



Guiding You Through the Legal Maze.SM

IMPORTANT CONTRACT ISSUES

FOR

AREA DEVELOPERS, AREA REPRESENTATIVES

AND

SUBFRANCHISORS

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IMPORTANT CONTRACT ISSUES FOR AREA DEVELOPERS, AREA REPRESENTATIVES AND SUBFRANCHISORS

In addition to the typical purchase of a single-unit franchise, there are three other franchise offerings made by many franchisors referred to as area development rights, area representative rights, and subfranchise rights. Recently, the North American Securities Administrators Association (“NASAA”), the group that drafted the 2008 Franchise Disclosure and Registration Guidelines for the franchise filing states (the “NASAA Guidelines”), adopted its Multi-Unit Commentary¹ to the NASAA Guidelines addressing the pre-sale disclosure obligations of franchisors to area developers, area representatives and subfranchisors. The Multi-Unit Commentary becomes effective on March 15, 2015 or within 120 days of the end of a franchisors fiscal year.

The Amended FTC Franchise Rule (the FTC Rule”) was amended in 2008 to become consistent with the Guidelines. The FTC and the Guidelines are merely a pre-sale disclosure and registration laws. The FTC Rule does not regulate the contractual terms of the relationship between a franchisor and its area developers, area representatives and/or subfranchisors. The parties are free to structure the contractual relationship in any manner to which they agree. Several states impose certain limitations on the contractual terms that are usually disclosed in a state addendum.

However, like the franchise agreement², the area development rights agreement, area representative rights agreement and subfranchise rights agreement were written by the franchisor’s attorney and are all extremely one sided agreements. The purpose of this white paper is not to explain all of the franchisor’s obligations under the FTC Rule, the Guidelines and the Multi-Unit Commentary, but rather to explain these three franchise relationships for prospective purchasers, and most importantly, the important contract issues that need to be addressed and amended to make the relationship fairer from the area developer’s, area representative’s and subfranchisor’s perspective before the investment is made.

¹ *The Multi-Unit Commentary can be accessed at <http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf>*

² *The “Important Contract Issues for Franchisees” is a separate white paper that will be sent to you upon request.*

AREA DEVELOPMENT RIGHTS

If you desire to own and operate more than one franchise unit, you may want to consider becoming an area developer. An area developer is really a multi-unit franchisee who contractually commits, at the beginning of the relationship with the franchisor, to open a number of franchise units within a given area ("Development Area") over a specified period of time ("Development Schedule). This is different from a franchisee that may have first purchased one franchise unit and later purchases another franchise unit, etc., without ever being contractually bound to open further franchise units.

If a franchisor offers area development rights, the FTC Rule and Guidelines require specific disclosure regarding the area development rights. This disclosure is included in the franchisor's Franchise Disclosure Document ("FDD") for a single-unit franchise and area development rights. The area development rights agreement is included as an exhibit. Where required disclosure is the same for a franchise agreement and an area development rights agreement (for example, ITEMS 2, 3 and 4) duplicate disclosure is not necessary. However there are certain items of the FDD (including ITEMS 5, 6, 7, 8, 9, 11, 12 and 17) where there is separate disclosure of certain terms of the area development rights agreement.

AREA REPRESENTATIVE RIGHTS

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 rights. 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.

SUBFRANCHISE RIGHTS

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 Multi Unit Commentary confirms that 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.

COMMON ISSUES FOR AREA DEVELOPERS, AREA REPRESENTATIVES AND SUBFRANCHISORS

There will usually be a number of terms contained in the area development rights agreement, area representative rights agreements or subfranchise rights agreements 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.

In addition, there are issues and terms common to area developers, area representatives and subfranchisors that must be addressed to make the relationship between the franchisor and the area developer, area representative and subfranchisor more equitable. A corresponding Addendum to Area Development Rights Agreement, Area Representative Rights Agreement or Addendum to Subfranchise Rights Agreement will contain these negotiated provisions.

