate franchises. Through this franchising model, the master franchisee pursues multiple avenues of brand expansion simultaneously, usually to an open number of franchisees, often leading to more rapid growth of a franchise system. In contrast, multi-unit developers bear the responsibility to own and operate a specific number of franchises within a defined territory, and usually according to a set schedule. Depending on the multi-unit developer's capitalization, multi-unit developers may be able to develop multiple units simultaneously, but usually multi-unit developers are required to develop their own franchised units in accordance with an agreed upon development schedule. Therefore, the speed at which brand expansion can occur under this franchising model is limited. Finally, unlike the limited growth rate under the multi-unit development model, area representation can lead to more rapid brand expansion, since area representatives are only obliged to recruit franchisees without having to train or continuously support them. Through this franchising model, the area representative can identify multiple franchisees that can simultaneously develop their franchised outlets leading to higher growth rates for the franchise system.

2. Penetration Strategy for New Geographies/Markets

Multi-unit franchising agreements are often used to support a franchisor's market penetration strategies because they serve as a conduit for unit development in new regions, countries, or other markets in which the franchisor may not have prior experience, familiarity, or business connections. With

4. *The 2018 Multi-Unit 50: Ranking the Most Multi-Friendly Brands*, Franchising.com (Sept. 28, 2018), https://www.franchising.com/articles/the_2018_multiunit_50_ranking_the_most_multi friendly_brands.html.

multi-unit franchising agreements, franchisors help to assure the continued development and expansion of their brand. Whether through a master franchise agreement, a multi-unit development agreement, or an area representative agreement, franchisors have a mechanism to penetrate markets and develop territories that may have otherwise been unattainable through company development or single unit franchising.

3. Collection of Large Upfront Fees

An attractive financial draw for franchisors to enter into multi-franchising arrangements is the ability to collect a higher amount of initial franchise fees upfront. With single unit franchising, franchisors are only able to collect the initial franchise fee and the amounts for initial products and services that the franchisee must purchase in connection with opening the franchised outlet.

The fee structure for multi-unit franchising arrangements is typically different and tiered. Under master franchising agreements, the master franchisee will typically pay a substantial initial fee to purchase the rights to develop and/or recruit third parties to develop franchised outlets in a large territory, region, or country. It is not unusual for master franchisees to pay a master franchise fee that falls within the mid to high six-figure range (and, for large enough deals, in the seven-figure range).[5] If the master franchisee elects to develop a franchised unit, then the franchisor is also entitled to collect the initial franchise fee for the development of that particular franchised outlet.

The fee structure for multi-unit development agreements is a little different than that used for master franchisees. Franchisors typically impose a two-tiered fee structure for multi-unit development agreements, comprised of (1) the initial franchise fee for the development of the first franchised outlet; and (2) a deposit (usually fifty percent of the initial franchise fee) for each additional franchised outlet the multi-unit developer has obligated itself to develop under the multi-unit development agreement.[6]

Finally, in area representative agreements, it is typical for the area representative to pay an upfront fee equal to a percentage of the initial franchise fee for a single unit multiplied by the number of franchised outlets that the area representative is required to sell. Whether the franchisor uses the typical formulas discussed above or devises a different formula, the upfront fees are customarily not refundable.

4. Higher Rate of Brand Uniformity

It is common for multi-unit franchisees to employ a manager to oversee their business operations. Through this manager, the multi-unit franchisee can impose high quality standards aimed at achieving an optimal level of uniformity in the products and/or services offered and sold from many

5. Woods & Yatchak *supra* note 2, at 2.
6. *Id.* at 4.

franchised outlets. This level of conformity and consistency is an integral aspect of customer retention. Customers tend to return if there is a high level of certainty that they will receive the same quality of products and/or services, and customer retention leads to the greater prospect of success.

5. Reduction in the Level of Support Per Unit

Ordinarily, franchisors provide operational support to each single unit franchised outlet in their system. Depending on the number of single unit franchise owners, this level of support can be draining on the franchisor's resources and, more importantly, can prove to be quite costly, particularly if the level of support required is extensive. Multi-unit franchising, on the other hand, helps to reduce the level of per-unit support that a franchisor may be required to render. As multi-unit franchisees become more familiar with the brand and the operational requirements necessary to garner success, they become more self-sufficient and require less of the franchisor's support. By having multiple franchised outlets in operation, multi-unit franchisees are likely to internally train their personnel and support their own business operations, rather than rely on the franchisor to provide such services. Multi-unit franchisees tend to not only conduct more self-management of their franchised units in tackling operational hurdles, but they can also serve as a resource for other franchisees who encounter operational issues. Thus, franchisors are able to allocate their resources to initiatives aimed at improving the franchise system, generating greater brand recognition, devising market penetration strategies, and strengthening the franchisor's brand overall.

6. Increasingly Sophisticated Franchisees

Before the franchisee landscape tilted towards multi-unit franchising, the traditional franchised outlet was often viewed as a "mom and pop shop." Implicit in that phrase is the view that single unit franchise owners are (or were) not as sophisticated as the large, multi-unit franchisees that are common in today's franchising industry. Whether accurate or not, the notion is that today's multi-unit franchisees have a higher level of business acumen and bring a plethora of other experience that the "mom and pop shop" owners do not (or did not historically) have.

