The Perils of Third Parties Selling or Servicing Your Brand: Broker, Area Representative and Area Developer Programs

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THE PERILS OF THIRD PARTIES SELLING OR SERVICING YOUR BRAND:
BROKER, AREA REPRESENTATIVE AND AREA DEVELOPER PROGRAMS

I. INTRODUCTION

From the initial franchise offering to a Franchise Agreement’s expiration, the traditional franchise relationship involves just two parties – the Franchisor and Franchisee. The Franchisor promotes its franchise opportunity, receives inquiries from potential Franchisees, engages in franchise selling activities and, after signing a Franchise Agreement, provides the Franchisee with opening and operational support.

Two may be company; but sometimes three is not a crowd. There are various alternatives to the traditional two-party franchise structure, each of which entails the Franchisor’s use of a third-party – organizations, individual independent contractors and even Franchisees – to engage in activities the Franchisor traditionally undertakes. These activities fall into two broad categories: franchise sales activities; and post-sale franchise servicing activities. “Servicing activities” can include any number of things that a Franchisor typically does using its own employees after the Franchise Agreement has been signed, from training, opening support and marketing support, to unit franchise compliance inspections.

This paper’s use of the terms “third-party” or “three-party” relationship does not refer to a single contract signed by three different parties, but rather, refers to a structure in which someone other than the Franchisor and the Franchisee is important to the franchise sale, or the post-sale servicing of the franchise.

While there are a number of business benefits to using a third-party to sell franchises or service franchises, these three-party structures come with a set of inherent legal risks. These risks come about from one or a combination of factors, including that the Franchisor, in delegating responsibility to a third-party, is ceding a degree of control, if not contractually, then practically speaking; the third-party is often less knowledgeable about the particulars of the Franchisor’s business than the Franchisor; the third-party has less at risk than the Franchisor who owns a brand and trademarks; and the third-party may have a financial interest in pursuing sales or service practices that the Franchisor might avoid.

This paper explores the ways in which Franchisors engage third-parties to perform a myriad of activities that Franchisors traditionally perform with their own employees; the perils inherent in these relationships; and ways that Franchisors can, through thoughtful planning and contract drafting, seek to minimize and manage these perils in order to take advantage of benefits that these third-party relationships can offer.

A. Why the Use of an Outside Franchise Seller/Servicer?

A franchising business is just that – a business. While there are a number of different reasons why a Franchisor may choose to retain a third-party to sell or service its franchises, in general a Franchisor who engages a third-party to sell or service franchises perceives doing so as a way to advance the Franchisor’s business interests. These interests can include increased franchise sales, increased brand awareness, reduced expenditures, or a combination of these goals. That is not to say that only the
Franchisor can benefit from these three-party relationships. When structured properly, these three-party relationships can benefit everyone. But if the potential perils of these three-party structures are not considered before the third-party relationship is formed, and taken into account during contract negotiation and drafting, then the benefits the Franchisor hopes to realize can be replaced by litigation and significant business losses.

In many instances the third-party will have considerable experience from which a Franchisor can benefit. Franchise Brokers often represent a number of brands, and should be knowledgeable about franchise sales laws, and how to identify prospective Franchisees. A local Area Representative will often be familiar with local demographics, real estate, and local contractors.

A knowledgeable Franchise Seller may also have a good sense of whether a particular prospective Franchisee may not be a good fit for the system. But, the third-parties are not compensated for turning someone away; they are compensated for franchise sales, and in many cases the Franchise Seller will not need to deal with the aftermath of an inappropriate match (e.g. a Franchisee whose entrepreneurial spirit conflicts with the need to conform to system standards).

Selling franchises from far away can be difficult, while maintaining a sales office and employees in every potential market is typically not practical from capital resource and human resource perspectives. In contrast, a third-party relationship in which the Franchise Seller is responsible for maintaining its own office, and is not dependent on the Franchisor for its overhead costs, can be very attractive to a Franchisor.

While a reduced investment in franchise selling resources is good, being paid to let someone else do the work can be even better. Under some three-party structures, the third-party typically purchases the right to sell franchises. However, depending on how the relationship is structured, the grant of a right to sell franchises may itself be a regulated sale within the scope of federal and/or state franchise laws.

A prospective Franchisee may also be more comfortable dealing with a local Franchise Seller, instead of a Franchisor hundreds or even thousands of miles away; particularly true if that Franchise Seller also has more than one concept to offer, and is therefore unlikely to make a “hard sale” for a concept that may not be a good fit for the prospect.

B. General Types of Franchise Sellers and Service Agents

In the franchising industry there are a number of terms that are commonly understood by those in the industry. Some, like “franchise,” have for years been defined in reasonably consistent ways by various laws regulating franchising.

In contrast, this paper describes a number of three-party structures that lack consistent industry nomenclature. What some Franchisors and legal practitioners may refer to as “master franchising” others refer to as “sub-franchising.” Similarly, terms like “Area Representative” and “Area Developer” can mean the same or different things, depending on the person using the term. Adding to the confusion is that a number of franchise sales laws define terms like “Franchise Broker” and “Subfranchisor” in very broad terms in order to ensure that a significant scope of franchise selling activities are regulated.
Therefore, at the outset it is important to describe, for the purposes of this paper, the structures of the three-party relationships being explored. However, it is critically important that the practitioner understand that state laws may differently define terms used in this paper, so as to bring within their ambit structures that this paper treats separately. By way of example, while this paper will differentiate a “Franchise Broker” from an “Area Representative,” the Illinois Franchise Disclosure Act of 1987 (the “IFDA”) defines the term "Franchise Broker" broadly enough to capture both structures, as well as most, if not all, of the other three-party structures described by this paper.\(^1\) In fact, regulations under the IFDA go so far as to declare that: “A person shall be deemed to be a Franchise Broker … if such [person] provides a prospective Franchisee with information about specific franchises other than the Franchisor's name, address and phone number.”\(^2\)

1. **Lead Generators**

As used in this paper, a “Lead Generator” refers to a person or organization that provides a Franchisor with the names and contact information of prospective Franchisees, but who generally does not actively encourage a prospect to purchase a particular franchise. A fee is usually paid for this referral. This three-party structure involves two contractual relationships. The first is a lead generation agreement entered into between the Franchisor and the Lead Generator; and the second is the Franchise Agreement between the Franchisor and Franchisee. Franchisors may also receive leads from a network of other sources such as Franchisees, lenders, consultants and realtors; but a Franchisor will not typically enter into any formal agreement with these lead sources.

As will be discussed in detail later within this paper, the degree to which a Lead Generator interacts with a prospective Franchisee, as well as the manner in which the Lead Generator is compensated will each have a bearing on whether the lead generation relationship will come within the scope of some franchise sales laws.

2. **Single System Representative**

A “Single System Representative” is a non-employee (i.e. independent contractor) or firm retained by the Franchisor on an exclusive basis to sell franchises. This three-party structure involves two contractual relationships. The first is single-system Representation Agreement entered into between the Franchisor and the representative; and the second is the Franchise Agreement between the Franchisor and Franchisee.

There is virtually no distinction between a Single System Representative and a more traditional Franchise Broker, discussed below, with two notable exceptions. First, a Franchisor who engages an independent contractor to sell its franchises to the exclusion of all other franchised concepts should be cognizant of the possibility that the

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1 “Franchise Broker” means any person engaged in the business of representing a franchisor in offering for sale or selling a franchise and is not a franchisor, an affiliate of a franchisor, or an officer, director or employee of a franchisor or an affiliate of a franchisor with respect to such franchise. Ill. Rev. Stat., Sec. 705/3(21), Bus. Fran. Guide (CCH) Para. 3130.03.

Single System Representative might be reclassified as an employee, resulting in the Franchisor being liable for back wages and benefits. Second, as a practical matter the issue of divided loyalties, discussed below with respect to traditional Franchise Brokers, does not arise in the case of a Single System Representative.

3. Traditional Franchise Brokers

For the purposes of this paper, “Franchise Broker” refers to an organization, or person, other than an employee of the Franchisor, engaged in the offer and sale of franchises, in exchange for compensation from the Franchisor, typically a commission. It is worthwhile to note however, as discussed later in this paper, various Franchise Sellers are “Franchise Brokers” within the meaning of some state laws.

This three-party structure involves two contractual relationships. The first is a Broker Agreement entered into between the Franchisor and the Broker; and the second is the Franchise Agreement between the Franchisor and Franchisee.

In contrast to Lead Generators, which in general put the prospect and Franchisor in a position to pursue a franchise relationship, a Franchise Broker occupies a selling capacity almost indistinguishable from a sale conducted by the Franchisor’s own employees. However, while the Franchise Broker is responsible for selling franchises, the Franchise Broker is not a party to the Franchise Agreement between the Franchisor and Franchisee.

4. Area Representatives/Area Developers

The terms “Area Representative” and “Area Developer” are often used inconsistently. This paper uses the term “Area Representative” to mean a person or organization in a contractual relationship with the Franchisor, under which the Area Representative will engage in franchise selling activities within a defined territory, and thereafter provide post-opening services that would otherwise be performed by the Franchisor.

In contrast, for the purposes of this paper, “Area Developer” refers to the typical two-party franchise relationship between the Franchisor and Franchisee, where the Franchisee, who is also the “Area Developer,” is granted the right to establish and operate several franchised outlets within a defined territory. While this structure does

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3 See Internal Revenue Service Publication 1779 “Independent Contractor or Employee” (Rev. 8-2008) Catalog Number 16134L; and Breaux and Daigle, Inc. v. US, 900 F. 2d 49, 53 (5th Cir. 1990), citing United States v. Silk, 331 U.S. 704, 67 S.Ct. 1463, 91 L.Ed. 1757 (1947).

4 Franchise laws definitions of “Franchise Broker” are discussed in Section III.


not involve a third-party, it can involve a shift of responsibilities from the Franchisor to the Franchisee, as will be touched on later in this paper.

The “Area Representative” arrangement is a three-party structure that involves two contractual relationships. The first is an Area Representation Agreement entered into between the Franchisor and the Area Representative; and the second is the Franchise Agreement between the Franchisor and Franchisee. While the Area Representative is responsible for selling the franchises, and providing post-opening services related to the franchises, the Area Representative is not a party to the Franchise Agreements, which are entered into directly between the Franchisor and Franchisees.8

Typically the Area Representative will pay an initial fee for the right to enter into the Area Representation Agreement, and, in exchange for selling efforts will share revenue associated with the initial franchise fees paid to the Franchisor.9 Additionally, in exchange for providing post-sale services typically provided by the Franchisor (e.g., depending on the specific situation, training, marketing support, systems-standards compliance audits), the Franchisor will compensate the Area Representative, often based on a percentage of royalty fees the Franchisor receives in connection with the serviced franchises.

5. Subfranchisors

In a “subfranchise” relationship, there are two distinct contractual relationships, each of which involves a distinct franchise. The first franchise is between the Franchisor (sometimes referred to as a “Master Franchisor”) and the Subfranchisor (sometimes referred to as the “Master Franchisee”), and the second is between the Subfranchisor and the Franchisee. For the sake of consistency here, we will use the Franchisor, Subfranchisor and Franchisee for the three parties involved, as well as Master Franchise Agreement for the agreement between the Franchisor and the Subfranchisor, and Unit Franchise Agreement for the agreement between the Subfranchisor and the Franchisee.

Typically the Subfranchisor will pay the Franchisor a large licensing fee for the right to grant sub-franchises to Franchisees within a specified territory, as well as a continuing license fee or royalties that may be tied to the Subfranchisor’s revenues from Franchisees, number of unit franchises established or in operation, or some other factor.

Because each relationship will satisfy the elements of a “franchise,” each contractual relationship, unless excepted or exempt, will be subject to federal and state franchise sales laws, a topic discussed later in this paper.

The most unique feature of a subfranchising relationship, which must be considered when drafting agreements, is the potential for the master-franchise relationship to end while unit-franchises remain in operation. This risk will be among those discussed later in this paper.


9 See, id.
C. Need for Regulation

The one thing that all these three-party structures have in common is that they involve the offer and sale of franchises. Therefore, the same problems that led to the enactment of laws protecting prospective Franchisees are no less important with respect to these three-party structures. In fact, to some degree regulation may be even more important when a third-party is involved in a franchise sale, because there are two distinct Franchise Sellers, each of which is in a position to engage in the types of conduct that franchise sales laws seek to redress. Hence, disclosure laws, prohibitions against fraud, and other laws intended to protect prospective Franchisees may take on even greater importance when one considers that an unscrupulous third-party selling franchises can engage in the same improper behaviors in which a Franchisor can engage.

II. WHO IS CONSIDERED A BROKER OR A FRANCHISE SELLER?

A. Franchise Broker Definition under the FTC Rule

1. Former Rule — 1979

Under the original FTC Rule on Franchising of 1979 (“1979 Rule”), the FTC defined “Franchise Broker.” The Broker was “any person other than a Franchisor or Franchisee who sells, offers for sale, or arranges for the sale of a franchise.”10 The 1979 Rule went on to impose responsibility on the Broker for disclosure and made the Broker liable for certain disclosure violations. Franchisor employees were not included—just third-party sellers. The Franchisor still had to disclose, but the Broker had an independent obligation to comply with the disclosure requirements—the “first personal meeting” rule, for example. A failure to comply by the Broker meant the possibility of an independent action against the Broker by the FTC or, in more likelihood, franchisee or state regulator initiated litigation action under state law.

2. Revised FTC Rule of 2007

Under the revised FTC Rule on Franchising effective in 2007 (“FTC Rule”),11 there is a new definition, that of a “franchise seller”:

“…a person that offers for sale, sells or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities.”12

The concept of a franchise seller is broader than that of the 1979 Rule’s Franchise Broker. It specifically includes the employees of the Franchisor, not just third party sellers. The concept also includes "Third-Party Brokers" but there is no separate defined term “Franchise Broker” as before. A Franchise Broker and Area

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10 16 CFR §436.2(j) (October 21, 1979).

11 In this paper, references to the FTC Rule shall be references to the FTC Rule on Franchising effective in 2007 unless otherwise specifically referred to as the 1979 Rule.

12 16 CFR §436.1(j) (July 1, 2007)
Representative arrange for the sale of a franchise, as does a Subfranchisor, and each is therefore a “franchise seller” under the FTC Rule. Some franchise consultants (a type of Lead Generator) might also cross the “franchise seller” line.

The intent of the FTC Rule is to make the Franchisor responsible for disclosure, even in the case where a third party franchise seller is used. Accordingly, the Franchisor will need to monitor the actions of its Franchise Sellers to ensure compliance with the FTC Rule.

The FTC Rule eliminated the requirement that the Franchisor provide a prospective Franchisee with a Franchise Disclosure Document at the “first personal meeting.” This means that, in most instances, it will be sufficient if the Franchisor discloses a prospect with the FDD the requisite number of days before a Franchise Agreement is signed and the initial franchise fee is paid. This actually facilitates the use of Third-Party Franchise Sellers, since franchise sellers in most instances will not need to bring an FDD to the initial meeting to discuss the possible sale of the franchise.

With two exceptions, the FTC Rule does not make a Franchise Seller, other than the Franchisor, responsible for disclosure. Under these exceptions, every Franchise Seller, including Franchise Brokers and Area Representatives, has an affirmative obligation to provide disclosures to a prospective Franchisee.

First, a Franchise Seller has an obligation to provide a franchise disclosure document upon the prospective Franchisee’s reasonable request. Specifically, the FTC Rule declares it to be “an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act for any Franchise Seller” to “[f]ail to furnish a copy of the franchisor’s most recent disclosure document … to a prospective franchisee, upon reasonable request” either (1) earlier in the sales process than the disclosure document must otherwise be provided, or (2) “before the prospective franchisee signs a franchise agreement.” Second, it is also an unfair and deceptive practice for any Franchise Seller making a financial performance representation to fail to provide certain specified information when the financial performance representation relates to past performance of the franchisor’s outlets; or to fail to “[i]nclude a clear and conspicuous admonition that a new franchisee’s individual financial results may differ from the result stated in the financial performance representation.” Other than in the case of these exceptions, the FTC Rule gives disclosure responsibility solely to the Franchisor, including a Subfranchisor. State franchise rules, as discussed later, may make the Franchise Seller responsible for disclosures in additional instances.

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13 16 CFR 436.1(j) (July 1, 2007).
14 16 CFR §436.2 (a), (b) (July 1, 2007); “The preparation and distribution of the disclosure document is the sole responsibility of the franchisor.” 72 Federal Register 61 (March 30, 2007) p. 15461.
15 16 CFR §436.9(e) (July 1, 2007).
16 16 CFR §436.9(f) (July 1, 2007).
17 16 CFR §436.9(c)(i) (July 1, 2007).
18 16 CFR §436.9(c)(ii) (July 1, 2007).
The contact information for the Franchise Seller involved in each offer must be included on the receipt pages of the FDD.\footnote{16 CFR §436.5(w)(2) (July 1, 2007).} This means that the Franchisor will need to ensure that the names and contact information for any third party franchise seller are included there, as more fully discussed in Section IV.B.2.a, below.