These common unique contract issues include the following:

A. ORGANIZATIONAL STRUCTURE; PURCHASE OF FIRST FRANCHISE

The franchisor normally requires an area developer to purchase his or her first franchise unit at the same time he or she purchases area development rights. The franchisor may require an area representative or a subfranchisor to also purchase a single-unit franchise that will become his or her showcase unit and training facility. You will be given the franchisor's form of FDD for a single-unit franchise and area development rights. You should negotiate purchasing area development rights, area representative rights or subfranchise rights in one business entity and form separate business entities (either subsidiaries or affiliates) for each franchise unit you own and operate. This separates any potential liability of each franchise unit from exposing the other franchise units and the company owning area development rights, area representative rights or subfranchise 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 Area Development Rights Agreement, Area Representative Rights Agreement or Subfranchise Rights Agreement personally. This means that your personal assets are at risk as to the monetary obligations of the area developer, area representative or subfranchisor to the franchisor. In my opinion, the franchise businesses should stand alone and generate enough income from which to pay the monetary obligations to the franchisor. As discussed above, the area developer, area representative or subfranchisor 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 to the agreements confidentiality and noncompetition provisions.

C. CROSS-DEFAULT

The typical area development rights agreement, area representative rights agreement and subfranchise rights agreement contains a provision in the default section stating that a default under any other agreement between the area developer, area representative or subfranchisor and the franchisor (for example, a franchise agreement) is also a default under the area development rights agreement, area representative rights agreement or subfranchise rights agreement. Additionally, a default under the area development rights agreement, area representative rights agreement or subfranchise 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 development rights agreement, area representative rights agreement or subfranchise 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!

D. YOUR OPTION TO RENEW

The term of an area development rights agreement, area representative rights agreement or subfranchise rights agreement can be five years or less. Once any of these agreements expire and is not renewed, the franchisor will be free to open company-owned units, grant franchises and/or appoint another area developer, area representative or subfranchisor within your former exclusive area so long as these units are not within the protected territories of your operating units. You should try to retain continued exclusive rights by negotiating an option to renew the area development rights agreement, area representative rights agreement or subfranchise rights agreement for an additional term subject to you and the franchisor negotiating in good faith a new development 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.

E. YOUR SALE OF RIGHTS

The area development rights agreement, area representative rights agreement and subfranchise rights agreement require the consent of the franchisor to your sale of your area development rights, area representative rights or subfranchise rights to a third party. Usually, you will be selling all of your existing 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 development rights agreement, area representative rights agreement or subfranchise 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.

F. 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.

G. LIMIT OTHER FEES

Each area development rights agreement, area representative rights agreement, subfranchise 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 development rights, area representative rights or subfranchise 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.

H. FORCE MAJEURE

If the area development rights agreement, area representative rights agreement, or subfranchise rights agreement does not contain a force majeure provision and specifically applies to the development schedule or 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?

I. 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, are a franchisee expire at the same time. This will give you more bargaining power at the time of renewal and preclude you from violating any in-term covenant to compete.

J. OTHER ISSUES

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

SPECIAL ISSUES FOR AREA DEVELOPERS

A. **DEVELOPMENT AREA**

A development area is the territory in which the area developer will locate its franchise units. You need to make sure that the franchisor gives you exclusive rights to the development area so that the franchisor cannot open company-owned units or grant a franchise to another party within your development 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 development 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 at any non-traditional location within your development area, unless you are not qualified to operate at the location.