Indeed, today's multi-unit franchisees (or their principals) are often established business entities comprised of a group of investors who bring a depth of knowledge of investment, research, business planning, and execution necessary to develop, own, and operate competitive and standardized businesses. Often well-capitalized, multi-unit franchisees come to the table with an infrastructure and system in place for building out franchised outlets. The experience and skill set of such multi-unit franchisees can prove an invaluable asset that strengthens the franchisor's brand. With this level of sophistication, franchisors tend to find greater comfort in some multi-unit franchisees' capabilities and experience.

B. *Advantages of Multi-Unit Franchising from the Franchisee's Perspective*

1. Higher Earning Potential and Return on Investment

Multiple streams of revenue are often the key to increasing a person's income. The same principle applies in multi-unit franchising. Unlike a single unit franchisee whose earnings are directly correlated with the sales generated by its lone franchised outlet, multi-unit franchisees enjoy the multiple streams of revenues earned by their multiple franchised outlets. However, the multi-unit franchisee's increase in revenue and return on investment are not just tied to the revenues that each franchised unit earns. By having more franchised outlets, the multi-unit franchisee can have an economy of scale that allows the multi-unit franchisee to save money. Through the operation of multiple franchised outlets, the multi-unit franchisee can yield higher earnings by allocating production expenses over multiple outlets. Additionally, multi-unit franchisees can find savings in the wholesale purchase of supplies, products, and services. With multiple franchised outlets, multi-unit franchisees possess a greater level of bargaining power, which they can wield to receive discounts, rebates, and other fringe benefits.

2. Pooling of Financial and Labor Resources

Multi-unit franchisees enjoy the ability to pool resources across franchised outlets. With multiple franchised outlets, the multi-unit franchisee can purchase supplies, goods, and services in bulk that can be shared among the franchised outlets, further reducing each franchised outlet's per unit expenses. Multi-unit franchisees can also share their employees across their multiple franchised outlets. Skilled employees from one location can be used to train new employees at other outlets or to fill open job vacancies. The multi-unit franchisee can also have a centralized back office operations center that can provide human resources and accounting services to all of the multi-unit franchisee's outlets.

3. More Influence with the Franchisor

Multi-unit franchisees tend to yield more influence with the franchisor, by the mere fact that they own more franchised outlets. The more units that the multi-unit franchisee owns, the more likely it will have the franchisor's ear and be able to advocate for improvements of the franchise system, and possibly have a greater vote in advertising or purchasing cooperatives, or on franchisee advisory boards.

4. Increased Access to Financial Resources

Multi-unit franchisees are more likely than their single unit franchisee counterparts to have readily available access to significant financial funding because their business model is more attractive to lenders. With more access to capital, multi-unit franchisees can better support their future development obligations and may even raise the credit profile of other franchisees within the same system in the eyes of lenders.

III. Franchisor Issues and Challenges

A. *Recruiting Capable and Experienced Multi-Unit Franchisees*

Perhaps the greatest risk that a franchisor takes in whichever form of multi-unit franchise arrangement in which they engage is the risk of not knowing whether the franchisee will or will not deliver. While this risk is present in any franchise agreement, it is compounded by the nature of multi-unit franchising, which often involves many units. A franchisor often will not have much experience with a candidate to be a developer of many units, before signing an agreement with them to do so.

Multi-unit franchisees often require much more capital, and upfront investment, to properly execute their obligations. The payoff for the franchisee takes longer to happen than it does with a single unit franchise agreement. Therefore, it behooves the franchisor to conduct a thorough due diligence investigation of the multi-unit franchisee to make sure that it is sufficiently capitalized.

Furthermore, the franchisor must look into certain characteristics of a multi-unit franchisee that are not as relevant (if at all) in the case of single unit franchising. For one, the franchisor needs to make sure that the franchisee has sufficient sales/marketing personnel to find and attract qualified unit franchisees (particularly in the case of area representatives and master franchisees); ideally, it should be a person or entity with prior experience doing so. Franchisors must bear in mind that the skill set required of a multi-unit franchisee is quite different from a unit franchisee. Multi-unit franchisees must have a demonstrated ability to delegate day-to-day operations of franchised units rather than running the operations themselves; in other words, they need the ability to manage the managers. Further, the multi-unit franchisee must know how to cultivate a pipeline of potential managers within each franchised outlet. Finally, with multiple outlets involved, it is all the more crucial that multi-unit franchisees have solid and dedicated bookkeeping/accounting talent, operations management, and ideally an administrator, but, at the same time, that they do it in a "lean" fashion, not wasting exorbitant resources on such functions.

In master franchising and area representative situations, the risk of an incompetent master franchisee or area representative also extends to that party's ability to identify well-qualified unit franchisees, site locations that fit the franchisor's criteria, and to provide franchise disclosure documents (where required) to the prospective unit franchisees in accordance with applicable franchise laws, rules, and regulations. A failure to do any of the above can result in poor performance, non-compliance with system standards, and potential litigation by unit franchisees, or even enforcement actions by regulators, all of which can strain the franchisor's time, money, reputation, and system.

Note that much of the above types of skills will not be covered much (if at all) within the franchisor's standard training curriculum for unit franchisees.

