



Guiding You Through the Legal Maze.SM

SPECIAL ISSUES

FOR AN

AREA REPRESENTATIVE

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SPECIAL ISSUES FOR AN AREA REPRESENTATIVE

An area representative is best described as a "super" franchise broker and servicing agent for the franchisor. If you will have management responsibility relating to the sale or operation of the franchise units, you must be disclosed in ITEMS 2, 3 and 4 of the franchisor's Franchise Disclosure Document with your last 5-year employment history and your last 10-year litigation and bankruptcy history.

An area representative differs from a subfranchisor in that the area representative uses the franchisor's Franchise Disclosure Document for a single unit franchise and area development. The franchise agreement is signed directly between the franchisor and the franchisee. The area representative is not a party to the franchise agreement. Under the area representative rights agreement between the franchisor and the area representative, the franchisor delegates to the area representative the sale obligation and certain of the franchisor's selling, servicing and support obligations to the franchisee. All initial franchise fees, royalties and other payments are usually paid by the franchisee directly to the franchisor. The franchisor then remits a portion of these fees to the area representative as negotiated in the area representative rights agreement.

There will usually be a number of terms contained in the area representative rights agreement that are identical to, or substantially similar to, those terms contained in the franchise agreement. Hopefully, as part of your review and negotiation of the terms of the franchise agreement, you have already addressed these issues from a fairness perspective and have negotiated an Addendum to Franchise Agreement¹. In addition, there are issues and terms that must be addressed to make the relationship between the franchisor and the area Representative more equitable. A corresponding Addendum to Area Representative Rights Agreement will contain these negotiated provisions. These special contract issues include the following:

A. ORGANIZATIONAL STRUCTURE; PURCHASE OF FIRST FRANCHISE

The franchisor may require an area representative to also purchase a single-unit franchise that will become his or her showcase unit and training facility. You should have been given the franchisor's form of Franchise Disclosure Document for area representative rights. You should negotiate purchasing area representative rights in one business entity and form separate business entities (either subsidiaries or affiliates) for each franchise unit you will own and operate. This separates any potential liability of each franchise unit from exposing the other franchise units and the company owning area representative rights. You should also have the right to have investors in individual franchise units provided you retain a controlling interest in the business entity owning the unit.

¹ The "Important Contract Issues for Franchisees" is a separate white paper that will be sent to you upon request.

B. YOUR PERSONAL GUARANTY

The franchisor will probably ask that you, and your spouse if you are married, sign the area representative rights agreement personally. This means that your personal assets are at risk as to the monetary obligations of the area representative to the franchisor. In my opinion, the business should stand alone, particularly because the payments from the franchisees go directly to the franchisor. As discussed above, the area representative rights should be a business entity and not you personally. Note that none of the franchisor's principals personally guarantee the obligations of the franchisor. Try to limit your guaranty of the agreements to the confidentiality and noncompetition provisions.

A. AREA OF RESPONSIBILITY (SERVICE AREA)

An area of responsibility or service area is the territory (for example, city, county or state) where the area representative can sell and service franchises. Make sure the franchisor gives you exclusive rights to the service area so that the franchisor cannot open company-owned units or grant a franchise to another party within your service area. Some franchisors reserve for themselves the rights to own and operate company-owned units or franchise to another certain key "non-traditional locations" and "alternate channels of distribution" within the service area (for example, units in regional malls, airports, highway facilities, schools, etc.). You should reduce or eliminate the franchisor's ability to compete with you without fair compensation. You should negotiate a right of first refusal to open in a non-traditional location within your service area, unless you are not qualified to operate at the location. You need to also provide that such sale is credited against your performance schedule and that you can service the non-traditional unit.

C. AREA REPRESENTATIVE FEE

An area representative fee is the up-front fee paid by an area representative to the franchisor for the area representative rights. This fee is usually negotiable. The franchisor desires to get as much up front as possible. The area representative desires to pay as little up front as possible. Although there is no set formula, the franchisor usually calculates the fee by taking a percentage of the initial franchise fee (*e.g.*, 25%) and multiplying it by the number of units to be sold by the area representative under the area representative rights agreement. The area representative should negotiate that he or she retains all initial franchise fees until he or she recoups the entire area representative fee. Thereafter, the initial franchise fees are divided as negotiated by the parties. Royalties and other fees paid by the franchisee are also divided as negotiated by the parties depending on the costs of the initial and ongoing services each party provides to the franchisees. A rule of thumb is 25% to the franchisor and 75% to the area representative, if the area representative does all the work. For any franchise units owned by the area representative, the initial franchise fees and royalties should be correspondingly reduced.