A Subfranchisor, while included in the definition of Franchise Seller, has the additional responsibility of preparing its own disclosure statement, since it is a “franchisor” in its own right.\footnote{16 CFR §436.1(k) (July 1, 2007); Franchise Rule Compliance Guide (May 2008), page 17.} Its disclosure must also include certain information about the Franchisor.\footnote{16 CFR §436.6(f) (July 1, 2007).} As stated in the FTC’s Franchise Rule Compliance Guide, “[b]oth the franchisor and any subfranchisor are responsible for each other’s compliance with the amended Rule and are jointly and severally liable for each other’s violations.”\footnote{Franchise Rule Compliance Guide (May 2008), page 17.} The Rule does not apply to franchises to be located outside of the United States or its territories\footnote{16 CFR §436.2 (July 1, 2007).}, so if the Master Franchise Agreement is for a foreign Subfranchisor who will grant franchises in a foreign country, this joint and several liability issue is not a factor. But where the Master Franchise arrangement is to be used on domestic soil, the Franchisor will need to see and be comfortable with the accuracy of the Subfranchisor’s FDD. Likewise in that case, the Subfranchisor will need to be comfortable with the Franchisor information it is provided for the preparation of its FDD.\footnote{“Although the amended Rule requires subfranchisors who prepare disclosure documents to include all required information about the franchisor, it does not assign responsibility for preparation of the disclosures to either the franchisor or subfranchisor, but leaves the determination to them.” Franchise Rule Compliance Guide (May 2008), page 123.}

The FTC Rule definition of “Franchisee Seller” expressly excludes “existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.”\footnote{16 CFR §436.1(j) (July 1, 2007).} Of course, if the Franchisor or someone acting on behalf of the Franchisor is actively involved in the sale of the existing outlet, then the FTC Rule’s disclosure requirements must be met, but a Franchisor simply exercising the “right to approve or disapprove” a Franchisee’s sale of its existing franchise does not make the Franchisor into a Franchise Seller with respect to the transferee.\footnote{FTC Franchise Rule Compliance Guide (May 2008), p. 18.}

\section*{B. The States} \label{b_the_states}

The North American Securities Administrators Association (“NASAA”) issued the “2008 Franchise Registration and Disclosure Guidelines,” adopting verbatim the FTC definition of “franchise seller.”\footnote{NASAA Guidelines, definition (h), page 29.} And, in general, a Third-Party Franchise Seller's
Disclosure obligations under state disclosure law will be consistent with the requirements of the FTC Rule in those instances when the particular state has adopted the NASAA Guidelines, although the NASAA Guidelines add several additional requirements. As discussed below, depending on the specific state and circumstances, a Third-Party Franchise Seller may need to separately register with a state regulatory agency, a Franchisor may be obligated to identify a Third-Party Franchise Seller to a state regulatory agency as part of the franchise registration process, or may even be required to identify Third-Party Franchise Sellers in certain FDD items.

Franchisors and Third-Party Franchise Sellers should be mindful that the franchise sales laws of New York and Rhode Island retain a “personal meeting requirement.

In the case of a franchise offering within the scope of the New York State Franchise Sales Act, a prospective franchise must be provided with a Franchise Disclosure Document “at the earlier of (a) the first personal meeting between the Franchisor or its agent and the prospective franchisee, (b) at least ten business days prior to the execution of a binding franchise or other agreement, or (c) at least ten days prior to the receipt of any consideration in connection with the sale or proposed sale of a franchise.” 28 The New York State Franchise Sales Act defines: “first personal meeting’ shall mean the first face to face meeting between a Franchisor or Franchisor’s agent or any representative or employee thereof and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise.” 29

The Rhode Island Franchise Investment Act similarly requires that a prospect be disclosed at or before the “first personal business meeting with the Franchisor which is held for the purpose of discussing the sale or possible sale of a franchise.” 30 While worded so as to apply to a first personal meeting “with the Franchisor,” other definitions within the Act bring a Franchise Broker or Area Representative within the scope of the “first personal meeting requirement.” 31 Specifically, the Area Representative’s payment for the right to sell or negotiate the sale of franchises results in a “master franchise” under the Act; making the Area Representative a “subfranchisor” under the Act; and a “franchisor” “with regard to its relationship with a franchisee.”

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29 Id.
31 Rhode Island Gen. Laws 19-28.1-3 (j), Bus. Fran. Guide (CCH) Para. 3390.03. "Franchisor" means a person who grants a franchise. Franchisor includes a subfranchisor with regard to its relationship with a franchisee, unless stated otherwise in this Act. (m) "Master franchise" means an agreement express or implied, oral or written, by which a person pays a franchisor for the right to sell or negotiate the sale of franchises. (u) "Subfranchisor" means a person who is granted a master franchise.
C. Particular Legal Issues Facing Franchise Sellers and the Companies They Represent

1. Franchise Seller Registration

In the case of states where registration of sales agents/brokers is required separately, New York and Washington\textsuperscript{32}, the Franchisor will need to ensure that the representative is registered as required. For example, the Franchisor will likely want the representative to provide the Franchisor proof of registration at the beginning of any relationship. See Section IV.

In states where the Franchisor must provide Franchise Seller information with its registration, including California\textsuperscript{33}, Hawaii\textsuperscript{34}, Illinois\textsuperscript{35}, Maryland\textsuperscript{36}, Minnesota\textsuperscript{37}, North Dakota\textsuperscript{38}, New York\textsuperscript{39}, Rhode Island\textsuperscript{40}, and Washington\textsuperscript{41}, the Franchisor may have some liability for inaccurate information, even though it may have been provided by the Franchise Seller. The Franchisor may also have an obligation to update this information, for instance where a Franchise Seller is no longer selling the franchise.

New York’s extra-territorial applicability provision\textsuperscript{42} makes its franchise law applicable to offers from New York. Thus, unlike the FTC Rule and laws of other states, it may include a Master Franchise arrangement even where the Subfranchisor and Franchisees are not in the United States, if the Franchisor sells franchises from New York, either because it is headquartered in New York, or its sales operations are based in New York. The precise extent of that issue is unclear, but New York Franchisors should keep it in mind. For example, it may be that New York Franchisors will be

\textsuperscript{32} New York Regulation 200.11, Registration of Franchise Sales Agents; Washington, Sec. 19.100.140. Registration Required – Franchise Brokers or Selling Agents; Washington Regulation WAC 460-82-200, Franchise Broker Record Requirements.

\textsuperscript{33} 10 C.C.R 310.111 requiring application conform to the “uniform franchise disclosure document” prescribed by the North American Securities Administrators Association (“NASAA”), 2008 Franchise Registration and Disclosure Guidelines, which specify the filing of a “Franchise Seller Disclosure Form (or “Form D”).

\textsuperscript{34} The exact regulatory basis is unclear; but the authors understand regulators in Hawaii to require the submission of salesperson disclosure forms.

\textsuperscript{35} Illinois Administrative Code, Sections 200.600 (original registrations), 200.603 (annual reports).

\textsuperscript{36} “Information for Franchisors: Before You Offer a Franchise in Maryland” published (updated June 30, 2008) by the Securities Division of the Office of the Attorney General for the State of Maryland, requiring the filing of a Franchise Seller Disclosure Form (NASAA format).

\textsuperscript{37} “How to Register” franchise registration information published on the Minnesota Department of Commerce website.

\textsuperscript{38} Registration of Franchises, North Dakota Securities Department, Bus. Fran. Guide (CCH) Para. 5340.50.

\textsuperscript{39} 13 N.Y.C.R.R. Section 200.3.

\textsuperscript{40} Rhode Island Franchise Registration Application (Revised June 25, 2008), Bus. Fran. Guide (CCH) Para 5391.

\textsuperscript{41} Wash. Admin. Code, Section 460-80-125.

required to register their international Master Franchise offering, and even find themselves jointly and severally liable to an international Franchisee with the Subfranchisor for the disclosure content.

The Franchisor could be held liable for the actions or inaction by the third party even where the third party is not the agent of the Franchisor. If the third party seller makes financial performance representations outside the FDD, they may be attributed to the Franchisor. Certainly the Franchisor will be named in the lawsuit, especially if there is fraud alleged.43

The Franchisor needs to implement standard procedures for disclosure when third parties are involved. If the Franchisor reserves the disclosure delivery to itself, the risk will be somewhat mitigated, but in a state that retains the first personal meeting rule, there will be a chance that the third party seller fails to inform the Franchisor when that meeting will take place, or worse, has taken place.

Who is to keep the records of disclosure, the dated, signed receipt pages? Will the Franchisor keep the originals? How about records pertaining to field support in the case where the third party is supporting the Franchisees post sale, for example in the case of an Area Representative? A Franchisor should have a clear policy and understanding with its Franchise Seller on these issues. Again, issues will arise if the records are poorly maintained, not kept or lost altogether.

2. **Third Party Franchise Seller Brand Concerns**

The Franchisor using a third party for sales or service loses some control. This means that the Franchisor will need to be vigilant in monitoring the third party seller/servicer to ensure that its brand is not adversely affected by the actions of the third party. For example, unscrupulous sales practices will adversely affect the brand image.

And the third party servicer may be directly responsible for training and field support, two other areas where the brand can be directly affected. For training, will the training standards meet those of the Franchisor? Will the appropriate subjects be covered?

How about system standards? What if the Area Representative or the Subfranchisor disagrees with the Franchisor on a particular standard? As a practical matter this may mean that certain areas may not be consistent with other areas in the system. For example, the menu items or services offered in the Area Representative's/Subfranchisor's territory may not be the same as those offered in another territory of the system. Or the cleanliness standards may differ from territory to territory. While standards may be difficult to maintain even in a company owned or managed system, the issues relating to consistency across the system are magnified by having a third party involved.

3. Liability Issues for the Franchisor

The actions of and failure to act by the third party can under some circumstances be attributed to the Franchisor. Even where the third party is not the agent of the Franchisor, there is risk that the Franchisor will be charged with the transgressions of the third party franchise. If the third party franchise seller makes financial performance representations, for example, they may be attributed to the Franchisor. Certainly the Franchisor will be named in the lawsuit, especially if there is fraud alleged.

Will the third party properly disclose the prospective Franchisee? Most franchise practitioners know the requirements—the prospective Franchisee must be given an FDD not later than 14 days before it signs an agreement or pays\textsuperscript{44}; if there are any Franchisor changes to the agreements, the prospect must be given completed agreements not later than 7 days before signing or paying\textsuperscript{45}; the Franchise Seller cannot make any financial performance representations that are not in writing, do not have a reasonable basis and are not contained in Item 19 of the FDD\textsuperscript{46}; and the Franchise Seller cannot make representations that conflict with the FDD\textsuperscript{47}. The Franchise Seller must also provide an FDD earlier than the 14 days if requested by the prospect, and the most recent FDD and any quarterly updates if the prospect requests it\textsuperscript{48}; among others. Both the Franchise Seller and the Franchisor should monitor the FDD disclosures to identify any material changes.\textsuperscript{49}

If the Franchisor reserves the disclosure delivery to itself, the risk will be somewhat mitigated, but issues remain. For example, in a state that retains the first personal meeting rule, there will be a chance that the third party seller fails to inform the Franchisor when that meeting will take place, or worse, has taken place. In the case where the third party is to make disclosure, the Franchisor remains responsible, so some standard procedure will need to be in place to ensure that proper disclosure has taken place.

Who is to keep the records of disclosure, the dated, signed receipt pages? Will the Franchisor keep the originals? How about records pertaining to field support in the case where the third party is supporting the Franchisees post sale, for example in the case of the Area Representative? Again, issues will arise if the records are poorly maintained, not kept or lost altogether.

In a Master Franchise, will the Franchisor have liability for the Subfranchisor’s failure to register its offering in the registration states? How about for content of the Subfranchisor’s FDD?

\textsuperscript{44} 16 CFR §432(a) (July 1, 2007).
\textsuperscript{45} 16 CFR §432(b) (July 1, 2007).
\textsuperscript{46} 16 CFR §436.9(c) (July 1, 2007).
\textsuperscript{47} 16 CFR §436.9(a) (July 1, 2007).
\textsuperscript{48} 16 CFR §436.9(e),(f) (July 1, 2007).
\textsuperscript{49} See Section V(E).
Is the Franchisor liable for third party franchise grants causing encroachment within the system? Is the Franchisor liable if the subfranchisor grants franchises resulting in encroachment? How can the Franchisor monitor and control the activities of the third party to prevent this?

These and other issues will be discussed below.

III. ADVANTAGES AND DISADVANTAGE OF EACH TYPE OF STRUCTURE

A hallmark of a successful franchise system is the ability to find quality Franchises, either for new locations or to replace those Franchisees that are no longer able or willing to operate their franchises. Franchisors may choose to engage a variety of internal and external sales agents as their systems evolve and their needs change. And, in some cases, the third party will also provide support to the franchisees after the sale. Each type of third party franchise seller/servicer will have different advantages and disadvantages. Franchisors seeking to enter into a third-party selling/servicing arrangement must choose the third party seller/servicer that will provide the best fit with the system.

A. Lead Generation Providers – Professional Lead Systems and Lead Referral Arrangements

Obtaining leads for potential Franchisees is an important aspect of selling franchises. Franchisors can choose to outsource their lead generation activities to third party referral sources. These referral sources may include internet lead generation systems or professional franchise consulting. Franchisors also may rely upon a network of other Franchisees in the system, lenders, consultants, realtors and business coaches but these sources usually do not involve contractual relationships.

The degree to which a Lead Generator interacts with a prospective Franchisee can vary considerably. On one end of the spectrum, the Lead Generator may simply use a web-based form to gather information from a prospective Franchisee (e.g. name, contact information, geographic interest, etc.), which is forwarded to one or more Franchisors based on the information provided by the prospect. On the other end of the spectrum, there are “franchise consulting services” positioned as able to match a prospective Franchisee to a particular concept, based on that prospect’s individual interests, goals and financial circumstances. The compensation structures can similarly vary. The simple Lead Generator will typically be paid simply for passing along the contact information of a prospective Franchisee, without regard to whether that information leads to a franchise sale, while a Franchisee consulting service may be paid a commission that is only earned if the prospective Franchisee signs a Franchise Agreement.

1. Internet Lead Generation Systems

Internet lead generation systems generate potential leads through online websites. These websites capture information regarding a potential Franchisee’s interests and qualifications through an online screening process. The lead generation systems then immediately transfer the leads to Franchisors; usually without engaging in any further contact with the potential Franchisee and almost always without engaging in

50 See, e.g., FranChoice website (as of June 1, 2011), www.franchise.com/services/franchise-consulting-services?origin=home&destination=whatwedo.
any substantive conversations with the prospective Franchisees. If the Lead Generator stays involved with the potential Franchisee throughout the entire process, then they are acting as more of a traditional Franchise Broker which is discussed later in this section. Franchisors are then “charged” for lists of leads that the Franchisor then has to pursue through its in-house staff. The payment structure is typically set up for a certain dollar amount per lead.

Franchisors may feel the pressure to ensure that their franchise system is adequately represented on the currently “popular” lead generation websites and in particular, on any lead generation system that includes a direct franchise competitor. Franchisors may also fear that not being listed on a lead generation website is an indication of a franchise system that is not sufficiently popular or successful enough. Certainly, a website that offers a comparison of franchise systems may appeal to a prospective Franchisee that is evaluating its prospects.

The disadvantages with an internet Lead Generator system are the costs and quality of the leads, along with the time investment. If there is a charge on a “per click” basis, the Franchisor may pay a great deal of money for lists of leads that only randomly found and browsed the lead website. The leads may only meet the most basic of criteria and many may not even contain valid information. In the worst instances, the potential lead may have only “clicked” on a general informational page relating to a Franchisee and might have had their contact information obtained without a real understanding that they would be contacted by a Franchisor. The result is that the Franchisor may see very little return on its capital expenditures. New Franchisors that are not experienced in allocating their marketing resources may find that they have spent their entire budget in the first few months with the internet lead services. The other main disadvantage is the time commitment. With the lists of leads, the Franchisor will usually spend a great deal of time further evaluating the quality of leads. The time considerations may lead the Franchisor to retain additional in-house personnel for the lead evaluation as well as the sales process. This retention carries the additional burden of costs for salary, benefits and employment taxes. A Franchisor may quickly become dissatisfied with paying for leads and lead evaluation services.

2. Lead Referral Arrangements

While the role of lead referral sources varies from system to system, generally lead referral sources provide the names of potential Franchisees to the Franchisor’s sales department based on some personal contact. The referral source may have a primary business of coaching potential Franchisees in their business options or even in selecting the franchise system that is right for them. An experienced lead referral agent may even make sure that the lead meets the Franchisor’s minimal operational and financial qualifications before referring the lead to the Franchisor. The lead referral source can also be other Franchisees in the system, lenders, franchise consultants, realtors and business coaches and the Franchisors may simply have a program that gives a limited fee to anybody who refers a prospect to them. Lead referral programs may be structured in a variety of ways, although some compensation is typical. Where possible, a lead referral program should be documented in formal policies that specify the commission or fee that a Franchisor will pay for each referral that it receives. Commissions vary from hundreds of dollars to a percentage of the initial franchise fee. Ultimately though, it is the Franchisor’s responsibility to review and approve the leads and work with the prospects during the franchise sales process.
From the Franchisee perspective, lead referral participants are often a better source of information on a system than a mere internet lead referral program. If the lead referral is already very familiar with the system, then the prospect is likely to come to the Franchisor as a very interested party. If the prospective Franchisee is hiring the referral source for its services in evaluating the system, the prospect may receive a better comparison of systems than if it were doing its own evaluation. Even with these positive attributes, there are certainly risks for any prospective Franchisee. Prospective Franchisees should know the commission structure as a safeguard against being steered toward a system with a higher commission structure. Prospects may also not be as comfortable working with the Franchisor’s representative when they are finally introduced, and may have been misled by the referral on certain aspects of the franchise system.

Franchisors will generally have better quality leads from a lead referral arrangement than from an internet based lead program because the referring party may have better information to present to the prospect. Certainly, the prospect is going to expect contact from the Franchisor even where the referral comes from a banker, realtor or other business contact. If the prospect is already discussing the investment with a third party, then the prospect is likely to have either researched becoming a Franchisee or even the actual franchise system. In the referral arrangements wherein the prospect hires a franchise consultant to help evaluate systems, the franchise consultant will have guided the prospect through some of the “internal” due diligence regarding whether the system is a good fit for their needs and goals.