The challenge, then, is finding multi-unit franchisees that actually have prior experience doing it. Otherwise, whether they will in fact be able to perform is inherently unpredictable and presents huge risks (business, legal, reputational, and otherwise) for the franchisor.

B. *Dealing with Failures to Meet the Development Schedule*

Multi-unit development agreements typically include a development schedule that states how many franchised units must be developed (often defined as commencing operations) within certain timeframes. However, it is commonly accepted knowledge that, in reality, "mandatory" development obligations are often not met.[7] For franchisors that accept this reality, the question is how to prepare for and manage it.

The risk to the entire franchise system, and to the franchisor's bottom line, is much greater if a multi-unit franchisee becomes insolvent or unstable, as compared to a unit franchisee. Franchisors should consider the risk of this or other defaults that may lead to termination of the agreement.

In regard to master franchise deals, where the master franchisee is essentially acting as the franchisor in its defined territory, the agreement must be clear on what happens to the master franchisee's obligations under unit franchise agreements if the master franchise agreement is terminated.[8] Does the franchisor have a choice of whether to simply terminate those unit franchise agreements or to assume them?

Likewise, in regard to area development deals, it should be negotiated and expressly agreed what happens if the developer fails to meet the development schedule. Does the franchisor have the option to terminate the entire development agreement? Can the franchisor reduce the number of units that the developer may develop? If so, what happens to the franchised units already developed? Will the franchisor have the option to purchase them from the developer, and at what price? Alternatively, does the franchisor have the option to terminate those parts of the territory that the developer has not yet developed, but must keep intact the parts that have been developed up to that point? Should the franchisor have the right to modify the term of the multi-unit agreement, and perhaps even take away the franchisee's right to renew the agreement? Alternatively, should the franchisor have the option to keep the agreement in place but take away whatever grant of exclusivity had been given to the multi-unit franchisee for that territory (thus opening it up for development by the franchisor or other franchisee(s)? And as for those franchised units that were never developed but were supposed to be, will the franchisor be entitled to lost future profits or even liquidated damages? All of these questions should be contemplated and addressed in the agreement, rather than waiting until a problem develops to debate these points.

7. Fisher & Staplin, *supra* note 2, at 51.
8. Curran et al., *supra*, note 2, at 3.

Note that a franchisor's waiver of development obligations in one instance, or on repeated instances that form a pattern, can serve as the basis for a franchisee to make a legal claim that future waivers are required. Perhaps the most well-known example of this was the case of *Burger King Corp. v. Family Dining, Inc.*[9] in which the Eastern District of Pennsylvania relied on both legal and equitable principles to conclude that a franchisor could not demand strict compliance with a development schedule after previously waiving the requirement.[10] While not foolproof, the best way a franchisor can protect against this risk is to draft for it in the development agreement by including express language referencing the development schedule to anticipate enforcement disputes. For example, a non-waiver provision can specify that a franchisor's choice to waive or renegotiate terms of the development schedule in one instance or even repeated instances does not waive the franchisor's right to insist on strict compliance in future instances.

In area development deals, a common way that franchisors deal with the uncertainty of how many units will really be developed is to have the developer pay the franchisor, upfront, a portion of the initial franchise fee for each unit on the development schedule, with the rest owed when each unit opens. As discussed earlier in Section II.A.3, this method is commonly utilized to properly incentivize the developer to perform. Usually the upfront payment is not refundable.

An issue that is often debated in drafting multi-unit franchise agreements, is the issue of cross-default provisions and cross-guarantees that would be triggered when development obligations are not met. Naturally, multi-unit franchisees resist them and argue that they are unnecessary because the unit franchise agreements (which will govern each respective unit) will typically already have default provisions in each one of them. However, a franchisor will want to insist on including such provisions in the multi-unit agreement, because it gives the franchisor maximum flexibility in a relationship that entails a great deal of unknowns and risk.[11]

C. *Dealing with a Multi-Unit Franchisee's Lack of Uniformity in Franchise Operations*

Part of the challenge for a franchisor when engaging in multi-unit franchising is a loss of control. The franchisor relies on the multi-unit franchisee to do some things that the franchisor normally handles (to a greater or lesser extent depending on the deal). A multi-unit franchisee delegating managerial or operational duties to unqualified employees, or giving them improper employee training, can affect a multitude of stores in the system and significantly hurt the goodwill of the system as a whole.

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9. Burger King Corp. v. Family Dining, Inc., 426 F. Supp. 485 (E.D. Pa. 1977).

10. *Id.* at 494–95. *See also* Fisher & Staplin, *supra* note 2, at 63 (discussing *Burger King* in detail).