C. PERFORMANCE SCHEDULE

In my experience, the major issue to be negotiated in an area representative rights agreement is the performance schedule. The performance schedule is the agreement between the area representative and the franchisor as to how many franchise units will be sold, constructed and opened by the area representative and/or another franchisee over a specified period of time. The franchisor wants the area representative to sell as many units as quickly as possible to saturate and pre-empt the market. The area representative wants a very conservative schedule because of the uncertainties of the future, the area representative's financial condition, and the ability to find prospective franchisees that want to purchase the franchise. The performance schedule is totally negotiable since the circumstances vary greatly in each deal. The performance schedule is usually a "minimum" performance schedule. You should negotiate the right (but not the obligation) to sell or open more units within your service area if it makes sense to you without the payment of any additional up-front fees.

D. FAILURE TO ACHIEVE PERFORMANCE SCHEDULE

The typical area representative rights agreement has a provision stating that, if you fail to achieve the performance schedule, the area representative rights agreement can be terminated by the franchisor resulting in your loss of your area representative rights and the entire area representative fee. You need to make insure that the area representative rights agreement provides that, if you fail to achieve the performance schedule, you have several possible options. These include the payment of an extension fee, payment of minimum royalties or other terms that are fair to both of you. In addition, make sure the area representative rights agreement provides that, if it is terminated due to the failure to achieve or maintain the performance schedule, you retain the right to continue to service the franchises already sold and receive the fees. In addition, if you are also a franchisee, that you retain the units already open or under construction provided you are not otherwise in default under the franchise agreements.

E. FORM OF FRANCHISE AGREEMENT

The area representative rights agreement normally provides that the franchisor retains the sole and unilateral right to change the form of franchise agreement you are selling. Since the area representative rights agreement runs for several years, conceivably, there could be major material changes to the franchise agreement unilaterally made by the franchisor including larger initial franchise fees and royalties and a smaller protected area. These changes may make the franchise less marketable. Therefore, negotiate in the area representative rights agreement that the franchise agreement you negotiate in conjunction with the negotiation of the area representative rights agreement will be the form of the franchise agreement you sell for each unit opened pursuant to the area representative rights agreement, unless you and the franchisor agree to any material changes.

F. INDEMNIFICATION BY FRANCHISOR

An area representative is considered a "franchise broker" under the FTC Franchise Rule and state franchise laws. You can be held responsible for errors in the Franchise Disclosure Document. Make sure the area representative rights agreement requires the franchisor to indemnify you for any liability you may incur due to any false or erroneous information contained in the franchisor's Franchise Disclosure Document. Also, have the franchisor represent and warrant to you that the franchisor has complied in all material respects with all applicable federal and state franchise disclosure and registration laws. Be prepared to indemnify the franchisor from any liability due to your violation of the franchise laws in selling franchises or errors in the information you supply.

G. FRANCHISOR'S FAILURE TO TIMELY UPDATE FDD

What if you are a salesperson with nothing to sell? This could happen to you if the franchisor fails to timely update its FDD and maintain its registration in the franchise registration states, of these states are part of your service area. Under the FTC Franchise Rule, a franchisor must update its FDD upon any material change in the information contained in the FDD and within 120 days after the end of the franchisor's fiscal year. If the franchisor fails to do this all franchise sales must cease. You need to negotiate a provision in the area representative rights agreement that, if this happens, the franchisor will pay you some amount of liquidated damages. In addition, the term and the development schedule should be correspondingly extended by the period in which you are prohibited to sell.

H. STATE REGISTRATION OF FRANCHISE BROKERS

Franchise brokers that franchisors retain no longer have to be disclosed in ITEMS 2, 3 and 4 of the Franchise Disclosure Document provided they are merely sellers of franchises and do not have any management responsibility to the franchisees. However, the name and address of the franchise seller must be included in the ITEM 23 Receipt. In addition, a Franchise Seller Disclosure Form for each franchise seller must be submitted as part of registering the franchise in the states of California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Franchise brokers must go through a formal registration process in New York and Washington. If you are going to sell franchises in any of these states, you will have to register. You will need to review the registration requirements. You should negotiate that the franchisor will have its franchise counsel register you at the franchisor's expense. Under Illinois law an area representative is considered a subfranchisor. If you will sell in Illinois you will have to separately register as a subfranchisor. This includes preparing your own Franchise Disclosure Document and having audited financial statements.