B. **DEVELOPMENT FEE**

A development fee is the up-front fee paid by an area developer to the franchisor for the development rights. This fee is usually negotiable. The franchisor desires to get as much up front as possible. The area developer wants to pay as little up front as possible, preferably by paying the entire initial franchise fee for each unit as locations are found and a franchise agreement is signed. Although there is no set formula, the franchisor usually calculates the development fee by taking a percentage of the initial franchise fee (for example, 25% to 50%) and multiplying it by the number of franchise units to be opened by the area developer under the area development rights agreement. A more reasonable development fee is \$5,000 per franchise unit. The development fee should be credited against the total initial franchise fees so that, as each franchise agreement is signed, you pay the standard initial franchise fee less the pro rata amount by the development fee previously paid. Some franchisors reduce the initial franchise fee for the second and additional franchise units because the franchisor's costs, particularly training, will be less since the franchisee is already trained. Keep this in mind in negotiating the development fee and the initial franchise fee for two or more units. Be aware that the area development rights agreement will usually contain a provision stating that upon a default by the area developer under the area development rights agreement (including the failure to achieve the development schedule), the franchisor has the right to terminate the area development rights agreement and retain the entire development fee. This is another reason to negotiate a lower development fee.

C. **DEVELOPMENT SCHEDULE**

In my experience, the major issue to be negotiated in an area development rights agreement is the development schedule. The development schedule is the agreement between the area developer and the franchisor as to how many franchise units are to be opened over a specified period of time. The franchisor wants the developer to open as many franchise units as quickly as possible to saturate and pre-empt the market. The developer wants a very conservative schedule because of the uncertainties of the future,

the developer's financial condition, the performance of the initial franchise units and the developers' ability to manage the construction and operation of multiple franchise units. The development schedule is totally negotiable since the circumstances vary greatly in each deal. The development schedule should be reasonable for both parties. The development schedule is usually a "minimum" development schedule. Consider negotiating the right (but not the obligation) to open more franchise units within your Development Area, if it makes economic sense to you, without the payment of any additional up-front fees.

D. FAILURE TO ACHIEVE DEVELOPMENT SCHEDULE

The typical area development rights agreement has a provision stating that, if you fail to achieve the development schedule in a timely manner, the area development rights agreement can be terminated by the franchisor resulting in your loss of your development rights and the entire development fee. You need to make sure that the area development rights agreement states that, if you fail to timely achieve the development schedule, you have several possible options that do not include the loss of development rights. These include the payment of an extension fee, the payment of minimum royalties or other terms that are fair to both of you. In addition, make sure the area development rights agreement provides that, if the area development rights agreement is terminated due to your failure to achieve or maintain the development schedule, you can retain the franchise units already opened or under construction provided you are not otherwise in default under the franchise agreements.

E. FORM OF FRANCHISE AGREEMENT

The area development rights agreement normally provides that the area developer will sign the franchisor's "then-current form of franchise agreement, which may be materially different than this Agreement." Since the area development rights agreement runs for several years, conceivably, there will likely be major material changes to the franchise agreement made unilaterally by the franchisor that are adverse to your interests. You will be obligated to sign it because you already agreed to do so when you signed the area development rights agreement. Therefore, you need to negotiate a provision in the area development rights agreement that states that the franchise agreement and addendum you negotiate in conjunction with your negotiation of the area development rights agreement will be the form of the franchise agreement and addendum you sign for each unit opened pursuant to the area development rights agreement.

SPECIAL ISSUES FOR AREA REPRESENTATIVES

There will usually be a number of provisions in the area representative rights agreement substantially similar to the provisions contained in the franchise agreement. Therefore, you need to renegotiate these provisions in the same manner as the franchise agreement. There are also contract issues unique to an area representative that must be addressed to make the relationship between the franchisor and the area representative more equitable, including:

A. AREA OF RESPONSIBILITY (SERVICE AREA)

An area of responsibility or service area is the territory (for example, state, county or city) 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.

B. 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.

SPECIAL ISSUES FOR SUBFRANCHISORS

There are special issues unique to a subfranchisor that must be addressed to make the relationship between the franchisor and the subfranchisor more equitable including:

A. 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.

B. 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.

C. 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.

D. 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.

F. 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 rights 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 franchise agreement require your consent, which consent will not be unreasonably withheld. Also, try to reserve the right in the subfranchise rights agreement for you to make changes to the franchise 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.

G. 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.

J. 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.

K. 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 master updated 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.

CONCLUSION

As you can see, an area representative rights agreement, area representative rights agreement and subfranchise rights agreement, as well as the 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.

Keith J. Kanouse, Esq.