11. Cross-defaults and cross-guarantees are discussed in detail by Cole & Stadfeld, *supra* note 2, at 18–20.

One of the issues is that a multi-unit franchisee is not an owner-operator of each franchised unit (or, possibly, of any franchised unit). Therefore, the multi-unit franchisee may be more focused on maximizing profits than on assuring quality or compliance with system standards. For example, an area developer is more likely to have managers of particular outlets who are not owners of the outlets that they manage. Theoretically at least, this would suggest that the managers will have less incentive to do their job in an excellent fashion. And some empirical research has shown this intuitive result to be accurate: a 1996 study of multi-unit franchising in the fast-food restaurant industry found that store-level incentive problems get increasingly troublesome as franchisees get more and more units and that the level of commitment franchisors feel toward continuing to franchise is negatively related to the average number of units per franchisee.[12]

In master franchising situations, a way to mitigate this structural/incentive issue is to have the franchisor be a named third-party beneficiary in each franchise agreement between the master franchisee and any unit franchise. In some cases, it may even be possible to have the franchisor be a party to each unit franchise agreement—subject to applicable state law. Further, the form of agreements can include a right of the franchisor to audit and inspect each unit franchise. However, with all of these types of provisions is a limit as to how much involvement and control that it is wise to give the franchisor in subfranchising matters because, at some point, it can result in liability exposure of the franchisor for the business of the unit franchisee.[13] In area representative agreements, a way to mitigate this same structural/incentive issue is to put in place a fee structure for the area representative that involves delayed payments that only are earned when certain performance benchmarks are met.[14] In addition, one simple thing the franchisor can do is to require in the agreement that the franchisor has the right to pre-approve any particular individual who is to serve as an area manager of the multi-unit franchisee. Such a provision is common in development agreements.

D. *Concessions to Multi-Unit Franchisees*

Large multi-unit franchisees may, over time, develop a large influence over the franchise system. For the same reasons that they tend to be attractive to franchisors (such as having large capitalization; access to business

12. Patrick J. Kaufmann & Rajiv P. Dant, *Multi-Unit Franchising: Growth and Management Issues*, 11 J. of Bus. Venturing 343 (Sept. 1996). The authors of that study state that the data were collected in a national mail survey of the franchised fast-food restaurant industry. The sampling frame was developed using the 1991 Info Franchise Directory. Franchise systems that did not exist before 1986 were screened, because the study was focused on the 1986–1991 period, yielding an effective sampling frame of 675 franchise systems. A questionnaire was mailed to the franchisors; 152 questionnaires were returned sufficiently complete to utilize for analysis; and a statistical regression analysis was performed on the data gathered from the surveys as well as the 1991 Info Franchise Directory.

13. For further discussion of these types of provisions and how far to take them, *see* Curran et al., *supra* note 2, at 4–5.

14. For further discussion of these types of provisions, *see* Curran et al. *supra* note 2, at 9–10.

connections and prime locations; more sophisticated management, legal counsel, and professional advisors), they also can develop a type of influence over the direction of the system as a whole, leaving the franchisor with less control over its own system. Making system-wide changes may then become more of a negotiation with "powerful" franchisees than the franchisor is accustomed to or would like to engage in.

Multi-unit developers, in negotiating with the franchisor, will often demand special concessions to entice them to execute the agreement. For example, they may ask for rights of first refusal on additional territories before those territories are granted to any other franchisee. A franchisor must be careful not to "give away the farm" in this respect. Multi-unit developers may also ask for discounts from the typical single-unit franchise fees charged to unit franchisees. On the one hand, developers may justify such a demand by arguing that the franchisor should account for the economies of scale that a multi-unit developer provides (for example, should they pay a technology fee for each franchised unit, in cases where it is the same technology licensed to them for all units), or by arguing that certain normal system controls (such as supply chain requirements) should not apply to them because of their size, experience, and superior local connections in the relevant market. If a franchisor agrees to loosen supply chain requirements in this regard, the parties should contemplate and carefully negotiate this option before entering into the franchise agreement, and the franchisor should always monitor closely to make sure that system quality standards are met and that the developer is aware of the local legal regime regarding supply quotas or other matters.[15] On the other hand, developers may simply demand concessions because they can, without seeking to justify them at all: reduced initial franchise fees, reduced royalties, and more favorable pricing and credit terms from the franchisor.[16]

The franchisor may well calculate and determine that providing such concessions to a multi-unit franchisee to move a multi-unit deal forward is, on the whole, better for the franchisor. However, the franchisor must also consider the legal and political risks of giving certain franchisees special treatment. The legal risks include, for one, that certain states have anti-discrimination laws that prohibit discrimination against "similarly situated" franchisees.[17] Additionally, many states have "Little FTC Acts," which

15. For further discussion of the balance between trusting multi-unit franchisees (particularly master franchisees) to supply or to find local suppliers, versus the franchisor's need to be involved in closely monitoring this, *see, e.g.*, Chernow et al. *supra* note 2, at 17; Curran et al. *supra* note 2, at 2.

16. Cole & Stadfeld, *supra* note 2, at 3.

17. *See* Hawaii Franchise Investment Law, Haw. Rev. Stat. § 482E-6(2)(C); Illinois Franchise Disclosure Act of 1987, 815 Ill. Comp. Stat. 705/18; Indiana Franchise Act, Ind. Code Ann. § 23-2.2.7-2(5); Minnesota Franchise Act, Minn. R. § 2860.4400(B); Washington Franchise Investment Protection Act, Wash. Rev. Code § 19.100.180(2)(c); D&K Foods, Inc. v. Bruegger's Corp., Bus. Franchise Guide (CCH) ¶ 11,506 (D. Md. 1998) (a bagel shop franchisor that purportedly offered financial assistance to certain franchisees *may* have violated Washington's franchise anti-discrimination provision).

prohibit unfair or deceptive practices in trade or commerce.[18] Creative lawyers for franchisees have been known to bring claims based on such laws. Finally, other franchisees may bring common law causes of action against the franchisor, such as breach of the implied covenant of good faith and fair dealing, or the tort of unfair competition. And aside from the legal risks, the political risk exists that other franchisees may object to special concessions being granted to a multi-unit developer, even if they have no legal basis to do so. The political risk is not a lawsuit so much as uncooperative or disgruntled franchisees in the system who may, for example, give unfavorable reports about the franchisor if they are contacted by prospective franchisees, or who may use their votes in advertising or purchasing cooperatives in ways that defy the franchisor's strategic direction for the system.