H. CROSS-DEFAULT

The typical area representative rights agreement contains a provision in the default section stating that a default under any other agreement between the area representative and the franchisor (for example, a franchise agreement) is also a default under the area representative rights agreement. Additionally, a default under the area representative rights agreement constitutes a default under all other agreements. While many events of defaults are automatic defaults under each agreement (for example, bankruptcy) that trigger defaults under each agreement, there may be a default that only applies to a particular unit ("bad location") leaving the other units not in default. This cross-default provision causes you to be in default under every agreement including every franchise agreement. Therefore, you must make sure that the area representative rights agreement and each franchise agreement stands on its own. Do not accept a cross-default provision. Otherwise, it would have a "domino effect" and jeopardize everything!

I. YOUR OPTION TO RENEW

The term of an area representative rights agreement can be five years or less. Once the agreement expires and is not renewed, the franchisor will be free to open company-owned units, grant franchises and/or appoint another area representative within your former exclusive area so long as these units are not within the protected territories of your operating franchise units. You should try to retain continued exclusive rights by negotiating an option to renew the area representative rights agreement for an additional term subject to you and the franchisor negotiating in good faith a new performance schedule based on demographic, economic and other conditions existing at that time. If the parties cannot agree, the issue will be submitted to binding arbitration.

J. YOUR SALE OF RIGHTS

The area representative rights agreement requires the consent of the franchisor to your sale of your area representative rights to a third party. Usually, you will be selling all of your existing franchise units as well, if any. You need to add that the franchisor's consent will not be unreasonably withheld, delayed or conditioned. The conditions to the franchisor's giving its consent should be reasonable and unambiguous. Your buyer should be able to assume your area representative rights agreement and any franchise agreements instead of signing the franchisor's then-current form of agreements. The transfer fee should be reasonable and not cumulative. Any general release should be mutual. Upon a permitted transfer, you should be released from all future obligations under the agreements.

M. REDUCED ROYALTY FEES

There may be economies realized by the franchisor in providing its services to all of the franchise units you own and operate. In addition, there may be certain functions that you handle that reduce the services provided by the franchisor. If this is the case, you may consider negotiating that the royalty fees of all your franchise units be aggregated and

applied against a reduced sliding scale of royalties as gross revenues increase. Two of your best arguments for reduced royalty fee are that this serves as a greater incentive to you to increase sales and also that the franchisor costs to provide its incremental services as gross revenues increase are reduced. While some franchisors already have a sliding scale of royalties, many do not.

N. LIMIT OTHER FEES

The area representative rights agreement and franchise agreement probably contains numerous other fees such as renewal fees, transfer fees, securities offering fees, etc. For example, if you decide to sell all your area representative rights and related franchise agreements, don't allow these fees to multiply just because you are a multi-unit franchisee. Limit these fees to something reasonable in the aggregate.

O. FORCE MAJEURE

If the area representative rights agreement does not contain a force majeure provision and specifically applies to the performance schedule, you should insist that it be included. A force majeure provision usually provides that a party to a contract is excused from performance where he or she is unable to perform due to an act beyond the control of the party such as terrorism, earthquakes, floods, hurricanes, tornadoes, and other act of God. Who knows when a fire, flood, earthquake, hurricane, riot, bombing, etc. will occur that interferes with your performance?

P. CO-TERMINUS AGREEMENTS

All the agreements you sign will contain or reference a provision stating you cannot own or operate a competitive business while you are a franchisee. What if you do not renew one of your franchise agreements and decide to operate a competitive business. You will breach your other agreements with the franchisor if you do. You should negotiate that the term of all of the franchise agreements to which you or your subsidiary or affiliate is a franchisee expire at the same time. This will give you more bargaining power and prevent you from violating any in-term covenant to compete.

Q. OTHER ISSUES

There may be issues important to the area representative other than the issues discussed in this paper. You and your attorney need to review the area representative rights agreement very carefully to see what impact certain terms have upon your rights. If there are terms that appear unreasonable and unfair, you need to attempt to negotiate these issues to protect your interests.

CONCLUSION

As you can see, an area representative rights agreement and franchise agreement are complex legal documents written by the franchisor's attorney for the franchisor's benefit. You need to retain a lawyer experienced in franchise law to renegotiate the terms of these agreements to protect your interests and your sizeable investment and potential liability.

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