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SPECIAL ISSUES

FOR A

SUBFRANCHISOR

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SPECIAL ISSUES FOR A SUBFRANCHISOR

A subfranchisor is sometimes called a "master franchisee," particularly in international deals. A subfranchisor steps into the shoes of the franchisor and acts as the franchisor in a given area (for example, a county, state or country). A subfranchisor sells its own subfranchises and directly enters into a subfranchise agreement with a franchisee. The franchisor is not a party to the subfranchise agreement.

The offer of subfranchise rights must be made separate and apart from the offer of a single unit franchise or area development rights. The franchisor must prepare a separate Franchise Disclosure Document for the offer of subfranchise rights and given to prospective subfranchisors describing the subfranchise relationship. A copy of the subfranchise rights agreement is attached as an exhibit to the FDD for subfranchise rights.

A subfranchisor is subject to the FTC Rule and Guidelines to the same extent as a franchisor. Therefore, a subfranchisor is obligated to have its own Subfranchise Disclosure Document separate from the franchisor but includes certain information about the franchisor, the franchisor's and the subfranchisor's audited financial statements, and state registration, if the subfranchisor will be offering subfranchises in a registration state or a prospective franchisee is resident in a registration state. Normally, the franchisor provides the subfranchisor's attorney with a "master" FDD containing the information regarding the franchisor. The subfranchisor and its attorney include the information required to be disclosed by a subfranchisor.

There will usually be a number of terms contained in the subfranchisor 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 Agreement[1].

In addition, there are issues and terms that must be addressed to make the relationship between the franchisor and the subfranchisor more equitable. A corresponding Addendum to Subfranchisor Rights Agreement will contain these negotiated provisions.

These special contract issues include the following:

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

A. ORGANIZATIONAL STRUCTURE; PURCHASE OF FIRST FRANCHISE

The franchisor may require a subfranchisor to also purchase a single-unit franchise that will become his or her showcase unit and training facility. You should also have been given the franchisor's form of Franchise Disclosure Document for a franchise and area development rights. You should negotiate purchasing subfranchisor 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 subfranchisor 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.

B. YOUR PERSONAL GUARANTY

The franchisor will probably ask that you, and your spouse if you are married, sign the subfranchisor rights agreement personally. This means that your personal assets are at risk as to the monetary obligations of the subfranchisor 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 subfranchisor 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.

C. SALES AREA

A sales area is the area (for example, state, county or city) where the subfranchisor can sell franchises. You should make sure the sales area is sufficiently large to support all the units contemplated under the performance schedule. In addition, make sure the franchisor gives you exclusive rights to the sales area so that the franchisor cannot open company-owned units or grant a franchise to another party within the sales 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 your 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. The non-traditional location should be credited against your performance schedule.

D. SUBFRANCHISE FEE

A subfranchise fee is the up-front fee paid by a subfranchisor to the franchisor for the subfranchise rights. This fee is usually negotiable. The franchisor desires to get as much up front as possible. The subfranchisor was 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 for each unit (10%-50%) and multiplying it by the number of units to be sold by the subfranchisor under the subfranchise rights agreement. The subfranchisor should negotiate that he or she retains all initial franchise fees until he or she recoups the entire subfranchise fee paid. 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. A rule of thumb is 25% to the franchisor and 75% to the subfranchisor, if the subfranchisor does all the work.

E. PERFORMANCE SCHEDULE

In my experience, the major issue to be negotiated in a subfranchise rights agreement is the performance schedule. The performance schedule is the agreement between the subfranchisor and the franchisor as to how many franchised units will be sold, constructed and opened over a specified period of time. The franchisor wants the subfranchisor to sell as many units as quickly as possible to saturate and pre-empt the market. The subfranchisor wants a very conservative schedule because of the uncertainties of the future, the subfranchisor'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 may want to negotiate the right (but not the obligation) to open or sell more units within your sales area if it makes sense to you without the payment of any additional up-front fees.