A franchisor is reliant on a multi-unit franchisee (to a lesser or greater extent depending on the deal) to successfully develop the territory assigned to it. As a consequence, in situations where the franchisor wishes to enforce certain terms of the contract, it must consider its alternatives in case the multi-unit franchisee refuses to cooperate. For example, as a practical matter, if the agreement includes (as many typically do) a post-term covenant not to compete (a provision that, by its nature, protects crucial assets of the franchisor such as trade secrets), enforcing that covenant can be challenging for a franchisor when the other party has immense resources to fight it in court.[19] More so than with a typical small business unit franchisee, a franchisor must consider its best negotiation alternatives in case the multi-unit franchisee does not comply with system standards and cannot easily be pressured to do so.

E. *Competitor Brand Issues*

Multi-unit owners are often also multi-brand. Because they tend to be larger companies already experienced in the franchising space, they are more likely to already be involved with brands that compete with the franchisor. Indeed, multi-unit owners sometimes join a franchisor's brand in the context of "converting" all or a portion of their existing sites from another brand to the franchisor's brand.[20] Moreover, as barriers to entry fall for new franchisors entering the market, there are ever-more benefits to be had from scale, centralization, and cross-brand synergies, resulting in more and more multi-brand sites where one franchisee operates the brands of more than one franchisor.

Accordingly, multi-unit franchisees are more likely to ask for exceptions to the franchisor's usual non-compete covenants. A core issue for the franchisor is the worry about the franchisor's confidential information, trade secrets, or other proprietary methods or materials being shared with competitor brands,

18. For a detailed discussion of these laws in this context, *see* Cole & Stradford, *supra* note 2, at 4–10.

19. *Id.* at 2, 13.

20. *Id.* at 2, 4.

and/or being associated in the public's mind with other brands.[21] This issue must be discussed with the multi-unit franchisee and clearly addressed in the agreement before any contract is signed. How to address it will depend on the circumstances of the particular situation.

F. *Determining the Optimal Territory Size and Amount of Units to Be Developed*

Before entering into any multi-unit franchise agreement that is significant to the franchisor's overall network, the franchisor should devote time and attention to carefully determining and negotiating an appropriate territory. Many franchisors, eager to secure a deal that is attractive to a developer, grant an exclusive territory that is too large. If the developer does not meet the development schedule or ceases to develop at all, this breakdown can leave the franchisor, many years later, with a territory that is tied up in an exclusive agreement and is stagnant.[22]

Hand-in-hand with the size of the territory, the franchisor should make sure the amount of units to be developed is realistic and attainable.[23] Of course, this can never be known for certain. But a franchisor needs to research the demographics, economy, and trends of the contemplated territory to get some sense of how many franchised units that the territory can likely support. The franchisor should also confirm that the multi-unit franchisee has a well thought-out and documented business plan for the targeted development, as opposed to "playing it by ear."

However, no amount of pre-contractual diligence can eliminate the inherent risk in trusting a multi-unit franchisee to perform, given that economic, market, and demographic conditions are constantly changing. Multi-unit franchising necessitates that the franchisor cede some of its ability to respond to market changes. With that said, it is possible to mitigate the risk by drafting agreements in a way that provides for changes to the development schedule, or even to the territory, if certain demographic changes occur in that market. It is also possible (and generally advisable for franchisors) to start by granting the multi-unit franchisee a smaller territory than what is ultimately envisioned, with a promise of expansion of that territory when and if certain performance and development benchmarks are met. Moreover, a franchisor should reserve certain development rights within the multi-unit agreement, such as the ability to sell products or services through non-traditional channels or in non-traditional locations. All of these ways hedge against the very substantial chance that a multi-unit franchisee will not develop all parts of the territory, or all of the units, contemplated by the parties' agreement.

21. Monaghan et al., *supra* note 2, at 10.
22. Chernow et al., *supra* note 2, at 14.
23. Monaghan et al., *supra* note 2, at 14.

G. *Growing Too Fast*

Related to the preceding concern, but somewhat different, is the risk of growing the franchise system too fast for the franchisor to keep up. A franchisor that has signed multi-unit development deals covering vast territories and providing for rapid growth of unit count may find that the franchisor's resources get stretched. The franchisor must maintain the ability to effectively monitor compliance with system standards, provide guidance and approvals/disapprovals of proposed site locations, provide training (where the deal requires the franchisor to train new unit franchisees), and (where applicable) compensate the multi-unit franchisee (such as an area representative) its agreed share of the revenues generated from each unit franchisee. Some franchisors underestimate the toll that this will take on the franchisor's executives and staff, if not done at a measured pace. In terms of having the cash flow necessary to pay multi-unit franchisees what the franchisor has agreed to pay them, some franchisors provide for a ceiling on the total amount of compensation payable to the area representative franchisee in any given year (or other pre-determined period). That is one way the franchisor can put some bounds on the rate of growth and the required outlay of its cash and other resources.