If the Franchisor is seeking a more formal referral relationship with a referral source, then it is important for Franchisors to know if the referral source is also referring its contacts to the Franchisor’s competitors and if so, how will the referral source determine which prospects are sent to which brand. A referral source may be tempted to steer the potential Franchisee towards the franchise system that will generate the highest commission if the only determination is the percentage of the sale that the referral source will obtain. If a Franchisor wishes to have a referral source not refer prospects to competitors, then the Franchisor might need to increase the commission payment. In this regard, the referral source might cross the line into becoming a traditional Franchise Broker. Additionally, a referral source might exaggerate the commitment of a prospective Franchisee in order to “encourage” the Franchisor to commit to a higher commission fee before providing the referral. To address these concerns, a commission structure that is based on either execution of the Franchise Agreement or the opening of the franchised business may be a better structure if feasible. Alternatively, a Franchisor might elect to use a traditional Franchise Broker.

B. Traditional Franchise Brokers

Franchise Brokers may vary in their level of involvement with the franchise sales process but their involvement in almost all aspects of the sales process distinguishes a Franchise Broker from a lead referral source. Franchise Sales Brokers generally have experience in marketing and selling franchises for multiple franchise brands even if they elect to enter into a Broker Agreement with only one system or multiple agreements with multiple Franchisors. Franchise Brokers prescreen prospects, provide information about the systems if the prospect is interested, often provide the FDD for disclosure.

51 As mentioned earlier, franchisors that contract with a Franchise Broker that works with only their system have the risk of being considered an employee and not a third party consultant.
purposes and arrange for meetings with the representatives of the Franchisor. Franchise Brokers may also have final disclosure obligations as a “franchise seller” under the FTC Rule, as discussed previously. Franchise Brokers are not, however, parties to the Franchise Agreement with the Franchisee and do not have post-franchise sale responsibilities.

1. **Advantages and Disadvantages from the Franchisor Perspective**

When compared to an internet Lead Generator approach or a lead referral system, traditional Franchise Brokers can offer a more dedicated sales approach for a franchise system. A good Franchise Broker is usually a true sales professional with an engaging manner and forthright sales pitch. If the Franchise Broker has been in the franchise sales business for years, then the Broker is likely to have had experience in multiple systems and can hopefully provide detailed advice and “war stories” on advertising campaigns. If the Broker represents multiple, but not competing systems, then there is the potential for increased lead generation from the Broker’s actions. Prior experience in franchise sales should also mean that the Broker knows the appropriate selling practices, or at least, has references that a Franchisor can then use to verify the Broker’s attitude and actions with disclosure compliance. If a Franchisor can structure the Broker representation in a way that the Broker is only compensated for preapproved expenses and for commissions on legitimate sales, then the Franchisor may obtain a good independent sales force for less cost than a hiring salaried in-house personnel.

Franchisors should be mindful of a Franchise Broker’s actual ability to generate franchise sales and experience as a Franchise Broker. A Franchise Broker might exaggerate his contacts in the franchise arena or his prior success stories. Both actions will lead to a lack of actual results. Even with a commission structure, a Franchisor is going to invest time and money into any Franchise Broker in order to train the Broker on the system and to increase the Broker’s visibility with potential Franchisees. The Franchisor may find itself having spent a great deal of money on travel expenses but without actual results. The commission structure itself may lend itself to situations in which the Broker provides unqualified leads by exaggerating the financial qualifications or experience of the franchise prospect in order to close the sale for the Franchisor. Franchisors should independently verify the qualifications of any potential Franchisee. A provision in the Broker Agreement in which a commission is not fully earned until the Franchisee qualifies for a business loan may be unpopular but will provide additional protection to the Franchisor. Furthermore, if a Broker represents more than one concept, the Broker may favor the concept that has a higher commission structure or a concept that is currently more popular with potential Franchisees.

2. **Advantages and Disadvantages from the Franchisee Perspective**

While a Franchisee may have little or no opportunity to decide its primary contact with a franchise system, a Franchisor should consider the Franchisee’s perspective in determining its sales approach. A Franchise Broker that represents several systems may be able to assist a prospective Franchisee in deciding which system is a good match for the Franchisee’s strengths and weaknesses. A Franchise Broker may be considered more trustworthy or more experienced in comparing systems in a prospect’s eyes than a Broker that is dedicated to only one system or an in-house sales person. There are also disadvantages to a Franchisee with a Franchise Broker. If the
prospective Franchisee is not experienced, the prospect may not realize that the Broker is paid by a commission for the sale. The Broker’s desire for such a commission may incentivize a Broker to recommend a "less than perfect" Franchisee to earn a commission or to recommend a franchise system that has a higher commission. A Franchisee may also not receive the most up-to-date or the detailed information on the system that it would receive if the prospect was working directly with the Franchisor, or with an Area Representative or Subfranchisor.

C. Area Representatives

As described above, an Area Representative has a contractual relationship with a Franchisor, under which the Area Representative sells franchises within a defined territory, and also services the franchises within that same territory. Franchise Agreements, however, are entered into directly between the Franchisor and Franchisee, and the Area Representative will not have a contractual relationship with the Franchisee. Typically the Area Representative will also be a system Franchisee with unit franchises within the same area.

1. Role of an Area Representative

An Area Representative's role depends upon the terms of its contract with the Franchisor, as well as the requirements imposed by franchises sales and related laws.

With respect to franchise sales, any Area Representation Agreement will typically include a development schedule establishing the number of unit franchises that must be in operation by specific points during the term. Depending on the particular Area Representation Agreement, the Area Representative may have a right, or an obligation, to itself operate a certain number of unit franchises by certain points during the term. An Area Representative’s unit franchises can be important to the Area Representative’s ability to effectively meet other obligations under the Area Representative Agreement, such as training other area Franchisees.

Although an Area Representative is typically not required to prepare its own FDD or register the franchise offering that it will sell; some state laws may be read to impose these types of requirements on Area Representatives. And of course, the Area Representative will in other respects be subject to a number of franchise sales laws, including provisions of the FTC Rule and state disclosure laws. The Area Representative, as a “franchise seller,” has an obligation to provide the FDD upon a prospective Franchisee’s request, and an obligation to provide written substantiation of financial performance representations.53

52 Upon the reasonable request of a prospective franchisee an area representative must, and it is a violation of Section 5 of the FTC Act for an area representative to “fail to furnish a copy of the franchisor’s disclosure document” at point “earlier in the sales process” than otherwise required under the FTC Rule. It is similarly unlawful for an area representative to fail to, upon a prospective franchisee’s reasonable request, furnish a copy of the franchisor’s “most recent disclosure document and any quarterly updates” prior to the franchisee’s signing of the Franchise Agreement. 16 CFR 436(f).

53 An area representative, as a “franchise seller,” has an affirmative obligation to, and it is a violation of Section 5 of the FTC Act for an area representative to, “fail to make available to prospective franchisees, and to the [Federal Trade] Commission upon reasonable request, written substantiation for any financial performance representations made in Item 19.” 16 CFR 436.9(d).
2. **Area Representative May be a "Subfranchisor" Under State Franchise Laws**

A potential disadvantage to both Franchisors and Area Representatives is an Area Representative could be treated as a “Subfranchisor” under some state franchise sales laws; even though an Area Representative does not enter into franchise agreements with Unit Franchisees. This is because, most franchise sales laws, including the FTC Franchise Rule, define “area franchise”

54 “subfranchise”55 “master franchise”56 or “franchise seller”57 in ways that fail to distinguish between an Area Representative and a Subfranchisor.

To illustrate this, consider California Corporations Code Section 31008.5, which defines:

"Subfranchise" means any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, for consideration given in whole or in part for that right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor. ...

This definition is broad enough to encompass an Area Representative, typically "granted the right, for consideration given in whole or in part for that right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor." The most significant implication is that, even though an Area Representative does not grant franchises, these state laws may be interpreted as requiring an Area Representative to prepare and register an FDD.

With respect to the FTC Rule, the FTC enforcement staff has stated that it would not consider an Area Representative a “franchisor” if that Area Representative does not enter into contracts with the Franchisees.58 NASAA has similarly distinguished between Area Representatives and Subfranchisors, while observing that "state laws may treat these arrangements as subfranchises.59 Along the same lines, the Commissioner of the California Department of Corporations issued a statement, making clear that under the California Franchise Investment Law, an Area Representative would not be a

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54 Hawaii Franchise Investment Law, HRS Sec. 482E-2; Maryland Franchise Law, 14-201(c); Michigan Franchise Investment Law, Sec. 445-1502(6); Minnesota Franchise Act, Minnesota Statutes Chapter 80C.01 subd. 7; New York General Business Law, Article 33, Sec. 681.6; North Dakota Franchise Investment Law, Sec. 51-19-02.2; Oregon Revised Statutes, 650.005(1); Wisconsin Franchise Investment Law, Sec. 553.03(2).


56 Rhode Island Franchise Investment Act, Sec. 19-28.1-3(m).

57 South Dakota, Section 37-5B-1(13); FTC Franchise Rule.

58 FTC Franchise Rule Frequently Asked Questions; Response to Question 9; Business Franchise Guide Par. 6090.

“subfranchisor” because the Area Representative is not a party to the franchise agreement with the Franchisee.60

The extent to which other state regulators are interpreting Area Representatives to be “subfranchisors” is unclear; and relatively few courts have considered the issue. Two recent cases under the Washington Franchise Investment Protection Act (“FIPA”) illustrate the lack of certainty regarding this issue. In 2009, the Court of Appeals of Washington declined to grant discretionary review of a partial summary judgment decision, which granted rescission of a franchise agreement on the grounds that the Area Representative for Nick-N-Willy’s Franchise Company had not independently registered the franchise offering.61 Yet, one year later, the same court, in an unrelated decision, held that the very same Area Representative “did not violate FIPA’s registration requirement because the Nick-N-Willy’s franchise offered … was already registered [by the franchisor].”

3. Advantages and Disadvantages from the Franchisor Perspective

The primary objective of an Area Representative relationship is the accelerated expansion of a franchised system within or into a discrete geographic area. While an Area Representative relationship can be a very effective means of targeted system growth, Franchisors considering entering into an Area Representative Agreement need to weigh the advantages and disadvantages of doing so.

a. Advantages

There are a number of significant favorable aspects to using an Area Representative to help expand a system’s presence within a defined territory. As mentioned above, typically an Area Representative not only engages in franchise selling efforts, but will itself establish and operate at least one unit franchise within the territory. By being located in the expansion market, an Area Representative, as compared to a distant Franchisor, is better-positioned to identify and meet with prospective Franchisees. However, because the Franchisor ultimately determines whether to enter into a Franchise Agreement with a prospective Franchisee, and the Franchisor is a party to the Franchise Agreement, the Franchisor retains considerable control over Franchisee selection and the enforcement of system standards. The Franchisor can quickly expand its market presence without sacrificing control over the franchise system.

A Franchisor using its own in-house franchise sales team to develop an area needs to pay salaries, engage in local promotional efforts, and often pay considerable travel expenses to spend time in a non-headquarters market. When a market is first being developed, it can be particularly expensive for a Franchisor to support. Until a critical mass of unit franchises exists in an area, the costs of visiting unit franchises, on a per unit basis, is relatively high, both from a human and financial resources perspective. This is particularly the case now, when fuel and airline ticket prices are at near historic rates. In contrast, an Area Representative typically pays an initial fee for the rights to


develop the franchise system in a particular market, and is responsible for its own operating costs.\textsuperscript{62}

An Area Representative who is also a Franchisee is uniquely poised to understand the dynamics that will be encountered by other Franchisees, and therefore may be in the best position to screen franchise candidates. Additionally, the Area Representative’s own operational experience will bring a degree of credibility that can be assuring to potential Franchisees.

A key benefit to the use of an Area Representative is that the Area Representative is “local” and has knowledge of the area. The Area Representative will be relatively well-positioned to identify resources, potential unit franchise locations, potential Franchisees and even potential employees. The Area Representative is better positioned than the distant Franchisor or local Franchise Broker to know the development and operational challenges faced in a particular area.

Although the Franchisor will be able to “veto” any prospective Franchisee identified by an Area Representative by declining to grant a franchise to that prospect, doing so other than in extreme situations will not be conducive to a mutually successful area representative relationship. Fortunately, an Area Representative has a significant interest in selecting Franchisees who will adhere to the system’s standards, and be good brand ambassadors. By being primarily responsible for Franchisee selection, the Area Representative will understand that the Area Representative’s selections will reflect upon the Area Representative; and could even influence whether the Area Representative relationship will continue. Additionally, typically the Area Representative will have a royalty sharing arrangement with the Franchisor, and a poorly operated unit franchise will lead to less revenue for the Franchisor and Area Representative alike. Moreover, because the Area Representative provides field support to area-Franchisees, it is the Area Representative, first and foremost, who will be forced to deal with any problem situations, even if ultimate enforcement of the Franchise Agreement rests with the Franchisor.

By selecting an Area Representative who the Franchisor can count on to be a good unit operator, the Franchisor will have someone in the market who can lead by example. Additionally, the Area Representative’s unit franchise can be incorporated into a training program for new Franchisees, or for the roll out of new products or services.

b. Disadvantages

Although beneficial to the Franchisor in a number of ways, there are some pitfalls associated with an area representative arrangement, including: giving up some control, giving up some revenue, putting itself in a position from which extricating itself may be difficult, potentially having to be highly involved in the area and potentially subjecting the sale of its franchises to added regulation.

Depending on where the Area Representative is located and how the relationship is structured, it may itself be a “franchise” under the FTC Rule certain state law,

particularly given the expectation that the Area Representative will itself operate a unit franchise.

And, as touched on above, and discussed in more detail below, some state franchise sales laws may be construed as imposing registration requirements directly upon an Area Representative, notwithstanding that the Area Representative is not entering into an agreement with Unit Franchisees. The consequences of an Area Representative’s non-compliance with state franchise sales laws can be significant. Consider that even if a Franchisor has properly registered its franchise offering, the sale of a franchise by an Area Representative who has not first complied with a particular state’s franchise seller registration laws could result in the Franchisee having a statutory right to rescind the franchise.63

Typically the Franchisor pays the Area Representative a percentage of the initial franchise fees and royalties paid by Franchisees in the area. As a result, the Franchisor’s revenue related to the unit franchises is significantly reduced as compared to what it might be if the Franchisor retained 100% of the moneys received. In considering whether to enter into an area representative relationship, the Franchisor needs to consider whether the benefits of using an Area Representative outweigh this revenue loss. If an Area Representative does not perform its obligations then the Franchisor may have to devote more time and resources with less than typical income.

When a Franchisor disagrees with decisions or actions of an employed franchise sales or operations person, the Franchisor can take corrective action including terminating that sales person’s employment. In contrast, it can be very difficult and costly to redress the identical issues when the person interacting with potential and actual Franchisees is an Area Representative.

To a significant degree, ending a relationship with an Area Representative is closer to terminating a franchise, than to discharging an employee. In contrast to an at-will employment situation, prematurely ending a relationship with an Area Representative requires that the Area Representative’s action or inaction rise to a breach of the Area Representative Agreement; and may require that the Area Representative have an opportunity to cure the breach. If an Area Representative Agreement is a “franchise” or operates one or more franchises within the meaning of an applicable franchise relationship law, then compliance with state law will also be necessary.

Additionally, the Franchisor’s interaction with Franchisees within the area during the pendency of a dispute with the Area Representative could be strained if the Franchisees are supportive of the Area Representative’s position.

It is important to recognize that the Franchisor’s obligations to Franchisees are determined by the Franchise Agreement, and that the Franchisor ultimately remains responsible for satisfying its obligations under the Franchise Agreement if the Area Representative is failing to do so. Being a good unit operator does not mean that the Area Representative will excel at selling franchises or training franchisees. Nor does

being an operational expert necessarily mean that the Area Representative will be able to successfully train other Franchisees. There are many skilled individuals who do not make great sales people or teachers.

A Franchisor who uses an Area Representative to service Franchisees within the territory must be prepared to jump in and do those things when an Area Representative is not adequately performing. Similarly, the Franchisor must be prepared to step into the breach if for some reason the Area Representative becomes incapable of continuing to service franchises. Whether or not the Area Representative is in breach of its contract is irrelevant; the bottom line is that the Franchisor will need to honor its contractual obligations to area Franchisees; and protect the Franchisor’s intellectual property interests. Additionally, there are aspects of the franchise relationship that, while not always contract-based, are important to the reputation of the system, and the performance of Franchisees, such as having a system is in place to receive and respond to consumer complaints. The Franchisor’s ability to contractually respond to the short comings of the Area Representative is not going to resolve the issue of the Franchisor’s continuing responsibilities vis-à-vis Franchisees within the territory.

As noted above, an Area Representative can set a good example for other Franchisees. However, as the preceding topics suggest, there are instances when an Area Representative, from the perspective of the Franchisee, may not be satisfying its obligations under the Area Representative Agreement, or under a Unit Franchise Agreement. When the issue is one that relates to the Area Representative’s operation of a unit franchise, there is a significant risk that other Franchisees within the territory will view an Area Representative’s non-compliance with system standards as a license to engage in the same non-compliant behaviors. For this reason, and others, it is not only important that a Franchisor carefully consider its selection of an Area Representative, but periodically and independently assess how the unit franchises are being operated within the territory, rather that relying entirely on the assessment of the Area Representative.

An Area Representative may, under the terms of the Area Representative Agreement, be responsible for determining Franchisee compliance with system standards. When the Franchisee is in compliance with the system standards, the Franchisor can simply rely on the Area Representative’s determination in that regard. But what if the Area Representative determines that the Franchisee is not in sufficient compliance with the system standards? Should the Area Representative have the authority to declare a default under the Franchise Agreement to which the Area Representative is not a party? Should the Franchisor declare a default on the basis of circumstances documented by the Area Representative? Should the Franchisor independently confirm non-compliance before declaring a default, or at least have its own employees determine whether a declared default was properly cured?