F. FAILURE TO ACHIEVE PERFORMANCE SCHEDULE

The typical subfranchise rights agreement provides that, if you fail to achieve the performance schedule you are in material default of the subfranchise rights agreement and the franchisor can terminate you and you lose everything. Make sure that the subfranchise 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, rather than termination. In addition, make sure the subfranchise rights agreement provides that, if it is terminated due to the failure to achieve or maintain the performance schedule, you retain the rights to continue to act as the subfranchisor under franchise agreements already signed including the right to retain the royalties and other 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.

G. FORM OF SUBFRANCHISE RIGHTS AGREEMENT

The form of subfranchise agreement that you will use with your subfranchises is included as an Exhibit to the FDD the franchisor must give to you for the offer of subfranchise rights. The typical subfranchise rights agreement provides that you will use the franchisor's "then-current form of franchise agreement" as your subfranchise agreement. The franchisor has total discretion to change the terms of the deal you are selling. You should try to provide that any changes to the economic terms of the subfranchise agreement require your consent, which consent will not be unreasonably withheld. Also, try to reserve the right in the subfranchise agreement for you to make changes to the subfranchise agreement you use including the right to change the initial franchise fee, royalties, etc. with the franchisor's consent, which consent is not to be unreasonably withheld, delayed or conditioned.

H. INDEMNIFICATION BY FRANCHISOR

The Franchise Disclosure Document you are required to have as a subfranchisor must include certain information about the franchisor. You assume that the information the franchisor provides to you is complete and accurate. Make sure the subfranchise rights agreement provides that the franchisor indemnifies you for any liability you may incur due to any false or erroneous information supplied to you by the franchisor and included in your Franchise Disclosure Document.

I. MASTER COPY OF FDD AND FRANCHISE AGREEMENT.

You should require the franchisor to supply you with an electronic version in Word of the franchisor's latest form of FDD, franchise agreement and related documents as well as all future supplements and annual updates. This will save your attorney time and you money, in preparing your own FDD, subfranchise agreement and related documents.

J. FRANCHISOR'S FAILURE TO TIMELY UPDATE FDD

What if you are a salesperson but cannot sell? This could happen to you if the franchisor fails to timely update its FDD and supply you its updated master FDD. Under the FTC Franchise Rule, a franchisor and its subfranchisors must update their respective FDDs upon any material change in the information contained in the FDDs and within 120 after the end of the franchisor's and subfranchisor's fiscal year. If the franchisor fails to timely update its FDD, you cannot update your FDD and all franchise sales must cease. You need to negotiate a provision in the subfranchise rights agreement that, if this happens, the franchisor will pay you some amount of liquidated damages. In addition, the term and performance schedule should be correspondingly extended by the period in which you are prohibited to sell.

K. CROSS-DEFAULT

The typical subfranchisor rights agreement contains a provision in the default section stating that a default under any other agreement between the subfranchisor and the franchisor (for example, a franchise agreement) is also a default under the subfranchisor rights agreement. Additionally, a default under the subfranchisor 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 subfranchisor rights agreement and each subfranchise agreement stands on its own.

Do not accept a cross-default provision. Otherwise, it would have a "domino effect" and jeopardize everything!

L. Your Option to Renew

The term of a subfranchisor 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 subfranchisor 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 subfranchisor 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.

M. Your Sale of Rights

The subfranchisor rights agreement requires the consent of the franchisor to your sale of your subfranchisor 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 subfranchisor 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.

N. 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.

O. Limit Other Fees

The subfranchisor 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 subfranchisor 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.

P. FORCE MAJEURE

If the subfranchisor 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?

Q. 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.

R. OTHER ISSUES

There may be issues important to the subfranchisor other than the issues discussed in this paper. You and your attorney need to review the subfranchisor 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, a subfranchisor rights agreement and subfranchise 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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