H. *Multi-Unit Franchisee Financing/Investor Groups*

Because large multi-unit franchisees tend to have much larger capitalization needs than a typical single unit franchisee, they often turn to co-investors, such as private equity funds, for financing. While this option can have many benefits for the franchise system as a whole, it also presents certain issues. For one, before approving a major financing of the multi-unit franchisee (which approval right should be in any multi-unit agreement), the franchisor should investigate whether the private equity or other investor group has the same basic vision for the system as the franchisor. Bear in mind that in cases where a multi-unit franchisee is large enough relative to the entire system, its owners (for example, a private equity fund) could eventually become "activist investors" within the franchise system as a whole. While their presence is an opportunity whereby the whole system may benefit from the investor group's expertise and existing finance or other relationships, it also can present a challenge. Investor groups may have a more short-term profit focus than the franchisor does, or than franchisees in the system as a whole do.[24] Key questions for the franchisor to ask before allowing a private equity or other investor group to own or control a multitude of units in the system include the following: what will be the nature of the investor group's control over the multi-unit franchisee entity (for instance, will they own a majority or just a minority stake; will they take an active part in operational decisions; and what types of restrictions will they impose

24. For a more detailed discussion of this dynamic, *see*, *e.g.*, Monaghan et al., *supra* note 2, at 13.

on how the multi-unit franchisee runs its business, invests in capital for the business, and attracts and compensates management personnel); and, what "exit timing" does the investor group have in mind for its investment in the multi-unit franchisee.[25]

I. *Disclosure and Statutory Compliance*

The existing franchise legal literature, as well as NASAA's multi-unit commentary, includes detailed discussions of what disclosure documents must be issued and furnished to different types of multi-unit franchisees by the franchisor, and to unit franchisees by the franchisor or multi-unit franchisee (as applicable).[26] Without covering all of those alternatives here, we highlight a few key points that a franchisor should bear in mind as it considers the compliance costs and risks involved in multi-unit franchising. In each circumstance, a franchisor and multi-unit franchisee should have experienced franchise legal counsel guide them on any disclosure and filing requirements.

In some circumstances, the franchisor will need to insert additional Item 20 data in its Franchise Disclosure Document (FDD) to account or adjust for certain multi-unit franchise arrangements. Under some state laws, such as California, additional disclosure regulations and waiting periods may apply if a franchisor renegotiates the development schedule during the term of the underlying agreement.[27] In some cases under California law, the franchisor must file or amend its FDD (as applicable) to list all negotiated changes within the past twelve months, and Illinois, Minnesota, and New York each have laws with similar requirements regarding negotiated changes.[28]

In both master franchising situations and area representative situations, the franchisor is required to have a separate FDD in regard to that offering.[29] It will involve some ongoing coordination with the multi-unit franchisee (whether a master franchisee or an area representative franchisee) to ensure proper disclosures (and periodic updates) of the FDD are promptly made.

Other than franchise disclosure laws, a franchisor entering into multi-unit agreements should be mindful of state franchise relationship laws, by which some states and U.S. territories put restrictions upon the circumstances under which a franchisor may terminate or refuse to renew a franchise agreement.[30] In doing so, a franchisor must bear in mind that some types of

25. For a more detailed discussion of key questions to ask of private equity investors, *see* Chernow et al., *supra* note 2, at 19–21.

26. *See*, *e.g.*, Curran et al., *supra* note 2, at 25–28; Woods & Yatchak, *supra* note 2, at 29–34. *See generally* NASAA Multi-Unit Commentary, *supra* note 3. While some points remain unclear from the existing literature (e.g., whether or not area representative franchisees must register their own Franchise Disclosure Document, *see* Woods & Yatchak, *supra* note 2, at 31–32), those points have not, to the authors' knowledge, since been resolved.

27. For discussion, *see* Fisher & Stapline, *supra* note 2, at 56.

28. For discussion, *see* Cole & Stadfeld, *supra* note 2, at 8–9.

29. NASAA Multi-Unit Commentary, *supra* note 3, at SF.01, SF 21.0, SF 21.1, AR 0.1.

30. For example (and without limitation), *see* California Franchise Relations Act, Cal. Bus. & Prof. Code §§ 20020, 20021, 20025, 20026; Hawaii Franchise Rights and Prohibitions Act,

multi-unit agreements will, by their nature, have relatively long terms (even for typical franchise agreements, which already tend to have long terms, ten years being fairly typical depending on the industry). For example, master franchise agreements typically will remain in effect for twenty to thirty years. This duration is because master franchise agreements typically (and logically) continue in effect until the expiration or earlier termination of all subfranchise agreements entered into under such master franchise agreement. Accordingly, a thorough understanding of the commitment that the franchisor is getting into is particularly crucial in the multi-unit context.[31]