There is not necessarily only one correct answer to these questions. However, consider that, if the Franchisor ultimately terminates the franchise, then the Franchisee might bring a wrongful termination suit. A judge or jury might be troubled by a Franchisor’s termination of a franchise without first independently determining that the Franchisee had breached the Franchise Agreement, and failed to timely cure the default. It may be more difficult for the Franchisor to introduce documentation into evidence that was compiled by a third-party. Therefore, the authors are of the opinion that, at a minimum, the Franchisor should not delegate to the Area Representative the authority to
issue any formal notices under the Franchise Agreement, and should independently determine whether a cure has been accomplished.

4. Advantages and Disadvantages from the Area Representative Perspective

An interesting dynamic of an Area Representative relationship is that, if successful, initially the Area Representative’s primary compensation from the relationship will be a share of the initial franchise fees, and as the territory continues to be developed, franchise sales, and therefore initial franchise fee revenue, will decline, but income from royalties will increase. Similarly, over time the Area Representative’s franchise sales efforts will decline, while its franchise support responsibilities will increase. As will be discussed below, these dynamics can have some positive and negative implications, especially if the relationship is not successful. The drafting considerations addressing these dynamics are discussed later in this paper.

a. Advantages

Being an Area Representative can interest someone who enjoys the dynamics of operating a unit franchise, but would also like to realize the intrinsic and extrinsic rewards associated with growing a franchise system locally. Additionally, when a franchise concept is first introduced to an area, building a brand and customer base can be challenging. An Area Representative who may not have the capital or inclination to establish all units within the territory can benefit from the brand awareness created by other Franchisees.

The Area Representative’s income stream will in part depend upon the degree to which unit franchises are successful businesses. Additionally, the Area Representative will need to deal with the Franchisees it recruits once the unit franchises are established. By having a significant role in the selection of the Franchisees who will operate within the territory, the Area Representative can recruit Franchisees best equipped to successfully operate the franchised businesses. An Area Representative who is good at training unit franchise employees may also enjoy imparting that same knowledge on other Franchisees that the Area Representative has recruited and may "structure" the learning curve to a successful franchise operation.

When the Area Representative is also a unit operator, the Area Representative “walks the walk and talks the talk.” This gives Area Representatives a degree of credibility that may be more difficult for traditional Franchisor employees to achieve.

One of the challenges in traditional franchising is locating qualified prospective Franchisees available when the market is right. While some Franchisors are equipped to operate Franchisor-owned locations nearly anywhere, others are not. In contrast, an Area Representative will presumably be capable of operating any unit franchise located within the territory. An Area Representative is capable of then establishing a unit franchise itself in those instances when another prospective Franchisee is not immediately available. Once the unit franchise is established, the Area Representative can remain the Franchisee, or transfer the franchise to another Franchisee.
b. **Disadvantages**

Perhaps the biggest downside to an Area Representative relationship from the perspective of the Area Representative is that the Area Representative's success is inversely proportional to the Franchisor's need for the arrangement. That is to say, once the territory is reasonably saturated, the Franchisor will not have a need to further develop the territory; and that same saturation may enable a Franchisor to service Franchisees within the territory more economically using its own employees. This dynamic means that unlike a unit franchise, which may have an extremely long life-span if all the right factors come together, an area representative relationship should be understood, from the outset, as being of a relatively limited duration. This will be discussed in more detail in the drafting considerations section of this paper.

As discussed above, the definitions contained in various franchise registration laws will at times bring an Area Representative within their ambit. Just as is the case with all Franchise Sellers, it is important for each the Franchisor and Area Representative to understand that an Area Representative may be subject to the laws of more than one state, based on the anticipated location of the unit franchise, the residency of the prospective Franchisee, and where the Area Representative meets with the prospective Franchisee to discuss the possible sale of a franchise.

Typically for an area representation arrangement to make sense for a Franchisor, the Franchisor will need the Area Representative to establish a specified number of unit franchises by specific points during the term. While good analysis and planning can help the parties agree to manageable targets, it is the Area Representative who will be at contractual risk if the agreed upon targets are not achieved. Many factors can influence the ability of an Area Representative to establish unit franchises, including general economic conditions, the entry of new competitors into the area, or underperformance by the initial units within the territory. Depending on how the Area Representative Agreement is written, the consequences of non-performance can be considerable.

Antitrust issues are beyond the scope of this paper. However, it is important for Franchisors and Area Representatives to understand that under some circumstances Franchisees, including the Area Representative, may compete with one another. To the extent an Area Representative may be viewed as competing with other Franchisees in the territory, allocating the market or price agreement amongst competitors can be unlawful. At a minimum, the Franchisor, and not the Area Representative, should make the final determination of the protected area associated with each unit franchise.

5. **Advantages and Disadvantages from the Franchisee Perspective**

For a Franchisee, having an Area Representative reasonably nearby can be both good and bad, depending on the particular circumstances and the personalities involved.

a. **Advantages**

A Franchisee can significantly benefit from having an Area Representative nearby, with whom the Franchisee can meet discuss issues of mutual interest. There are practical, economic limits to the degree a distant Franchisor’s employees can spend time in any particular market, especially when the market is relatively undeveloped. In
contrast, an Area Representative servicing local franchises can meet with Franchisees on a relatively frequent basis. This means that Franchisees have someone nearby to consult with about such things as training, employee hiring and retention, local marketing, and a host of other day-to-day topics.

The Area Representative will likely be more familiar with the local market than a distant Franchisor. Local knowledge can be useful in many ways, including helping to address development issues, identify potential sources of employees, the best options for local advertising, and even a local repair person to call when equipment is in need of service or repair.

While many Franchisors have a number of long-term employees who have worked with the same Franchisees for many years, in general employees can come and go, and be reassigned from time to time. An Area Representative has made a local investment in the system, to which Franchisees who have similarly invested in the system can relate. For this reason Franchisees may perceive an Area Representative as having interests very much aligned with their own; a perception that may not be present when the person with whom the Franchisee is dealing is the Franchisor’s employee.

b. Disadvantages

Not every Franchisee wants to have a Franchisor representative nearby. However, in general, a Franchisee operating within the system standards and complying with its franchise obligations will have few if any reasons to desire that the Franchisor’s representative not be able to drop by at a moment’s notice – or no notice at all. But there are exceptions when a Franchisee has legitimate concerns about an Area Representative.

In the context of servicing franchises, an Area Representative is interacting with Franchisees in ways that the Franchisor would typically do so using its own employees. If the Area Representative lacks competence, has a difficult personality, or otherwise does not live up to Franchisee’s expectations, then the Franchisee will at best be frustrated and disappointed. Making matters more complex is that a Franchisor receiving legitimate complaints about its employees is generally in a position to correct the situation in ways that are significantly more difficult in a relationship that is not “at will.” The Franchisee may experience further frustrations and delay when the Franchisor has to manage its Area Representative before resolving a problem. Franchisees may also perceive an Area Representative to be competing for the same customers, or even additional locations for the establishment of a unit franchise.

Although there are a number of issues to consider, the Area Representative structure can be very effective under the right circumstances. Drafting considerations that can help make an area representative relationship successful are discussed later in this paper.

D. Area Developers

As noted above, an Area Developer is essentially a unit Franchisee who has been granted the right to establish a number of unit franchises within a defined territory. Because only the Franchisor is engaged in franchise sales, and the Franchisor retains the traditional post-sale servicing role, many of issues and considerations inherent in the
other relationships described by this paper are typically not implicated by an area development relationship. However, to some degree there may be a contractual shifting of certain aspects of the traditional franchise relationship which warrant consideration.

An area development relationship can be quite attractive to a prospective Franchisee with significant relevant experience, who might not be inclined to put effort into developing a single unit franchise; and equally attractive to a Franchisor who may not desire to put the necessary effort into place to develop a territory that will lack critical mass for some time.

1. **Role of the Area Developer**

   Generally speaking, a Franchisor and Franchisee enter into an area development relationship for the purpose of achieving relatively rapid unit establishment within the territory. Like other relationships discussed, the Area Developer / Franchisee may be selected in part based on its familiarity and experience within the territory. In contrast to a more typical unit franchise relationship, the Franchisee may contractually agree to be responsible for site selection and other development efforts typically performed by the Franchisor, and may be granted the right and responsibility to provide unit manager training that would more typically be performed by the Franchisor.

2. **Advantages and Disadvantages from a Franchisor’s Perspective**

   Typically the area development territory will be one in which the franchised concept is either not yet represented, or under-represented. By entering into an area development relationship, the Franchisor can limit its selling efforts by identifying one highly-qualified Franchisee to establish multiple unit franchises, instead of needing to engage in several distinct sales efforts. Additionally, the Area Development Agreement may specify a significant up-front payment to the Franchisor, in part for the Franchisor’s agreement to not permit any other prospective Franchisee to develop units within the territory. A relatively sophisticated Franchisee will also be better equipped to function with less support from the Franchisor, which can significantly reduce the Franchisor’s costs of servicing distant franchises.

   On a practical level, shifting responsibilities to the Franchisee can reduce the degree to which the Franchisor is in control of its brand and system standards. Whether the relationship will be successful from the Franchisor's perspective will depend on whether the Franchisee is able and self-motivated to satisfy the Area Development Agreement and the Franchisor’s standards. If the Franchisee lacks that ability or motivation, then the Franchisor can find itself having granted exclusive area development rights to a Franchisee who is underperforming, and incurring greater costs to support that underperforming Franchisee than had been anticipated.

3. **Advantages and Disadvantages from an Area Developer’s Perspective**

   A Franchisee with area development rights can find great unit franchise locations without the pressure of competing with other system-Franchisees. As individual units are opened, they create a degree of brand awareness that can facilitate the establishment and performance of additional units, and provide the Franchisee with a
pool of manager candidates for those additional units. From an efficiency standpoint, the ownership of several units within a close proximity provides an opportunity for mid-level multi-unit managers, and creates opportunities for administrative efficiency (e.g., centralized bookkeeping).

Typically the Franchisee will need to make a significant financial outlay to acquire exclusive area development rights, and even a great operator can run into difficulties if a development schedule turns out to be overly aggressive. A development schedule makes the Franchisee responsible for contending with unanticipated factors that would otherwise be the Franchisor’s problem. This is particularly the case if unanticipated events outside the control of the Franchisee result in a different economic climate than had been anticipated. Financing has been difficult for many Franchisees in recent years. Not meeting a development schedule can have significant consequences from the elimination of territorial exclusivity to a financial penalty, or even cross default and termination of the area development rights and each unit franchise.

E. **Subfranchisors**

1. **Role of the Subfranchisor**

A Subfranchisor is an entity that has been granted the rights to an area in which it will grant franchises on its own behalf. For that area, for all intents and purposes, the Subfranchisor is the “Franchisor” with respect to Unit Franchisees, and individual Franchisees execute a Franchise Agreement only with the Subfranchisor. Not only is there no direct contractual relationship between the Franchisor and the Franchisee, but typically the Franchisor and Franchisee will not interact with one another. Royalties are paid by the Franchisees to the Subfranchisor, and the Subfranchisor in turn pays royalties to the ultimate Franchisor. The Subfranchisor has all of the rights and duties of a Franchisor to its Franchisees in the area. From the perspective of the Franchisee, interaction with the Subfranchisor will be like the interaction that more typically takes place between the Franchisor and Franchisee. The Franchise Agreements are between the Subfranchisor and the Franchisees. It is not unusual, by way of example, for a Subfranchisor to be entirely responsible for all sales and support for the system in the area, including training, marketing, and all other operational matters respecting unit franchises. Because there is no privity of contract between the Franchisor and Franchisee, a failure of the Subfranchisor to enforce system standards and proper trademark usage could damage the goodwill associated with the Franchisor’s trademarks, and, in severe cases, put the trademarks themselves at risk of losing their protectable status. This topic will be discussed in greater detail below.

A Subfranchising relationship is commonly used in international settings, where the Franchisor may license the Subfranchisor to sub-franchise an entire country. While giving a Subfranchisor considerable responsibility to franchise a large area can result in significant license fees for the Franchisor in exchange for minimal effort, the Franchisor needs to be mindful of the need to control its brand and trademarks, something that can be difficult from far away, particularly when the Franchisor may have no involvement whatsoever with the local Franchisees.
2. **Advantages and Disadvantages from the Subfranchisor’s Perspective**

   a. **Advantages**

   The Subfranchisor system is yet another way to grow the system quickly. Rather than taking time in each instance to develop an area, the Franchisor selects a good Subfranchisor to develop that area, then goes on to another area.

   A Subfranchising arrangement gives the Franchisor even more leverage than the Area Representative relationship. The Subfranchisor uses solely its resources to develop the territory granted. From sales and support to training and termination — there is no operational area that is not the responsibility of the Subfranchisor. The Franchisor has delegated almost all responsibilities. The Franchisor grants the rights, then steps back and lets the Subfranchisor work its magic. The Franchisor can focus its efforts and resources on another area. If it chooses, it can grant subfranchises in all areas, limiting itself to selecting the right Subfranchisors and collecting royalties.

   For certain systems or regions, especially in an international context, one of the areas that may be taken off the plate of the Franchisor is the preparation and registration of the disclosure document. If the Franchisor so chooses, the FDD can be prepared by the Subfranchisor. This is a significant delegation of time and expense. But the information includes some provided by the Franchisor to the Subfranchisor, and under the FTC Rule, the Franchisor remains jointly and severally liable with the Subfranchisor for the FDD.64

   To the degree that capital is necessary for the leasing or construction of training facilities, it is that of the Subfranchisor, not the capital of the Franchisor.

   The Subfranchisor is often selected for its experience in the operation of the business franchised or because it is an experienced Franchisor. As in the case of the Area Representative, an experienced Subfranchisor can be expected to do a good job in selecting the persons to which to grant franchises. And after the Franchisees are in the system, the experience of the Subfranchisor enhances its support operations, leading to continued revenue growth for the Subfranchisor, and for the Franchisor.

   Also like the Area Representative, the Subfranchisor normally has better knowledge of the demographics, the territory and the culture of the territory that it is granted. Again, this knowledge can be expected to result in faster and more successful development of the area. Marketing generally and local store marketing should also benefit from the Subfranchisor's territory knowledge.

   There are incentives for the Subfranchisor to develop its territory. Of course, the Subfranchisor is normally subject to development quotas. Perhaps more importantly, the Subfranchisor also has a financial interest in the rapid development of the market.

   The Subfranchisor will be responsible for the franchise relationship. If there are issues, the Franchisees will normally not look to the Franchisor. Dispute resolution will be the responsibility of the Subfranchisor. If there is a lawsuit, the Franchisee will

64 See footnotes 20 and 22 above
normally file its action against the Subfranchisor, since there will not be privity of contract with the Franchisor. Of course, allegations relating to system viability or standards may involve the Franchisor.

Finally, a problematic franchising issue that has recently arisen is whether, in some systems, the Franchisee can be construed to be the employee of the Franchisor under applicable law. This in turn triggers some unintended liability for the Franchisor from a tax, workers compensation, and benefits perspective, along with other issues. However, as has been held in a recent case, in a Master Franchise system, the Subfranchisor may have the “employer” issue, but the Franchisor will normally not be viewed as an employer, especially if the Franchisor does nothing more than provide the name and the system to the Subfranchisor. There is simply not the close relationship with the Franchisee that triggers the employment implications in the one tier system.

b. Disadvantages

The royalty split is an issue for the Franchisor with the Subfranchisor, just as it is with an Area Representative. Because the Subfranchisor can be required to prepare the FDD for Franchisee sales and file the appropriate registrations, the initial costs to the Franchisor can be to the cost of preparing and entering into the Master Franchise Agreement, and that cost should be covered by the initial fee for the Master Franchise Agreement. However, the ongoing royalty to the Franchisor will be relatively reduced.

The Franchisor will be jointly and severally liable for the content of the FDD. The Franchisor may also find itself jointly and severally liable for the Subfranchisor’s failure to follow disclosure requirements.

Additionally, if there is a problem with a unit that needs attention, the Franchisor will have to rely on the Subfranchisor to take action, since there will be no contractual relationship between the Franchisor and the Franchisees.

The Franchisor needs to choose its Subfranchisor carefully. Substantial responsibility is being entrusted to the Subfranchisor. Because of the difficulty in dispute resolution and the difficulty in system control, the relationship will work best when the Franchisor and the Subfranchisor see eye-to-eye on important issues. Parting company will be difficult, especially parting company on terms that work for the Franchisor.

If the Subfranchisor has financial difficulty, the Franchisor will need to have the operational resources and the financial wherewithal to step into the Subfranchisor’s shoes in its relationships with its Franchisees. The Franchisor should not underestimate this contingency and will need to plan for it from the outset if it does not want to lose a substantial part of its distribution network in the event the Subfranchisor does falter.


3. **Advantages and Disadvantages from the Subfranchisor Perspective**

The autonomy in the Subfranchisor relationship will be even greater than in that in the Area Representative arrangement. If the Subfranchisor is experienced and has the financial strength to develop the system on its own in the area, the lack of supervision and interference from the Franchisor will make it easier to operate. The Subfranchisor will make most of its own decisions without having to obtain the approval of the Franchisor. It will retain substantial flexibility, permitting it to make business decisions quickly.

The Subfranchisor will be able to analyze the Franchisor’s operations and learn from its errors as it determines how to implement the system in its territory. So, at least to some degree, it will not be starting completely from scratch.

The Subfranchisor will need to have substantial financial and operational strength to operate basically on its own. Its balance sheet and borrowing capacity will drive how quickly it will be able to grow the business in the territory. And it will be required to have operational expertise and depth, as in most cases it will not receive help from the Franchisor after initial guidance and assistance at the very beginning of the relationship.

In some cases, the Subfranchisor will be able to go to the Franchisor to obtain programs, policies, and plans that the Franchisor is using in its own operations. But even in these cases, the Subfranchisor will be required to revise and adapt these programs to its own territory.

The Subfranchisor will need to develop its own disclosure document, to the degree one is required in its territory. In the United States, it will need to prepare its own FDD even if it is provided a “form” FDD from the Franchisor to update. If the Subfranchisor is selling/operating in a franchise registration state, it will need to register. The Subfranchisor will also be jointly and severally liable with the Franchisor for the content of the FDD, and some of that content will come from the Franchisor.