As discussed earlier, given that in many cases a multi-unit operator takes on roles that the franchisor would otherwise normally play—such as marketing to prospective unit franchisees, furnishing them with a franchise disclosure document in some instances, and in some development deals, training the unit franchisees in how to operate their outlets—the franchisor and multi-unit franchisee should include appropriate indemnification provisions in their multi-unit franchise agreement. The franchisor should seek to be indemnified by the multi-unit franchisee in the event that it negligently performs such roles, for example, if it deceives, makes misrepresentations to, or makes unauthorized financial performance representations to, a prospective unit franchisee, or if it violates any franchise disclosure or relationship statute. The indemnification should survive termination of the multi-unit franchise agreement, since the relationships created with unit franchisees pursuant to the multi-unit agreement may extend for many years thereafter.[32] As a matter of practice, in the authors' experience, it is uncommon for the franchisor to provide much, if any, indemnification in favor of a franchisee, other than in connection with the franchisee's proper use of the franchisor's marks. However, some multi-unit franchisees are able to extract more indemnification from the franchisor.

IV. Multi-Unit Franchisee Issues and Challenges

A. *Inability to Locate Sites in Accordance with the Development Schedule*

The location of a business is a paramount factor attributed to its success. The same mantra holds true for multi-unit franchisees seeking to locate and secure multiple desirable locations within a defined territory that meet the franchisor's site selection criteria. Franchisors know that the location of their franchised outlets is integral to the success of the franchise system. Therefore, it is customary that franchisors set forth in their Operations Manual

Haw. Rev. Stat. § 482E-6(H); Illinois Franchise Disclosure Act, 815 Ill. Compiled Stat. 705/19, 705/20; Indiana Deceptive Franchise Practices Law, Ind. Code § 23-2- 2.7-1(7), (8); Michigan Franchise Investment Law, Mich. Comp. Laws, § 445.1527(c)–(e); New Jersey Franchise Practices Act, N.J. Rev. Stat. § 56-10-5.

31. For further discussion of this point, see, for example, Woods & Yatchak, *supra* note 2, at 12–13, and Curran et al., *supra* note 2, at 30.

32. For further discussion regarding indemnification in multi-unit franchise agreements, *see, e.g.*, Woods & Yatchak, *supra* note 2, at 23–24.

the criteria that the site must meet before the franchisor will approve the location as a site for one of its franchised outlets.

Depending on the assigned territory, finding and securing a specific number of locations within a designated timeframe may often prove more problematic than it seemed when the multi-unit franchisee and franchisor executed the multi-unit franchise agreement. While this concern is faced by single-unit franchisees as well, it is compounded for multi-unit franchisees, particularly multi-unit developers.[33] Unlike a single unit franchise agreement, where the franchisee is obligated to find (or may already have found) one site, the multi-unit developer is required to find and develop a prescribed number of sites for franchised outlets within a defined territory over a designated time period. But no multi-unit franchisee has a crystal ball that will allow it to see development possibilities years in advance. Any mistake in the multi-unit franchisee's assessment as to the number of franchised outlets its defined territory can successfully sustain may lead to financial and legal peril. Therefore, thoroughly investigating the matter up front is crucial.

Once the multi-unit franchisee and franchisor reach an agreement as to the number of franchised outlets that the multi-unit franchisee will be obligated to develop, the most important term to negotiate is the pace at which the multi-unit franchisee must develop them.[34] The multi-unit franchisee will want to negotiate the maximum amount of time that the franchisor will allow, while also inserting a level of flexibility to alter the development schedule should unforeseen circumstances arise. From the multi-unit franchisee's standpoint, it is taking a substantial risk in agreeing to commit to a development schedule that is subject to infinite uncertainties that, should they arise, can be financially devastating for the multi-unit franchisee.

The practicality of identifying and securing sites that satisfy the franchisor's site selection criteria may be problematic given the inventory of real estate options that are available after the multi-unit franchise agreement is executed. This challenge is especially true for development territories involving densely populated metropolitan areas, where there may be limited inventory of commercial spaces due to high demand. In such areas, securing multiple commercial spaces that attract the foot traffic necessary to build and sustain successful businesses may prove challenging. Some locations may come at a price that far exceeds the multi-unit developer's rent projections and are, therefore, not viable options. Other locations may fall within the multi-unit developer's budget but are too close in proximity to the multi-unit franchisee's existing franchised outlets; the multi-unit franchisee will

33. Master franchisees that also undertake the obligation to develop and operate franchised outlets may also encounter this issue.

34. The standards by which a franchised outlet will be deemed to be "developed" can be a heavily negotiated issue between franchisors and multi-unit franchisees. From the franchisor's point of view, the franchised outlet should be open and operating or at the very least substantially under construction before the multi-unit is considered to have met its development schedule. The multi-unit franchisee, however, may only want an executed franchise agreement or lease in place to be considered to have "developed" a unit.

undercut its own profits if the markets for its franchised outlets overlap. The multi-unit franchisee may find the perfect location at the right price, but face opposition from local officials or residents who do not want the franchise in their city or town, or the franchisee may not be able to negotiate amenable lease terms if the market conditions are not favorable for tenants. Couple any one of these issues with the fact that the landscape of prospective sites can dramatically change over the course of the development schedule, and all the factors swirl for a perfect storm.

For a multi-unit developer, a failure to comply with the development schedule due to the inability to secure locations will not only subject the multi-unit franchisee to substantial financial liability but can also have a terrible, negative "domino" effect. The multi-unit agreement may be terminated with respect to the development of all or some outlets, or the multi-unit franchisee's rights thereunder may otherwise be curtailed. The multi-unit franchisee will also likely lose the development fee it paid to the franchisor (unless the franchisor is open to negotiation). In addition, the multi-unit franchisee will also lose all amounts that it paid landlords or other third parties in its efforts to identify, secure, and plan for locations for franchised outlets. This includes real estate broker fees, attorneys' fees, contractor fees, and architectural fees. If the franchisor elects to terminate the multi-unit franchise agreement, then the multi-unit franchisee may be liable to reimburse the franchisor for losses and expenses incurred in connection with the termination. Besides the countless financial liabilities that the multi-unit franchisee potentially faces, the multi-unit franchisee may also be subject to legal exposure. For example, if the franchisor elects to terminate the multi-unit franchise agreement and the agreement contains a cross-default provision (giving the franchisor the right to terminate all other agreements that the franchisor entered into with that multi-unit franchisee, including any unit franchise agreements for existing locations), then the multi-unit franchisee may be subject to liability under any of the following: (1) leases for the locations of its existing franchised outlets; (2) leases for any furniture, fixture and equipment used in connection with the operation of the franchised outlet; and/or (3) business loans.

It is clear that the potential liabilities that a multi-unit franchisee faces, if it fails to develop the prescribed number of franchised outlets, can far exceed any liabilities that single unit franchisees face in developing and operating a single location.

B. *Inability to Secure the Funding Necessary to Support Development*

As discussed earlier, one of the main attractions that tilts the scales towards multi-unit franchising being the preferred business model for many franchisors is the multi-unit franchisee's likelihood to have the capital to support development of many units. As discussed earlier, the capital required to operate a multi-unit franchising business far exceeds the capital needed by single unit franchisees. For master franchisees and area representatives, this means having access to the capital necessary to fund their efforts in recruiting franchisees and providing ongoing training and support. Multi-unit developers—and master franchisees who undertake the obligation to develop and operate franchised outlets—must have the capital necessary to cover the per-unit initial investment set forth in the franchisor's franchise disclosure document and to fund the outlets' ongoing operations.[35] And as operations grow over time, the capital required to support such operations and (in some cases) provide services to franchisees will increase.

Some multi-franchisees use the cash flow from their initial franchised outlets to fund their development obligations. But what happens if the franchised outlets have subpar performance for a period of time, or seasonally for certain months, or if it takes longer than anticipated to secure and build out the franchised outlets? Multi-unit franchisees must have access to (1) a continued pipeline of capital; or (2) unfettered financial resources to provide a significant buffer. This means having provisions allowing the principals to make contributions or loans to the multi-unit franchisee entity as needed; securing credit lines with banks and other lending institutions; and/or bringing on minority investors that can inject capital into the multi-unit franchisee entity. Without having the available cash (or the access to financial resources that will provide the necessary capital), a multi-unit franchisee can easily derail its efforts to meet its development obligations.

C. *The Challenges of Managing a Multi-Unit Business*

As discussed in Section III.A, because it may be difficult for the multi-unit franchisee to oversee the operations of many franchised outlets, it is imperative that the multi-unit franchisee hire a management team with the same drive and passion that the multi-unit franchisee has in making its business a success. Multi-unit franchisees must also consider methods that will help them retain personnel. The last thing the multi-unit franchisee wants to be is a training camp for talented personnel who then take their skills elsewhere. Hence, the multi-unit franchisee must concern itself with developing career growth opportunities for its executives, trainers (where applicable), and other employees.

Having the right infrastructure in place is also vital to the success of the multi-unit franchisee's business. That means, beyond simply having the infrastructure the franchisor requires, the multi-unit franchisee will need to set up the right technological infrastructure (such as Internet, telephone, cloud services, cyber security, and Wi-Fi), but also infrastructure catered to running various separate but related businesses to manage, integrate (where advantageous), and support multiple franchised outlets. The right IT infrastructure will allow the multi-unit franchisee to share information with its local management teams and communicate system and policy changes efficiently.

35. The estimated initial investment to open a franchised outlet, broken down by each type of expenditure, the amount, the method of payment, when due, and to whom payment is to be made, is set forth in Item 7 of the franchisor's Franchise Disclosure Document.

All of the above will take additional capital. At times, the multi-unit franchisee may find itself paying its personnel before returning a profit, but investing in the collective business infrastructure is paramount. However, an investment in human resources and IT systems is necessary to ensure the quality of a multi-unit franchisee's operation.

V. Conclusion

Growth by multi-unit franchising is a complex endeavor and can take various forms. It is a long-standing growth trend, and it is here to stay. Whether it is a deal to develop a dozen or a hundred franchised outlets, an agreement to be the master franchisor covering a state, country, or continent, a contract to be an area representative in a defined territory, or anything in-between, it behooves franchisors and multi-unit franchisees alike to consider the issues, challenges, advantages, and disadvantages of a multi-unit franchise arrangement before embarking upon such a journey together.