Notwithstanding the increased autonomy of the Master Franchise relationship, depending on the requirements of the Franchisor, the Subfranchisor may have to enforce standards in the operation of its franchised units that it does not agree are important. Often, the form of Franchise Agreement and operations manual is provided, or even required, by the Franchisor. The Subfranchisor may have to seek approval from the Franchisor for material language changes in the Franchise Agreement. This may cause friction, either with the Franchisor, or with the Franchisees. The Subfranchisor will not have complete autonomy as to system standards.

4. **Advantages and Disadvantages from the Franchisee Perspective**

As in the Area Representative relationship, the Franchisee will normally benefit by the local experience and proximity of the Subfranchisor. Its Subfranchisor will not normally be as far away, either geographically or philosophically. The Subfranchisor should be better in its support operations for this reason.
The Franchisee should also benefit from the autonomy of its Subfranchisor. When it needs quick approval for a new vendor or a change in an operational procedure, the Subfranchisor should be able to more quickly give its attention to request of the Franchisee.

If the Subfranchisor is incompetent or inattentive, the Franchisee may have a serious problem. Because it does not have a contract with the Franchisor, the Franchisor has no obligation to the Franchisee to resolve the issues with the Subfranchisor. The only recourse of the Franchisee will be against the Subfranchisor. Further, if there are disclosure issues, notwithstanding a possible claim on the basis of the joint and several liability of the Franchisor, the Franchisee may not be able to pursue the Franchisor, it may have to deal instead solely with the Subfranchisor who made the disclosure.

And if the Subfranchisor has a dispute with the Franchisor, or fails in someway to meet its obligations to the Franchisor, the fact that the Master Franchise Agreement is in jeopardy will normally affect the Franchisees. That is, if the Subfranchisor is terminated, the Franchisee may lose its rights to the franchise.

IV. STATE LICENSING AND REGISTRATION OBLIGATIONS FOR CERTAIN FRANCHISE SELLERS

California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, Wisconsin have laws regulating the sale of franchises, and, with the exception of Oregon are “registration states,” meaning that their laws have franchise offering registration components.

Over half of the registration states also require that certain Franchise Sellers be licensed or registered, either separately or as part of the Franchisor’s franchise registration. When a Franchisor contracts a Third-Party Franchise Seller, the Franchisor and Franchise Seller have an interest in ensuring compliance with these laws. Whether a particular third-party structure requires that the third-party be licensed or registered will depend upon the definitions contained within the applicable statute or regulation. And, as mentioned above, it is critically important that any contemplated three-party structure be closely considered in the context of applicable state franchise laws.

A. State Licensing and Registration Obligations for Franchise Sellers

Franchise Seller registrations serve several purposes as a practical matter. Among other things, they enable a prospective Franchisee to obtain a bit of background information about the person attempting to sell them a franchise; although more likely than not only a small number prospective Franchisees seek out information on file about the Franchise Seller with whom they are dealing. However, the information can be useful in the event of legal action by a Franchisee or regulator; and a failure of a Franchise Seller to comply with registration requirements is a violation of laws.
1. **Sales Representation Forms Filed with Franchise Registrations**

   a. **States:** California, Hawaii, Illinois, Maryland, Minnesota, North Dakota, New York, Rhode Island, and Washington

   Several registration states require that Franchise Seller registration forms be included as part of the Franchisor’s franchise registration materials. These states are California, Hawaii, Illinois, Maryland, Minnesota, North Dakota, New York, Rhode Island, and Washington. In general, these states require or permit that the Franchise Seller registrations be made using the NASAA “Franchise Seller Disclosure Form” (or “Form D”).

   b. **Content of Form: Employment, Litigation**

   In general, in those states requiring the filing of a Franchise Seller Disclosure Form, the Franchisor is required to submit a form for each person selling that Franchisor’s franchises within the state, including both employees and non-employees. The form contains the name and business address of the Franchise Seller, along with employer and title, as well as a five year employment history.

   Whether that Franchise Seller has pending against it, any “administrative, criminal or material civil action” “alleging a violation of franchise, antitrust or securities law, or alleging fraud, unfair or deceptive practices, or any comparable allegations” must

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67 Cal. Admin. Code §310.11, Bus. Fran. Guide (CCH) Para. 5050.08 (requiring application conform to the “uniform franchise disclosure document” prescribed by the NASAA 2008 Franchise Registration and Disclosure Guidelines (“NASAA Guidelines”), which specify the filing of a “Franchise Seller Disclosure Form” (or “Form D”)).

68 This obligation has been confirmed by the authors with the Hawaii franchise examiners and does not appear to separately stated in a statute or regulation.

69 Ill. Admin. Code, §§ 200.600 (original registrations), 200.603 (annual reports).


71 “How to Register” franchise registration information published on the Minnesota Department of Commerce website.


76 NASAA Guidelines, Pages 15-17.
be disclosed, along with details of any such proceeding.\textsuperscript{77} The same is true with respect to any matters concluded within “the 10-year period immediately before the” date of the FDD, resulting in a felony conviction or nolo contendere (no contest) pleading; or civil liability in an action alleging “violation of a franchise, antitrust or securities law, or allegations of fraud, unfair or deceptive practices or comparable allegations.” \textsuperscript{78}

Whether the Franchise Seller “[i]s subject to a currently effective injunction or restrictive order or decree resulting from a pending or concluded action brought by a public agency and relating to the franchise, or to a … franchise, securities, antitrust, trade regulation or trade practice law” must also be disclosed, along with the details of any such proceeding. \textsuperscript{79}

c. \textbf{Issue of Disclosures for Multipersonnel Franchise Sellers}

As noted above, these Franchise Seller Disclosure Forms are required to be filed by Franchisors as part of their franchise registration filings. This can present some practical challenges if the Franchisor uses a Franchise Seller that has numerous people working for the seller, such as a national or regional Franchise Broker firm, because the Franchisor may not be determining the specific individuals who will sell its franchises in any particular state. Therefore, it is important that the Franchisor and Franchise Seller coordinate with one another, so that the Franchisor will at all times know who will be engaging in franchise selling activities on its behalf, enabling the Franchisor to make the proper filings. Because the Franchisor must also certify that its registrations are true and correct, the Franchisor should consider requiring that the Franchise Seller provide the forms to be filed fully-completed, along with an affidavit certifying that they are complete and correct.

2. \textbf{Separate Broker Registrations in New York and Washington}

While most Franchise Seller registrations are made as part of a Franchisor’s registration filing, two states, New York and Washington, specifically require that certain Franchise Sellers file state Seller registrations prior to offering or selling a franchise within those states.

New York law requires that franchise sales agents, offering or selling in New York franchises not exempt from registration under the New York franchise sales law, be registered as a Franchise Seller. \textsuperscript{80} “Franchises sales agent” does not include a Franchisor’s own employees. \textsuperscript{81} The law defines: “Offer’ or ‘offer to sell’ as including any attempt to offer to dispose of, or solicitation of an offer to buy, a franchise or interest in a franchise for value.” \textsuperscript{82} This language is broad enough to bring within the registration

\textsuperscript{77} NASAA Guidelines, Form D.

\textsuperscript{78} NASAA Guidelines, Form D.

\textsuperscript{79} NASAA Guidelines, Form D.

\textsuperscript{80} Sec. 683(13).

\textsuperscript{81} Sec. 681(8).

\textsuperscript{82} Sec. 681(11).
requirement Franchise Brokers, Area Representatives, and some, if not all, Lead Generators.

It is unlawful for a “Franchise Broker” (as defined by the Washington Franchise Investment Protection Act) to offer or sell franchises in the State of Washington, unless that person has first registered as a Franchise Broker.\(^{83}\) The Act defines “Franchise Broker” to be “a person who directly or indirectly engages in the business of the offer or sale of franchises [but] does not include a Franchisor, Subfranchisor, or their officers, directors, or employees.”\(^{84}\) Hence, “Franchise Broker” within the meaning of the Act, includes not only “Franchise Brokers” as defined by this paper, but also Area Representatives, and, probably some Lead Generators.

It is important for a Franchisor that engages a “Franchise Broker” within the meaning of the Washington Franchise Investment Protection Act ascertain that the Franchise Broker is in fact registered, as it is unlawful for a Franchisor to retain an unregistered Franchise Broker to sell its franchises in Washington.\(^{85}\) Failure to independently verify the Broker registration before filing a franchise registration could delay approval of the franchise registration.

As part of its registration the Franchise Broker must consent to service of process within the State of Washington. Washington also requires that a Franchise Broker, as part of its registration, file a balance sheet prepared in accordance with generally accepted accounting principles current as of a date within 90 days prior to the registration filing.\(^{86}\) There are other Broker record keeping responsibilities that are beyond the scope of this paper.

B. The Franchisor’s Obligations to Disclose the Existence of Franchise Sellers

Today, whether a Franchisor must disclose prospective Franchisees with the identity of Franchise Sellers is a matter of state law to a significant degree because the Federal disclosure requirements are greatly reduced.

1. Prior Federal Disclosure Rule

The 1979 Rule made no distinction between a Franchisor and a Franchise Broker, expressly referring to each Seller, when declaring it to be a violation of the Section 5 of the Federal Trade Commission Act for a “Franchisor or Franchise Broker” to fail to timely furnish a prospective Franchisee with the required written

\(^{83}\) Wash. Rev. Codes § 19.100.140.

\(^{84}\) Wash. Rev. Codes § 19.100.010(11).

\(^{85}\) Wash. Rev. Codes § 19.100.140.

\(^{86}\) Washington State Department of Financial Institutions, standard form “Application for a Franchise Broker License” (http://www.dfi.wa.gov/sd/franchiseformssapps/fba.pdf). It is worth noting that subfranchisors, while exempt from this broker registration, would be required to separately submit a franchise registration application.
disclosure document. \(^{87}\) The 1979 Rule defined a “Franchise Broker” to mean “any person other than a Franchisor or a Franchisee who sells, offers for sale, or arranges for the sale of a franchise.”\(^{88}\) As such, under the 1979 Rule, with the possible exception of certain Lead Generators, every third-party structure described by this paper would have had an obligation to provide a prospective Franchisee the required disclosure documents at a specified point during the franchise sales process.

The 1979 Rule, however, did not require that Franchise Brokers actually be identified by the franchise offering document. However, the 1986 version of the NASAA Uniform Franchise Offering Circular guidelines ("UFOC Guidelines") expressly included “Franchise Brokers” among the persons who must be disclosed in Item 2 of the UFOC.\(^{89}\) Information pertaining to litigation and bankruptcy matters involving Franchise Brokers identified in Item 2 was required to be disclosed in Items 3 and 4 respectively.\(^{90}\) This disclosure obligation vanished with the FTC Rule.

2. **Current Disclosure**

When the 1979 Rule was revised in 2007, although substantially modeled after the UFOC Guidelines, it omitted the requirement that Franchise Brokers be identified in Item 2. In the Statement of Basis and Purpose for the FTC Rule, the Federal Trade Commission explained why it ultimately determined to not require that Franchise Brokers be identified in Item 2:

Unlike Franchisors, Brokers do not create or implement Franchisor policy, nor do they oversee performance of post-sale obligations to the Franchisee. Accordingly, prospective Franchisees are less likely to give decisive weight to an individual Broker’s expertise or background in assessing the merits of purchasing a franchise. Moreover, even if a Broker were to make false claims, the prospective Franchisee has the benefit of the Franchisor’s disclosure document to assess those claims before purchasing a franchise. …\(^{91}\)

As discussed above, the FTC Rule introduced the term “franchise seller.”\(^{92}\) Under the FTC Rule, there are several requirements respecting Franchise Sellers.

a. **FDD Receipt pages**

The FTC Rule requires that the Franchisor disclose in Item 23, the receipt for the Franchise Disclosure Document, “the name, principal business address, and telephone number of each Franchise Seller offering the franchise.”\(^{93}\) Of course, a Franchisor using

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90 Id.


92 See Section II above.

93 16 CFR § 436.5 (instruction for preparing Item 23).
a large network of franchise might have a very long list. Fortunately, the FTC has expressly permitted that “a Franchisor can comply with this provision either by leaving a blank space [on the receipt] in the standard disclosure document that can be filled in by the seller or by including the name(s) and contact information in an attachment to [the Franchise Disclosure Document], which is then referenced in the Item 23 receipt.”

b. **NASAA State Cover Page Language**

Soon after the FTC Rule was enacted, NASAA promulgated a revised set of uniform registration and disclosure guidelines. The NASAA Guidelines require that certain “risk factors” be included on the “State Cover Page.” Risk factor number six is applicable when a Franchisor uses “a Franchise Broker or a referral source,” and requires the Franchisor include the below disclosure on the State Cover Page:

We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A Franchise Broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise.

The NASAA Guidelines, however, do not define “Franchise Broker,” and do define “franchise seller” to include “third-party brokers who are involved in franchise sales activities.” It is therefore unclear how broadly “Franchise Broker” is to be applied. However, when combined with the reference to “referral source” it would appear that NASAA intends the risk factor to apply whenever a Franchisor uses any Third-Party Franchise Seller to sell its franchises.

c. **Additional State Requirements**

At this point not all states have adopted of the revised NASAA Guidelines; nor of course are states required to do so. As such Franchisors are still required to comply with any additional Franchise Seller disclosures required by state franchise disclosure laws. In this regard the FTC, in the Statement of Basis and Purpose accompanying the FTC Rule, expressly noted that, “Franchisors, of course, would still be required to include broker information, if mandated by state law.”

**V. THE FRANCHISOR’S RESPONSIBILITIES TO ENSURE THAT FRANCHISE SELLERS ARE COMPLYING WITH APPLICABLE LAW**

A. **General Concepts & Responsibility Issues**

Once a Franchisor has elected to use a Franchise Seller, then that seller should be considered an integral part of the Franchisor’s business strategy and a “tool” in the franchise sales process. If the Franchise Seller is a Franchise Broker, then that Broker should be trained on system specifics and continue to at least be informed as to the

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direction of the Franchisor or to be part of the strategic process. In all too many cases, a Franchisor may be tempted to only be highly involved with the Franchise Broker at the beginning of the relationship. Instead, it is important for the Franchisor to continually monitor the actions of the Franchise Broker, both in the sales process and to evaluate if any adjustments are necessary based on the results of the seller’s actions. The monitoring and training for an Area Representative and Subfranchisor should be more inclusive as it would include both sales and operational aspects of the franchise system.

Part of the Franchisor’s training should emphasize compliance with the federal and state disclosure laws, as well as complying with the state franchise sales representative laws. Under the FTC Rule, the preparation and distribution of the FDD is the sole responsibility of the Franchisor. If the Franchisor is not thoroughly satisfied with the Franchise Seller’s knowledge of the law, then the Franchisor should implement a compliance training program to minimize its liability risks for disclosure and sale violations. Franchisors should ensure that their Franchise Sellers in these states are complying with this disclosure obligation as the ultimate responsibility rests with the Franchisor.

Both Franchisor and Franchise Sellers should be aware of the FTC Rule’s restrictions on sales activities. The FTC Rule has deemed that the following acts are unfair or deceptive acts or practices: (1) making any claim or representation that contradicts the disclosure document; (2) misrepresenting that any person (a) purchased or operated a franchise of the type offered by the Franchisor or (b) can provide an independent and reliable report regarding the franchise or the experience of any current or former Franchisees; (3) if requested by the prospective Franchisee, failing to provide a copy of the disclosure document to a prospective Franchisee earlier in the sales process than required by the FTC Rule; (4) disseminate any financial performance representations to prospective Franchisees unless the Franchisor has a reasonable basis and written substantiation for the representation at the time made, and the representation is included in Item 19 of the disclosure document; (5) failing to make available to prospective Franchisees written substantiation for any financial performance representations made in Item 19; (6) failing to provide a copy of the most recent disclosure document and any quarterly updates to a prospective Franchisee, upon reasonable request, before the prospective Franchisee signs a Franchise Agreement; (7) presenting for signing a Franchise Agreement in which the terms and conditions differ materially from those presented as an attachment to the disclosure document, unless the Franchise Seller informs the prospective Franchisee of the differences at least seven days before execution of the Franchise Agreement; (8) disclaiming or requiring a prospective Franchisee to waive reliance on any representation made in the disclosure document, its exhibits, its amendments; and (9) failing to return any funds or deposits in accordance with any conditions in the disclosure document, Franchise Agreement or any related document. Franchisors should provide its Brokers, Area Representatives and Subfranchisors with this list of violations as part of the training discussed in more detail below.

If a Franchisee elects to pursue a lawsuit or a counterclaim against the Franchisor, then any party involved in the sales process may be named in the suit. For example, in Adams v. North American Business Brokers, Inc., a Broker assisted a

Franchisee with the purchase of a Hungry Bull Family Steakhouse franchise. The Broker also assisted the Franchisee with trying to find a developer for the possible sites but sites were either unavailable, no developer would agree to develop the property based on Franchisee’s financial qualifications or the Franchisee was unable to secure the lease. The Franchisee sued the Franchisor and Broker for breach of contract, fraud and negligence and sought a refund of the initial franchise fee. The court held that neither the Franchisor nor the Broker promised the Franchisee that it would be able to find a location and that the Franchisee was not due a refund. The court also cited to the Franchise Agreement’s provisions that clearly provided that the site selection was the Franchisee’s responsibility.

While the focus of this presentation is on the perils to a Franchisor through its use of a third party franchise seller, a Franchise Broker, or even an Area Representative, should also be concerned about the misrepresentations a Franchisor may make after the Franchise Seller transfers the prospect to the Franchisor to continue the sales process. In *Salkeld v. V.R. Business Brokers* 99, the plaintiff had responded to an advertisement placed by a Broker to sell cocktail drinks in a specific sales territory. The plaintiff purchased the rights to the territory and began business. The plaintiff filed a lawsuit against the Broker and the seller and alleged that the seller of the drinks misrepresented the product, lied about the lack of competition and did not properly disclose him with the required franchise disclosure. The court held that the Broker only participated in the initial introductory meeting and the closing, did not make any misrepresentations and did not have a duty to investigate the seller’s representations without any facts indicating that the representations were untrue. The court held that the plaintiff stated a *prima facie* case of common law fraud on the part of the seller and that the system met the elements of a franchise.

The allocation of responsibility between Franchisor and its Brokers, Area Representatives and Subfranchisors with respect to compliance should also include the determination of responsibility for the filing of the NASAA Form D (the salesperson disclosure form) 100 and the responsibility for the filing of the state franchise seller registrations if the third party seller will offer franchises for sale in Washington or New York. In this regard, it may be more common for the Franchisor to obtain a Form D from the Franchise Seller, or to prepare the Form D itself based on a questionnaire from the Franchise Seller, because the Franchisor is the party who is filing an application for registration or renewal of an existing registration with the states that require registration of a franchise. The responsibility for the filing of state Franchise Seller registrations is more typically the Franchise Seller’s responsibility because the Franchisor may not wish to pay the registration fee for a Franchise Seller, the Franchise Seller may be working with more than one Franchisor and the relationship might not last the entire time period of the Franchise Seller registration. As noted earlier, the Franchisor should independently verify the Franchise Seller’s current registrations.

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100 See Section IV(A)(1)(b) for further discussion of Form D.
B. Training

Franchisors may risk being held vicariously liable for their Franchise Sellers’ actions and misrepresentations even with a Franchise Seller contract that clearly allocates responsibility for compliance with the federal and state franchise sales laws, prohibits the Franchise Seller from making misrepresentations to prospective Franchisees and provides for indemnification provisions. For example, the Illinois statute states that any person who offers or sells a franchise in violation of the Illinois statutes is liable to the Franchisee who may sue for damages. Additionally, any person who directly or indirectly controls a person liable under that statute, including every principle officer or director, any person who acts in those functions and every employee, is also jointly and separately liable for a violation of the Illinois franchise statutes unless the person had no knowledge, or no reasonable basis to know, of the violation. Although the cases to date under this statute have involved holding a Franchisor’s corporate officer individually liable for violations of the disclosure laws and have not addressed holding a Franchisor liable for its Broker’s actions, the language of the statute is certainly broad enough to encompass this possibility. A formal training program may minimize the risks and should be carefully planned and implemented with a Franchise Seller whose role will be more than lead generation. Even with an experienced Franchise Seller, a Franchisor should verify for itself that the Franchise Seller is aware of the restrictions on sales misrepresentations in the federal law as stated above. There are also state franchise laws that also expressly prohibit a Franchise Seller from making certain misrepresentations of a prospective Franchisee. The California Franchise Investment Law provides:

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communications not enumerated in [any application, notice or report filed with the California Commissioner] which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.

A training program should also verify the Franchise Seller’s knowledge of the pre-sales disclosure rules. Given the required content of a FDD, Franchise Sellers may be reluctant to provide such a formal legal document to a franchise prospect without first selling the system to the prospect in terms of the business and market. Before the change in the FTC Rule, the requirement that a Franchise Seller provide the franchise prospect with a FDD at the earlier of the first personal face-to-face meeting to discuss the franchise (the “face-to-face meeting requirement”) or within ten business days of the payment of any money or the execution of a binding agreement, was a source of potential risk exposure if the Franchise Broker engaged in any substantive conversations with potential Franchisees without providing the disclosure document. The FTC Rule eliminates the face-to-face meeting requirement and only requires disclosure fourteen calendar days before the payment of any money or the execution of a binding agreement. This change lessens the disclosure risk with Franchise Brokers and Area


Representatives because the Franchisor has the opportunity to confirm disclosure before any execution of the Franchise Agreement. Subfranchisors will also have less disclosure risk from violations with their in-house sales agents. Franchise Sellers, however, should be reminded by the Franchisor that New York and Rhode Island still require that a Franchise Seller provide the franchise prospect with a FDD at the earlier of the first personal face-to-face meeting to discuss the franchise or within ten business days of the payment of any money or the execution of a franchise or other agreement. Any Franchisor with sales or Subfranchisors in New York or Rhode Island should specifically state this requirement in the Franchise Seller’s agreement and also institute a separate compliance program to confirm that the prospective Franchisee is receiving a FDD at the legally required time-point.

C. Financial Performance Representations

A key area of disclosure that could be considered misleading under federal and state law is disclosures relating to the Franchisor’s financial performance. If a Franchisor elects to not use a financial performance representation in its FDD, then a Franchise Seller agreement should contain an express prohibition on the seller making any statements other than repeating the FDD disclosure, including a prohibition on general approvals on business plans or even non-committal statements on success that could be misconstrued. More important are the contractual provisions is the interaction between the Franchisor and Franchise Seller. The Franchisor should sufficiently explain the Item 19 representation to the Franchise Seller in order to assist the Franchise Seller in accurately explaining the representation in a way that is not misleading. While the FDD may contain general qualifications or limitations on the representations, a Franchise Seller is in a prime position to either reinforce those limitations or to mistakenly “gloss” over the limits; to the potential peril of both the Franchise Seller and the Franchisor. The Franchisor should also provide the written substantiation for the representation to the Franchise Seller or instruct the Franchise Seller to immediately contact the Franchisor if the prospective Franchisee requests the substantiation. As part of the monitoring process, more fully described below, a Franchisor should personally question each prospect that worked with a Sales Broker or Area Representative as to whether any financial statements or approvals were made. While this questioning should be documented in a sales compliance representation, which should also be part of the FDD, a more complete understanding of the potential sales process will be obtained with an interview. For sales that are made by a Subfranchisor, a Franchisor should randomly audit the Franchisees to discover if the Subfranchisor is following the sales procedures in a legally compliant manner.

D. Monitoring

To minimize the risks involved with using a third party agent as a Franchise Seller, a Franchisor should implement a system by which it can monitor compliance with the federal and state rules and regulations. A Franchisor can require periodic status reports that keep the Franchisor informed of the status of each prospect’s interest level, disclosure date, franchise visit date, date of sending the closing documents and closing date. At a minimum, the reports should contain information that is relevant to

determining the applicable state franchise laws such as the prospect’s state of residence, the state of residence of any other business partners of the prospect, the location that sales activities occur and the prospect’s preferred locations of the intended franchised business. The important business considerations such as the prospect’s financial worthiness and prior business experience are commonly found in such reports as well.

The procedures should involve both verbal discussions with the Franchise Seller and potential Franchisee, as well as written confirmation of the sales procedures. The closing process can be complex and both the Franchise Seller and Franchisee may not be as careful as they should be with the documents. It is important that at least two people review the closing documents to verify that all procedures have been followed. At a minimum, the Franchisor should first verify that the FDD disclosure rules have been followed before the Franchisor schedules any closing of the franchise sales. If the Franchisee is in New York and Rhode Island, then the Franchisor should confirm if the FDD was disclosed as the first personal meeting.

With larger Franchise Sellers, such as Area Representatives and Subfranchisors, there may be several employees that are in charge of the sales process. A Franchisor can require that its approval be received before any of the Franchise Seller’s employees may engage in sales activities. This process can provide the Franchisor with time to evaluate the seller’s knowledge of the compliance obligations. If the Franchise Seller is selling in a state that requires a sales person registration filing, then the Franchisor can independently confirm that the Franchise Seller and the new employee are properly registered. This clause can also offer some insight by the Franchisor into the nature of the Franchise Seller. If the Franchise Seller is not sufficiently organized to seek such approval or does not seem to find compliance with the contract necessary, then it may be a warning sign that the Franchise Seller may not be compliant in other areas of its duties. If the Franchise Seller does not seek the Franchisor’s preapproval and that employee violates the sales laws, then the Franchisor may be able to use the Franchise Seller’s breach of contract to defend its own actions in a misrepresentation claim.

Every Franchise Seller contract should contain a provision requiring the Franchise Seller to notify the Franchisor in writing if it receives any demand or claim against the Franchise Seller that relates to the Franchisor’s system. At this stage, the Franchisor may be able to guide the Franchise Seller in a manner that may minimize the risks to itself. Such advance warning may also give the Franchisor an opportunity to either retrain the Franchise Seller or to cancel the Franchise Seller’s contract to stop further improper sales from occurring. Similarly, the contract should also specify that written notice is required if the Franchise Seller is involved in any mediation, arbitration, administrative investigation or other enforcement action that relates to the franchise system. At this stage, cancellation and reliance upon the indemnification provision in the seller’s contract may be the only recourse for the Franchisor. Please see further discussion on drafting and structural considerations in Article VII.

E. The Franchisor’s Responsibilities to Inform Franchise Sellers Regarding Material Changes in the System

Franchise Sellers that are involved in the disclosure process should endeavor to ensure that the FDD they are providing to potential Franchisees complies with the FTC Rule. Compliance involves not only the initial preparation of the FDD but the monitoring
of the system to identify any “material change”\textsuperscript{104} in the information presented in the FDD and any material change that the seller knows or should have known has occurred in an Item 19 financial performance representation when disclosing a franchise prospect.\textsuperscript{105} Liability for failure to provide material information may be broader under state laws than the federal law. North Dakota for example states that it is unlawful for any person in connection with the offer, sale, or purchase of any franchise, to make any untrue statement of material fact or omit a material fact necessary to make the statements made not misleading.\textsuperscript{106} Mere notification to a Franchise Seller of a material change is not sufficient, however, and Franchisors should independently verify that their Franchise Sellers are making disclosures with the amended FDD. Franchise Sellers that make offers or sales in registration states may face a significant “hold” period and may be tempted to bend the rules to continue convincing a potential Franchisee on the benefits of a system. This independent verification may be through informal discussions with the prospective Franchisees or may be through internal document numbers on the revised receipt pages that identify the version of the FDD that was provided to the prospective Franchisee.

For systems using subfranchising in their United States activities, the obligations to provide disclosure, as well as liabilities for non-compliance, apply to both the Franchisor and any Subfranchisor.\textsuperscript{107} Both parties will need to cooperate to ensure compliance because the Prospective Franchisees must receive disclosures about both the Franchisor and the Subfranchisor.\textsuperscript{108} Due to this dual responsibility, Franchisors and Subfranchisors will be affected by material changes relating to the other party (such as litigation filed involving either the Franchisor or Subfranchisor) or arising from their relationship with each other. While there are certain bright-line standards, the evaluation of the materiality of a particular change with respect to either (or both) the Franchisor or Subfranchisor will be a fact intensive analysis in many cases and will depend on the franchise system specifics. Franchisors and Subfranchisors might disagree on whether a particular change is material. Additionally, depending on the states in which the Franchisor and Subfranchisor are active, the standards for materiality and time frames for amending may vary.\textsuperscript{109} A Subfranchisor may find itself active in a registration state with updating requirements more stringent than the Franchisor’s states of direct operation (or vice versa). In order to avoid violations or potential claims, Franchisors

\textsuperscript{104} A “material change” is information that is likely to affect a Franchisee’s conduct or decisions with respect to the franchise at issue. FTC Statement of Basis and Purposes, Section III[A][4], Bus Fran Guide (CCH) Para. 6060. State regulations may also specify lists of defined occurrences that are considered material changes, such as changes in the control, personnel changes, litigation and specific percentage changes in the number of Franchisees.

\textsuperscript{105} FTC Rule, §436.7(d), Bus. Fran. Guide (CCH) Para. 6018.


\textsuperscript{107} C. Noyes, P. Dosik, Oh No, Is that Really a Material Change, IFA Legal Symposium 2011 (selected additions from R. Almosh as moderator).

\textsuperscript{108} FTC Rule, 16 C.F. R. Section 436.6(f). Subfranchisors must disclose the required information about the franchisor, and, to the extent applicable, the same information concerning the subfranchisor.

\textsuperscript{109} See C. Noyes, P. Dosik, Oh No, Is that Really a Material Change, IFA Legal Symposium 2011 for various timeframes.
and Subfranchisors should be proactive and coordinate to ensure that material changes are not overlooked and are made in the required time frames.

VI. DRAFTING AND STRUCTURAL CONSIDERATIONS TO REDUCE THE RISK TO THE FRANCHISOR IN THE USE OF THIRD PARTIES IN THE SELLING PROCESS AND FOR ONGOING SERVICES ISSUES

As with any business arrangement, Franchisors should spend the time to document their arrangements with any Franchisee Seller. Although the legal risks can never be completely eliminated, an open discussion of certain matters and the documenting of the parties’ understanding can minimize the risks to the Franchisor. This section of the paper will focus on particular areas of concern with each type of Franchisee Seller.

A. Lead Generation Providers – Professional Lead Systems and Lead Referral Arrangements

Franchisors may either receive leads on prospective Franchisees from an informal network of referral providers or from a more structured approach. Even if a Franchisor has chosen to only receive leads informally, a Franchisor should have an internal policy regarding if and when a referring party will obtain any payment from the Franchisor. Without such a policy, there is a risk that inconsistent agreements may be made between the Franchisor’s employees and their particular referral networks. The inconsistencies can lead to an impression that the Franchisor’s system is not well organized or even to bad feelings if referral sources find out about the inconsistent treatment. As the primary goal of a referral network is to have positive referrals being made, a thought-out policy is worth the time and effort to minimize this risk.

1. Internet Lead Generators

If a Franchisor has chosen to have a more structured approach to lead generation and elects to pay an internet Lead Generator, then Franchisors need to document in the Lead Generation Agreement how the lead generation process will work as well as when and how the Lead Generator earns his or her payment. The commission structure can be structured as a “click per lead” payment system or payment could be due upon any transfer of contact information. Because the typical internet Lead Generator may refer leads to dozens or even hundreds of Franchisors, often times the structure will need to be based on how the particular Lead Generator typically does business. The exact criteria for the lead to meet before it is transferred to the Franchisor should be specified, as well as the process the Lead Generator will take to evaluate the prospect (e.g. will the Lead Generator only capture the information electronically from searches or will it require the prospect to complete an application). At the very least, in those instances when the Franchisor is paying for leads that have been screened as likely to meet the Franchisor’s qualification criteria, a minimum number of qualified leads to be provided and the time frame for the leads to be provided should be specified to try to avoid paying for leads that are unqualified or that were received a year ago and are now “stale.” As the greatest risk to the Franchisor is to overpay for worthless leads, it is recommended that the Franchisor only agree to purchase a small number of leads to verify the quality and provide for either a refund or a payment hold back if a specific percentage of the leads do not meet the established criteria. If the Franchisor is truly wishing to minimize its risks, then the Franchisor could negotiate that payment is due only upon validation by the Franchisor of the prospect’s qualifications.
One potential downside to Lead Generator systems is that the Lead Generator could resell the leads to many competitors, leading prospects to receive multiple calls from various franchise systems and potentially irritating the prospect. Accordingly, whether the leads may be "sold" to more than one client and the disclosure of competing systems is an important provision to be negotiated.

Given the possibility of unqualified leads, it is important for a Franchisor to be able to terminate a professional lead arrangement upon 30 days notice without further obligation for payment. As leads will be coming in during the time period between the notice of termination and the actual termination date, the contract should specify the timeframe and obligation for transferring leads received during the time that the contract is still valid. A Lead Generator may be tempted to hold onto the leads in order to sell them to another party. The Franchisor should receive regular reports and if possible, automated reporting. A Franchisor may have a difficult time enforcing such terms, however, without a legal battle and a new Franchisor might not have the capital to enforce compliance.

2. Lead Referral Sources

Many Franchisors may not have specific agreements with all of its possible referral sources but should at least have an internal policy regarding commission structure. If the Franchisor does enter into an agreement, then the Lead Referral Agreement should state whether the appointment is exclusive or if the lead referral source may handle leads for competing franchise systems. The services to be provided by the lead referral source should be specified such as the generation of leads, submission of qualified leads to the Franchisor, providing background information regarding the Franchisor, collecting application material from prospects and maintaining records. The compensation to be paid for the receipt of qualified leads will vary from system to system but a percentage of the initial franchise fee is standard. Similar to Franchise Broker arrangements, the lead referral agent should be notified that they cannot make any financial performance representations. If there are other restrictions such as accepting money from a prospect or enter into a binding contact on behalf of the Franchisor then those restrictions should be specified. A Franchisor should not forget to specify whether the referral source can advertise to generate the leads.

Generally, Franchisors are not required to disclose their lead referral programs or the identity of their referral sources in their franchise disclosure documents. However, Franchisors should carefully structure their lead referral programs to ensure that the lead referral source does not qualify as a Franchise Broker in which case the Franchisor must comply with the federal and state laws related to Franchise Brokers as discussed elsewhere in this paper. In addition, if the Franchisor implements a referral program pursuant to which its existing Franchisees can receive payments for referring prospects, then the Franchisor should have its legal counsel evaluate the referral program to ascertain whether it should disclose the program in their FDD. Although the exact details of the referral program need not be mentioned, the Franchisor might elect to do so if the amount is significant. The Franchisor’s operations manual should fully describe the program, including how and when a Franchisee can earn the referral fee and how the Franchisor will ascribe a lead to a particular Franchisee and track that lead through to the closing on the sale.

110 16 CFR Part 436.5(W)
B. Traditional Franchise Brokers

Oftentimes, the Broker agency will provide a form agreement to the Franchisor for review. Some Franchisors prefer to adopt their own form of Broker Agreement to ensure that the proper protections are in place before engaging the Broker. Since most Franchise Brokers are personable and enthusiastic people, Franchisors need to distance themselves from the personal side and look for specific terms to clarify the Broker’s responsibilities and to protect the Franchisor and the franchise system. Franchise Brokers generally work on a commission basis and are deemed to have earned the commission upon various "benchmarks" such as the prospect’s payment of the initial franchise fee and/or execution of the Franchise or Area Development Agreement.

1. Authority

A Franchisor may enter into a Broker Agreement with a sales group or with an individual Broker. With a sales group, the agreement should specify the Broker who will serve as the Franchisor’s primary contact and how much time that sales agent will devote to the Franchisor’s system. Without such a provision, the Broker might spend more time on a system with a higher commission. A Broker Agreement should first appoint the Broker to solicit “qualified” prospects for the franchise system. The agreement should specify whether the Broker has any authority to negotiate the terms of the Franchise Agreement that the Franchisor will sign with the prospect or whether the Broker’s responsibilities cease after determining whether a prospect meets the Franchisor’s financial and operational standards. The agreement should reserve to the Franchisor the final acceptance and approval of a prospect in its sole and absolute discretion. If a Franchisor specifically reserves this discretion, it can minimize the chances that a Broker might claim it was due a commission for introducing a “qualified” prospect that the Franchisor unreasonably rejected. The agreement should correspondingly require that the Broker make clear to prospects that it has no authority to make an approval decision for the Franchisor.

2. Territory and Market Limitations

The Broker Agreement will identify the territory where the Broker is authorized to market and sell franchises on behalf of the Franchisor and whether the Broker will have any exclusivity in that territory vis-à-vis other Brokers. The agreement should contain a sufficiently detailed description of the territory using terms such zip codes, area codes, county boundaries or specific states. The Franchisor should reserve the right to market and sell franchises through its own officers and employees in each Broker territory and the agreement should clarify whether the Broker is entitled to any commission from such sales.

3. Compliance with Franchise Disclosure Laws

Although Franchisors retain the sole responsibility for ensuring that their franchise prospects receive a franchise disclosure document in accordance with the FTC Rule, the Broker Agreement should require the Broker to comply with all applicable state and federal disclosure laws. In particular, the Broker may not offer or sell franchises in any state where the Franchisor is not then registered to sell franchises. If the Franchisor chooses to have their Brokers involved in the disclosure process, the Franchisor should commit to provide the Broker with complete and accurate copies of its franchise disclosure documents for the applicable jurisdiction, which shall be prepared by the Franchisor at its own expense. The Broker Agreement should have the Broker recognize that there may be delays in its ability to offer or sell franchises in that state.
and that the registration may be beyond the Franchisor’s ability or control. The Broker’s compliance requirements should include the obtaining and forwarding of franchise disclosure document receipts as well as adhering to the restrictions on financial performance representations. Some Franchisors prefer to send the franchise disclosure documents out to the prospects themselves rather than having the Brokers involved in the process. If that is the case, the agreement should specify each party’s obligations with respect to disclosure.

4. Responsibility for Sales Materials

All sales materials used by the Broker should be subject to the prior written approval of the Franchisor. The Franchisor should review the materials to ensure that the statements are consistent with the franchise disclosure document, do not contain any improper financial performance representations, and comply with the federal and state advertising laws. The Broker Agreement should require that any advertising promote the integrity and reputation of the franchise system, and that the Broker will not make any representations to any prospective Franchisee which are misleading, incomplete, fraudulent, untrue or contrary to the Franchisor’s policies or standard agreements.

5. Qualification and Approval of Franchisees

The Broker Agreement should explicitly state that the Franchisor has the sole discretion to approve any prospect presented by a Broker. In order to streamline the process, Franchisors should provide their Brokers with a copy of its detailed Franchisee qualification requirements. These qualifications can be financial and/or be related to a certain professional or operational experience. Since Franchise Brokers usually receive commissions based on the number of franchise sales deals that they close and not on whether the Franchisees stay in business, Franchise Brokers may be tempted to “oversell” a prospect that is not qualified. It should be a stated default of the Broker Agreement if the Broker presents more than a certain number of prospects that do not meet the stated criteria.

Franchisees that meet a Franchisor’s qualifications often do not meet a bank’s qualifications for lending the necessary capital. It is an unfortunate circumstance that many loan Brokers initially tell a franchise prospect that they qualify and then, after the Franchise Agreement is signed, the executive bank personnel decide that the bank cannot bear the risk of financing. Even if the Franchisor is willing to refund the initial franchise fee, the Franchise Broker often has already been paid the commission. A Broker Agreement should address whether the Broker is responsible for returning all or a portion of the Broker commission if the Franchisee does not obtain financing. If the Franchisee was not as qualified as the Broker presented, then certainly the Broker should not retain the commission. In order to reduce issues related to refunding a commission payment if all or part of the commission is subject to a refund, the Franchisor can place the commission in an escrow account pending the outcome of the financing decisions.

6. Best Efforts or Limited Competitive Representation

The Broker Agreement should identify whether the Franchise Broker is required to use its “full time” and “best efforts” to identify qualified prospects and sell franchises on behalf of the Franchisor. The agreement can also state whether the Broker will be actively and directly involved in the performance of his or her Broker obligations at all times. Given the IRS’ determinations that a person is more likely to be an employee
than a consultant if the employer controls all the day-to-day activities, a Franchisor may not wish to require the “full time” efforts of the sales Broker.

7. Compensation

The parties must specify their compensation arrangements in the Broker Agreement. Typically, a Broker will earn a specific commission for each sale closed by the Franchisor but, as stated above, other performance benchmarks can be implemented. This commission may range from 10% to 50% of the initial franchise fee paid by the Franchisee to the Franchisor. The agreement should specify whether the fee will be paid at closing or a specific number of days after closing. Some Franchisors also pay their Broker a percentage of the royalties earned from the Franchisees that the Broker introduces to the system. Franchisors should limit the royalty commissions to a specific number of months or years and should specify whether the payments will continue only while the Broker is working for the system and the Franchisee remains a Franchisee in good standing in the system. The Broker Agreement could also provide for an hourly consulting fee for consulting services performed by the Broker. Alternatively, the agreement could provide that the Broker will from time to time consult with the Franchisor on the system at no charge unless the Franchisor pre-approves an additional consulting fee.

In addition to commissions, the Franchisor might agree to pay a minimal monthly fee to the Broker to cover some of its operating expenses including marketing expenses, copy charges and travel expenses. This monthly fee is usually much lower than the regular salary of an employed sales agent. In addition to any monthly fee, the parties must specify whether any specific expenses will be reimbursed by the Franchisor. The Franchisor should provide that the Broker submit appropriate documentation and receipts for these expenses.

The agreement should provide that the Broker is responsible for paying its own federal and state income taxes. The agreement should also state whether or not the Franchisor is withholding any taxes from the compensation paid. If the Franchisor is not withholding any taxes, then the Broker should be responsible for all employment taxes. It is a complicated tax issue with regards to whether the Broker will be considered an independent contractor or an employee. Franchisors should see tax advice from a tax attorney on this issue.

8. Intellectual Property Issues

The Broker should expressly agree to maintain the confidentiality of any proprietary information or trade secrets of the Franchisor except to the extent necessary to carry out the Broker’s obligations under the Broker Agreement. Information that is publicly known, lawfully obtained from a source other than the Franchisor or approved for release by the Franchisor is not generally subject to these restrictions.

The Broker Agreement should contain an acknowledgement by the Broker that the trade name, trademarks and all goodwill are the sole property of the Franchisor. The Broker should not have any right to use the trademarks or trade name except to identify the Franchisor in performing the Broker services.

The Franchisor should give careful consideration to any noncompetition provision. Certainly, the Broker Agreement should provide whether or not the Broker can market and sell franchises for other franchise systems. At a minimum, the agreement should prohibit the sales Broker from marketing franchise opportunities or selling franchises for a competing franchise system during the time the agreement is in
place and after it is terminated. The time frame should be reasonable and the restriction on the Broker should be as limited in geographical scope as necessary. The Broker Agreement can also grant the Franchisor the right to unilaterally reduce the scope of the covenant upon written notice. The Franchisor may wish to do so before pursuing any enforcement to reflect the current law of the relevant state.

9. **Indemnification**

   Even if both the Franchisor and Broker act appropriately in the franchise sales process, a Franchisee seeking to terminate its Franchise Agreement early may sue both the Franchisor and Broker.\footnote{See for example, in *Adams v. North American Business Brokers, Inc., et al.*, 168 Ga. App. 341, 342-344 (1983), a broker assisted a franchisee with the purchase of a Hungry Bull Family Steakhouse franchise. The franchisee had turned down several locations and was unable to obtain financing for other franchisor approved locations. After the franchisee was unable to find a suitable location, the franchisee sued the franchisor and broker for breach of contract, fraud and negligence and sought a refund of the initial franchise fee. The court held that neither the franchisor nor the broker promised the franchisee that it would be able to find a location and that the franchisee was not due a refund. *See also, Salkeld v. V.R. Business Brokers, et. al.*, 548 N.E.2d, 1151, 1152-1154 (1990), a plaintiff responded to an advertisement placed by a broker to sell cocktail drinks in a specific sales territory. The plaintiff filed a lawsuit against the broker and the seller and alleged that the seller of the drinks misrepresented the product, lied about the lack of competition and did not properly disclose him with the required franchise disclosure. The court held that the broker only participated in the initial introductory meeting and the closing, did not make any misrepresentations and did not have a duty to investigate the seller’s representations without any facts indicating that the representations were untrue. The court held that the plaintiff stated a *prima facie* case of common law fraud on behalf of the seller and that the system met the elements of a franchise.} Accordingly, the Broker Agreement should contain a mutual indemnification provision whereby each party agrees to indemnify the other for its actions. For example, the Broker will indemnify the Franchisor for situations where the Broker violates any laws in conjunction with the marketing and sale of the franchises, including financial performance representations and the Franchisor will indemnify the Broker for situations where the Franchisor’s franchise disclosure document is misleading or fraudulent. The indemnification should be broad and hold each party harmless from any and all fines, suits, proceedings, claims, demands, debts, obligations, liabilities, and actions of any kind by anyone, including attorneys’ fees and costs.

10. **Termination and Expiration of the Agreement**

    Generally, a Franchisor will wish to have the Broker Agreement terminable without cause, by either party with a certain amount of notice to the other party. This notice period is usually a longer period such as 30, 60, or 90 days. Additionally, the Franchisor usually has the right to terminate for cause after providing notice and an opportunity to cure the default. If the default is not curable, such as deceit or theft, then the Franchisor should have the right to terminate the agreement without notice and opportunity to cure.

    Upon expiration or termination of the agreement, the Broker should agree to return any materials it has related to the Franchisor and the franchise system and to turn over any lead information that the Broker possesses. The Broker Agreement also should specify how and when the Franchisor is required to pay the Broker for the services the Broker performed prior to termination or expiration. If the agreement is terminated by the Franchisor for cause, then the agreement may specify that the Broker has forfeited its right to payment. If the Broker is in mid-process with a lead, then the agreement should specify what percentage, if any, of the commission the Broker is entitled to be paid if the lead matures into a franchise sale. If the agreement is silent on
this issue, the Broker may pursue a claim for its commission if the sale closes after termination.

C. **Area Representatives**

When structuring an Area Representative Agreement it is important to recognize that, if the arrangement is successful, then the Area Representative’s responsibilities will have a tendency to shift from primarily franchise sales to franchise support during the term. It is also important to understand that the Area Representative, by being successful, may eliminate the Franchisor’s future need for an Area Representative for the territory.

Just as is the case when drafting any other agreement, it is important to consider the “what if” questions. What if the Area Representative misses the development target? What if a unit franchise that the Area Representative sold is not operational until the day after the Area Representation Agreement expires? What if someone independently approaches the Franchisor desiring to establish a unit franchise within the territory? These and other circumstances can easily be addressed in an Area Representation Agreement, but if not addressed can lead to significant consternation.

1. **Territory and Market; Exclusivity**

As with any territorial grant, it is important that the territory be clearly defined, that the parties’ rights and obligations with respect to the territory be clear, that whether the territory is exclusive or non-exclusive be clear, and, if exclusive, that the agreement clearly articulate any exceptions or ways in which the territorial exclusivity can be lost.

If there are any unit franchises operating within the territory before the Area Representation Agreement is signed, then it will be important to articulate whether the Area Representative will be expected to service those already operating unit franchises, and whether the Area Representative’s compensation in respect to those already operating franchises will be calculated in the same manner as would be the case had the Area Representative sold the franchise.

If the territory is exclusive, then it is important to identify any exceptions to the exclusivity. By way of example, a long-time Franchisee with unit franchises outside of the territory may identify and desire to pursue a unit franchise within the territory. The Franchisor should absolutely have the right to work with the existing Franchisee, since the establishment of the unit franchise is consistent with the objective of the Area Representative Agreement. However, unless the Franchisor intends to compensate the Area Representative to the same extent as if the Area Representative was responsible for the franchise sale, it will be important for the agreement to contemplate the rights and responsibilities of the parties. For example, the Franchisor retains entire initial franchise fee, but the unit franchise is credited against area developer’s development quota and the Area Representative might be compensated for services performed.

2. **Specific Rights Granted**

In general, the Area Representation Agreement should grant the Area Representative the right to use the Franchisor’s marks to promote the sale of franchises
(on those terms offered by the Franchisor), identify and conduct preliminary screening of prospective Franchisees. Any limitation on those rights, such as Franchisor pre-approval of franchise marketing materials, should be expressly stated in the Area Representation Agreement. Any additional rights, such as the right of the Area Representative to itself establish unit franchises as a Franchisee should be clearly expressed by the agreement.

3. **Fees to be Paid**

   It is important that fees be clearly defined by the Representation Agreement. The way in which the fees are expressed can be important. It makes a difference whether the Franchisor, in connection with the grant of a new franchise, commits to pay the Area Representative a specified dollar amount or a percentage of the actual initial franchise fee. Consider that a Franchisor may increase or decrease its initial franchise fee during the term of the Area Representation Agreement, or may establish a franchise fee discount program. By discussing how a change would impact the amount the Franchisor must pay the Area Representative, the parties can avoid a potential area of disagreement.

   Similarly, if the Area Representative will receive a portion of royalties paid by Franchisees, then it is important that the method of calculating the Area Representative’s portion be clear. Since it is possible for Franchisees to incorrectly report sales, or fail to pay royalties, prudence dictates specifying whether the Area Representative’s right to compensation is tied to what the Franchisor actually collects, or what the Franchisor has a right to collect. As it can be expensive to argue about amounts that should have been collected, but were not, a risk adverse approach is to base the Area Representative’s compensation on royalties actually received by the Franchisor. However, this results in the Area Representative sharing in the risk of non-payment; and the Area Representative may be concerned that the Franchisor may be relatively less inclined to pursue a royalty collection action if a percentage of the amount recovered would need to be paid to the Area Representative.

   If the Franchisor normally charges for training, and the Area Representative provides the training to area Franchisees, then the Representation Agreement should discuss whether and to what degree amounts collected by the Franchisor for training should be paid to the Area Representative. Similarly, if the Area Representative is responsible for undertaking marketing within the territory to promote the franchised businesses, then the agreement should articulate the degree to which marketing funds collected by the Franchisor from Franchisees will be made available to the Area Representative for marketing efforts.

4. **Quotas and Responsibilities**

   The primary objective of an Area Representative Agreement is system growth within the defined territory. While the Area Representative’s compensation will in all likelihood be tied to performance, it will be important that the area Representation Agreement establish specific minimum development quotas. If the minimum development requirement is the establishment of one additional unit franchise by the end of each year of the term, and half way through a ten-year term only three unit franchises have been established, then the Franchisor should have the right to alter the terms of the relationship. That does not necessarily mean that the Franchisor should have the
right to terminate the Area Representative Agreement. Perhaps the remedy would be the elimination of the territorial exclusivity granted to the Area Representative, so that the Franchisor could use additional methods to grow the system within the territory, without being obligated to pay the Area Representative in connection with the establishment of unit franchises the Area Representative did not sell.

Any other obligations of the parties should be clearly established by the agreement. Who provides training? Does the Area Representative need to attend certain Franchisor training programs in order to remain abreast of any new information? If so, who pays for the expenses to attend?

If the Area Representative is responsible for auditing unit franchise compliance with system standards, then the agreement ought to specify a minimum number of times per year that the Area Representative must conduct an inspection, whether a certain number of inspections must be unannounced, and whether certain factors, such as a non-passing inspection, would trigger a change to the number of inspections that must be conducted. On a related note, the Area Representation Agreement should make clear that the Area Representative, when servicing the system, will comply with the same procedures that would be utilized by the Franchisor for the identical purpose.

5. **Requirement for Area Representative to Operate a Unit Franchise**

The Area Representative’s operation of a unit franchise, or even a “flagship” location within the territory can be an effective tool to promote the sale of additional franchises. Other responsibilities contemplated by the Area Representation Agreement may also be functionally dependent upon the Area Representative’s operations of a unit franchise. By way of example, if the Area Representative is responsible for initial training, or putting on periodic training seminars, then it may be important that the Area Representative have a unit franchise as a place to also conduct training.

6. **Transfer to Successor**

An Area Representative will likely be selected based on a unique set of abilities and characteristics. In general, except to the extent applicable law requires otherwise, the Area Representation Agreement should not be transferrable. However, there may be circumstances under which the Area Representative is no longer able to perform, or is performing in unacceptable manner. While termination might be an option, another possibility would be for the Area Representation Agreement to contemplate how the parties might thoughtfully transfer the Area Representative’s responsibility to the Franchisor or a replacement Area Representative. Among the items that might be considered is whether and to what degree the initial Area Representative will be compensated in connection with the opening of a unit franchise due to the Area Representative’s efforts, if the opening occurs at a point after the Area Representative is no longer performing under the agreement.

7. **System Compliance**

The Franchisor, under the Franchise Agreements, will have a right to enforce system standards directly, using its own employees. While the Franchisor may delegate this responsibility to the Area Representative, the Franchisor should expressly reserve
the right to assess system compliance and take any other actions that, as the Franchisor, it would be able to take in the absence of the Area Representative relationship.

The Area Representative Agreement could provide for a flexible approach. For example, the Area Representative could be primarily responsible for system compliance, but the Franchisor could be able to independently assess compliance if it was concerned about the performance of the Area Representative. Alternatively, the Franchisor could simply benchmark whether the Area Representative’s operational assessments are consistent with the Franchisor’s own assessments.

A Franchisor should give consideration as to whether it would declare a system standard non-compliance default based on an Area Representative’s assessment, or first independently confirm the Area Representative’s assessment. Similarly, the Franchisor should consider whether it would terminate a franchise based on the Area Representative’s determination that the default had not been timely cured. The Franchisor should assume that any termination will result in litigation, and it may be easier to admit into evidence the Franchisor’s own business records than to admit into evidence information compiled by the Area Representative.

A judge or jury might be concerned that an Area Representative, against whom the terminated Franchisee may have been competing, may have ulterior motives for giving a poor operational report. In contrast, if the Franchisor independently confirms a situation to exist respecting a unit franchise, there will be cumulative testimony that will be more difficult for the Franchisee to overcome. Therefore, perhaps the balance that makes the most sense would be to, in the case of a curable operational default, declare a default based on the assessment of the Area Representative, but only terminate the franchise if the Franchisor independently verifies that a cure has not been accomplished.

8. **Vicarious Liability, Indemnification and Insurance**

An Area Representative is an agent, with the Franchisor being the principal. In servicing franchise relationships, the Area Representative is carrying out those activities that the Franchisor would otherwise be performing pursuant to, incident to, or in furtherance of, the relationship defined by the Franchise Agreement.

In general, a principal is vicariously liable for the acts of an agent occurring within the scope of the agency. Rather than try to contract away this dynamic, which would probably be unsuccessful, the Franchisor should require that the Area Representative defend, indemnify and hold harmless the Franchisor from and against all claims arising from the negligence or willful misconduct of the Area Representative. Likewise, the Area Representative should require a reciprocal indemnity.

Similarly, each the Franchisor and Area Representative should be required to have general business liability insurance sufficient to cover the types of situations that can arise in connection with their interaction with the Franchisee, the Franchisee’s employees, customers, guests and invitees. Each should require that it be named as an additional insured under the other’s insurance policy.

In considering these issues the practitioner should assume that any set of circumstances that would result in legal action against either the Franchisor or Area
Representative might be brought against both. If the Area Representative negligently injures a Franchisee’s employee during a unit franchise inspection, both the Area Representative and the Franchisor stand a good chance of being sued. If the Franchisor gets sued for wrongful termination of a unit franchise within the Area Representative’s territory, the Area Representative may very well be named as a co-defendant.

9. Termination and Non-Renewal

One of the most important issues to consider in drafting any contract is the ways in which it can come to an end, and what areas will need to be dealt with in connection with its ending. This is particularly true with respect to an Area Representation Agreement, because the agreement will almost certainly end while franchises established within the territory are either in the sales pipeline or at the very least, are still operating. Obviously the Franchisor will need to provide any support services that were previously provided by the Area Representative.

If the Area Representative receives a percentage of royalties in exchange for servicing franchises, then it would make sense for the Area Representation Agreement to specify that upon the expiration or earlier termination of the Area Representative Agreement, the Area Representative’s right to receive a percentage of royalties will end. However, if a unit franchise is established soon after the Area Representation Agreement ends, and would not have been established but for the efforts of the Area Representative, then the Area Representation Agreement should contemplate whether and to what extent the Area Representative would receive compensation in connection with the opening.

The Franchisor should also understand that the Area Representative Agreement may itself be subject to a state relationship law requiring good cause for termination and non-renewal if its terms satisfy the particular definition of a “franchise.” This issue can be problematic if the natural course of the Area Representative Agreement would lead to dynamics in which it no longer made sense for the Franchisor to have an Area Representative. In this regard the parties could agree that the failure of the Area Representative to establish a certain number of additional unit franchises within a specified period (e.g. one per year) would constitute good cause for termination or non-renewal; however, the Area Representative may want the agreement to specify at what point the same grounds, while good cause for ending the relationship, would not be a material breach entitling the Franchisor to damages.

As additional precautions to the potential impact of a non-renewal law, the Franchisor may want to establish defined points at which the Area Representative’s obligations and compensation structure will change, so that, if a non-renewal law applies to the relationship, then the continued relationship would make sense in terms of the parties’ long-term expectations. By way of example, a ten-year Area Representation Agreement could specify a that at the end of year 9, the Area Representative will no longer have the right to engage in franchise selling activities, and will only be compensated in connection with newly-established unit Franchises already under development at the end of year 9.
D. **Area Developers**

The drafting considerations for an Area Development Agreement are very similar to those involved when drafting an Area Representative Agreement, except that there is no need to contemplate selling or servicing efforts by the Area Developer. As such, the most significant considerations are:

- What territorial rights will be granted, are there any exceptions, and under what circumstances can those rights be lost or modified?
- What will the Franchisee pay, and when?
- By what time frames must the Franchisee have established a certain number of unit franchises; and what are the consequences if the Franchisee does not meet the agreed upon schedule?
- What site selection and development, training, and other responsibilities will the Franchisor assign to the Franchisee?
- What are the appropriate grounds for termination and non-renewal?

However, because the Area Developer is also the Franchisee, there are some additional considerations when drafting an Area Development Agreement.

1. **Form of Franchise Agreement**

   It is not atypical for a Franchisor, from time to time, to modify its standard form franchising documents. The Franchisor will generally desire that the Franchisee enter into the most current form of Franchise Agreement in connection with the establishment of any particular unit franchise. The Area Developer should consider insisting on financial caps, to ensure that fees (initial franchise fee, royalties, etc.) for unit franchises developed at all points during the term will be in line with the costs upon which it made the initial decision to enter into the Area Development Agreement. While it is possible to have one Franchise Agreement cover multiple unit locations, doing so would be ill-advised, because there may be future circumstances where having separate Franchise Agreements will facilitate changes, such as the sale or default of one of several unit franchises.

2. **Cooperating with Franchisor’s Disclosure Efforts**

   Because each unit franchise will be operated under a separate franchise agreement, the Area Development Agreement should require the Area Developer to cooperate with any pre-sale obligations imposed upon the Franchisor.

3. **Unit Franchise Territory**

   The Area Development Agreement should make clear that the territory, if any, applicable to any unit franchise will be established in the manner that the Franchisor typically uses when granting territorial rights; and that upon the ending of area development rights, the Franchisee’s exclusivity, if any, will be only that which is granted by the individual Unit Franchise Agreements.
4. **Not a Trademark License**

While the Area Development Agreement contemplates the grant of franchises, and almost certainly would come within the scope of franchise disclosure laws, the Area Development Agreement should not grant, and in fact should disclaim that it is granting any trademark license to the Franchisee. The Franchisee’s trademark rights will be contained within the several Franchise Agreements; and by structuring the Area Development Agreement so as to not meet statutory definitions of a “franchise,” the Franchisor may be able to avoid termination and non-renewal laws that would apply to the individual Unit Franchise Agreements.

E. **Subfranchisors**

1. **Fees**

Fee provisions in the master Franchise Agreement between a Franchisor and Subfranchisor (“Master Franchise Agreement”) are likely to be two tiered. First, the Franchisor must decide if it wants to have control of any kind relating to the fees to be charged to the Franchisees. Should the fees be specified? That is, should the specific royalty be dictated to the Subfranchisor? If the Master Franchisor Agreement is for a territory within the same country or market as other territories, then the Franchisor may want to specify fees and royalty for the sake of consistency.

If the market granted is an entire country, on the other hand, then the Franchisor may want to grant some flexibility. However, even in this latter case, the Franchisor may want to specify the types of fees and put minimums, in the case of advertising fees, and/or maximums, in the case of general royalty fees. Caps on general royalty fees may rein in the Subfranchisor that might otherwise become greedy at the expense of the general well being and expansion of the system.

Drafting issues for fees to be paid to the Franchisor have two aspects — how much, and how to get paid — regardless of whether the agreement is an Area Representative Agreement or a Subfranchisor arrangement. The first decision is subject to an analysis like that in setting fees for the franchise system generally, that is, what will the system bear? If the fees are set too high, the system will not grow. System turnover will occur as the Subfranchisors fail. Management time will be consumed in trying to keep the Subfranchisors from cheating the system in some way, or managing the disruptions caused by angry Subfranchisors.

The other aspect, how to get paid, involves an agreement on a method for payment of the fees due the Franchisor. For the Master Franchise Agreement, the issue of how to get paid is more important than with the Area Representative arrangement because funds flow to the Subfranchisor from the Franchisees. The Master Franchise Agreement will need to have a specific provision relating to fees in the event of default or termination. If the Subfranchisor's default relates to its support of its Franchisees, the problem is exacerbated. In that case the issue is not only how the Franchisor gets paid, it becomes one of how the Franchisees will continue to receive the support that they are paying for with their royalties and other fees. At a minimum, the Franchisor will want some type of control over the fees. For example, the agreement could provide that in the event of default the fees be paid into an escrow account, with specific amounts being paid for support.
Different issues arise if there is a termination. In the event of termination, the Unit Franchise Agreements must provide that the Franchisees attorn to the Franchisor, or a new Subfranchisor. There should be no doubt that the obligation to pay royalties continues and that they are to be paid to the “new” Subfranchisor, whether that is the Franchisor stepping into the "shoes" of the Subfranchisor or a new Subfranchisor entirely.

2. Quotas

In a Master Franchise Agreement, like the Area Representative Agreement, the Subfranchisor will need to meet goals to retain its rights in the market for the Franchisor to ensure the continued expansion of its market footprint. The quotas can be stated in terms of units opened, or in terms of revenue, or both.

What happens when quotas are not met? Generally, the Franchisor will want to be able to carve out territory from that which has been granted to the Subfranchisor if the quotas are not met. The provision would permit the Franchisor to grant rights to another Subfranchisor. However, that might not solve the problem. Another Subfranchisor may not be willing to make the needed investment if it is not granted exclusive rights to the market.

Another solution might be to provide for financial penalties for failure to meet the minimums. That penalty could be set as a penalty for each unit short. Another way to affect this would be to have a minimum royalty to be paid to the Franchisor for the territory, regardless of the number of units or royalty paid to the Subfranchisor. The issue can quickly become a compelling one for the Subfranchisor if there is insufficient development from the Franchisees.

The Subfranchisor could be provided an escape clause in the event that it cannot pay the minimum; that is, it could terminate the Master Franchise Agreement and turn over the operations to the Franchisor. That might at least help to avoid the fight that would arise if the quota was not met and the Subfranchisor did not have the funds to cover the minimum.

Of course, if the issue is a serious one for the Franchisor, the Master Franchise Agreement can provide for termination in the event that the quotas are not met. The termination provision can be triggered by repeated failures to meet quota, or a shortfall of a particular magnitude.

3. Termination

The Master Franchise Agreement needs to be specific regarding the responsibilities of the parties in the event of termination. Will the Franchisees be on their own, with rights to continue in business under a different name? Will the Franchisees instead be required to attorn to the Franchisor or a new Subfranchisor? Will the Franchisees simply be required to shut down? Will the Franchisees have an option as to which path they choose?

The Franchisor will want to ensure that the Unit Franchise Agreements are clear on what happens in the event of a termination of the Master Franchise Agreement.
Typically the Unit Franchise Agreements stay in effect, but specify that the Franchisor becomes the Franchisor under the Unit Franchise Agreements. The ability to verify these provisions exist in the Unit Franchise Agreements is one reason for the Franchisor to require its Subfranchisor to use the form of FDD provided by the Franchisor. Of course, in that event, the Franchisor will immediately pick up obligations to the Franchisees unless the Unit Franchise Agreement has limited the liability of the Franchisor.

If practical, the Franchisor will want the Unit Franchise Agreement to require that the Franchisee attorn to the Franchisor, but limit the liabilities of the Subfranchisor that the Franchisor is required to assume in that case. Certainly, the Franchisor is going to want the Master Franchise Agreement to require indemnification for those liabilities. Depending on the Franchisor’s assessment of the risk at the outset of the Master Franchise Agreement, the Franchisor may want some type of additional security — perhaps the escrow of funds or a letter of credit.

It can be appropriate for the Subfranchisor to pay some liquidated damage amount in the event of termination, since at a minimum there will be a cost involved to the Franchisor in taking over the territory, supporting any existing Franchisees for any interim period and finding another Subfranchisor, even before considering the issue of potential lost profit. The amount of the escrow or letter of credit referenced earlier could be calculated to cover all or a portion of the liquidated damage amount. The liquidated damages amount might be graduated based on the initial franchise fee paid by the Subfranchisor and the time frame of the termination.

In the unlikely case where the Franchisee is permitted to continue in business out of the franchise system, the Master Franchise Agreement will need to be specific on de-identification. Likewise, all confidential information will need to be returned and there should be agreement not to disclose any of that information.

4. Disclosure Obligations

As discussed above, the obligations for disclosure in the Master Franchise context are joint and several between the Subfranchisor and the Franchisor. And, the Subfranchisor must include certain information regarding the Franchisor in the FDD, also as discussed above. The FDD will be required to address the issues that will arise in the event that the Master Franchise Agreement is terminated for any reason. In Risk Factors, the Subfranchisor will state the fact that the franchise offered is conditioned on its continued compliance with the Master Franchise Agreement.

Indemnification for Subfranchisor’s disclosure to prospective franchisees is important. Since the obligations for disclosure are joint and several with the Subfranchisor, any action relating to failure to disclose will likely also name the Franchisor. The Subfranchisor should agree to cover this eventuality and any other liability that arises from the Subfranchisor’s disclosure or failure to disclose the franchise prospects.

5. System Compliance

As the Subfranchisor will normally provide all post sales support, it will also normally be responsible for system compliance. However, if the Franchisor wants to ensure that the Franchisees are meeting the standards of the system, the starting point
will be to require that the Subfranchisor use the Franchisor’s Unit Franchise Agreement form or one approved by the Franchisor, and the Franchisor’s operations manual or one approved by the Franchisor. The provision should also require that the Franchisees meet all standards that are set by the Franchisor, either through directives to the Subfranchisor or through revisions to the operations manual. The Subfranchisor should be required to adopt and pass on all standards set by the Franchisor. The Franchisor should also include an inspection provision that allows the Franchisor to periodically visit the Franchisees, with and without notice.

What happens if the Franchisor finds problems with the inspected units? Can it require corrective action or the termination of the Unit Franchise Agreement? Does it want that power as to the Franchisee? A Franchisor might not as it might find itself with liability to the Franchisee or the ultimate consumer that it does not want to have. However, if it does want that right, it will need to require the Subfranchisor to include a specific provision to that effect in the Unit Franchise Agreement.

If Franchisor wants to be able to require that the Subfranchisor take action, it will need to specify that in the Master Franchise Agreement. Specific remedies should also be outlined for the circumstance where the Subfranchisor does not take action to enforce the standards. Repeated failure should be cause for termination. Interim measures could include a requirement that the Subfranchisor pay for follow-up inspections, and/or allow the Franchisor to step in and manage certain support functions at the cost of the Subfranchisor.

6. Relationship Issues

Since the Franchisor will not be a direct Franchisor in the relationship with the Franchisees, relationship management will be the province of the Subfranchisor. If the Franchisor does not reserve any rights in the Master Franchise Agreement to monitor and take action in the case where the relationships between the Subfranchisor and its Franchisees deteriorates, it may find itself unable to affect an issue that stifles its system growth or commercial success.

But what rights to reserve? For example, does the Franchisor want to be the arbiter of disputes between the Subfranchisor and the individual Franchisees? Or, does it only want to become involved in disputes that affect all of the Franchisees of a given Subfranchisor? A Franchisor will want to carefully consider which approach will work best with its system and its own resources.

The relevant provision could be drafted to give the Franchisor some flexibility—give the Franchisor the right to intervene, but not require intervention. In any event, the Unit Franchise Agreement would also need to have a provision that covered the right or duty of the Franchisor to intervene to resolve any disputes.

7. Vicarious Liability

A continuing concern in any franchise relationship is the vicarious liability of the Franchisor for the actions or omissions of its Franchisees. This issue is present even where there is the additional operational layer between the Franchisor and the unit Franchisee, the Subfranchisor. Further complicating this issue is that in a Subfranchisor
relationship, there are two layers of potential liability — liability for the actions/omissions of the Subfranchisor and liability for the actions/omissions of the Franchisees.

To mitigate the risk of claims, the Franchisor should consider how much control it retains over the actions of the Subfranchisors and the Franchisees. As in the vicarious liability analysis in the normal franchise relationship, the Franchisor must decide how much it needs to retain control over specific issues—the more control retained, the more the risk of a successful vicarious liability claim. For example, if the Franchisor retains control over the personnel decisions of the Subfranchisor, there is a higher likelihood that a court will let a jury consider whether the Franchisor should be responsible for the acts/omissions of those Subfranchisor employees.

One drafting method that has been used with some success in the direct franchise relationship is to allow the Franchisor limited input into the day-to-day operational decisions of the Franchisee through operating manual guidelines, but give the Franchisee ultimate decision making authority over those day-to-day decisions. In that regard, in most franchise systems, there are items that cannot be left to the Franchisee. The same approach can be used in a subfranchise arrangement. The net effect of that inherent conflict is that as to certain decisions, there will be a decision to control the matter and accept the risk of a claim.

The indemnification provision in the Master Franchise Agreement should cover the problem where it cannot be eliminated. The Subfranchisor should be required to indemnify for actual liability, and it should cover the legal fees/costs of defending claims, whether those arising from its acts/omissions or those of the Subfranchisees. There should also be a similar indemnification provision in the Unit Franchise Agreement in favor of both the Franchisor and the Subfranchisor.

VII. CONCLUSION

A Franchisor desiring to enlist the aid of a third-party to expand its franchise system has quite a few options, from engaging a Lead Generator to Subfranchising. While each of these options is not without some risks, the risks can be managed if the proper considerations are taken into account when entering into a relationship with a third-party, and structuring the agreement defining that relationship.
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