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**DRAFTING THE FDD FOR MULTIPLE OR OTHERWISE
COMPLEX OFFERINGS**

**Lulu Chiu Gomez
California Department of Business Oversight
Los Angeles, CA**

**Beata Krakus
Greensfelder, Hemker & Gale, P.C.
Chicago, IL**

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Biographies

DRAFTING THE FDD FOR MULTIPLE OR OTHERWISE COMPLEX OFFERINGS

I. INTRODUCTION¹

Franchise offerings can take an endless variety of forms and structures. Franchisors offer unit franchises, area development rights, area representation arrangements, or master franchising arrangements, or can utilize alternative forms of distribution models, such as joint ventures. Even the seemingly simple unit franchise model can be made complex by offerings of multiple brands, non-traditional venues, limited services/offerings operations, or kiosk or mobile models. With all of the possible variations, it is not surprising that confusion and inconsistent practices abound among franchise practitioners in how to describe the various arrangements and models in franchise disclosure documents or FDDs.

To help alleviate some of the confusion, the North American Securities Administrators Association (“NASAA”) adopted its Multi-Unit Commentary on September 16, 2014.² The reason for this commentary was the increasing use in franchising of different types of multi-unit arrangements and the lack of consistency in how the different arrangements and models were treated in FDDs. While the Multi-Unit Commentary is far from complete, it addresses both terminology and specific issues regarding area development arrangements, master/sub-franchise arrangements and area representative arrangements. Importantly, the commentary recognizes that arrangements may or may not fall squarely within one of these three categories. Combinations are possible. To the extent applicable, this paper will use the terminology used by the Multi-Unit Commentary.

However, the Multi-Unit Commentary does not address every possible franchise model nor every possible issue that may arise. This paper discusses a broader range of issues that arise when drafting the FDD for such complex offerings than the Multi-Unit Commentary does. It provides some suggestions and advice on how to deal with such issues in light of available guidance from the FTC, states laws and regulations, and of course, from NASAA.

II. MULTIPLE BRANDS IN ONE FDD

A. Disclosure Issues Relating to Affiliate Brands

Franchising has throughout the years evolved from mainly involving successful business owners that used franchising to expand their brand during its early days to nowadays teeming with large franchisor corporate entities that own and offer multiple brands. Most people have heard of McDonald’s—an example of the former type of single-brand franchisor—but they also are familiar with the family of Marriott hotel brands, which owns over 30 brands—an example of the latter type of corporate franchisor. These large franchising companies can own many brands in the same industry, as do Marriott or Yum! Brands, which owns the KFC, Pizza Hut, and Taco Bell brands. Or they can own many brands in a wide variety of industries; in many cases, these are private equity firms, like Roark Capital Group or Levine Leichtman Capital Partners. Roark Capital Group, for example, directly or indirectly owns or has invested in a

¹ The views expressed in this paper are those of the individual authors. Ms. Gomez’ views do not represent the views of the California Department of Business Oversight or its commissioner.

² NASAA, *Multi-Unit Commentary* (September 16, 2014), <http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf>.

number of food, health, beauty, fitness, and auto industry franchises.³ Levine Leichtman Capital Partners directly or indirectly owns or has invested in franchises in the signage industry (Fastsigns), lawn care industry (Lawn Doctor), and food industry (Great American Cookies, Marble Slab Creamery, MaggieMoo's, Hot Dog on a Stick, and Pretzelmaker, which are all owned by Levine Leichtman's Global Franchise Group).

Companies that own multiple brands may want to offer multiple brands in one FDD for a variety of reasons but must first determine whether it can do so within the confines of the federal and state laws regulating franchising. The FTC Franchise Rule⁴ and the accompanying Compliance Guide⁵ are silent on when multiple brands can be offered in one FDD, as are most state franchising registration and disclosure laws.⁶ In most cases, it is necessary to rely mainly on inferences that can be made from the rules as to when the FTC and state regulators would permit offering multiple brands in one FDD.

Note that this section of the paper relates to offerings of two or more separate franchise brands where the franchisee would be operating one or the other or two separate franchises. This section does not refer to offers of franchises with two brands being sold in one location, which is also known as co-branding and is discussed in the next section.

1. When Is Having Multiple Brands in One FDD Allowed?

For franchisors, only having one FDD for their different offerings may hold great allure: it may be easier to administer one rather than multiple FDDs; there is less risk that the sales team do not disclose a prospect with the proper FDD; and there is some savings in state filing fees and potentially legal fees as well.

Franchisors are required by the FTC Rule to describe the rights (including any rights to trademarks, patents, or copyrights) they are granting and how they acquired or hold the right to grant such rights. Thus, as an initial matter, the franchisor making the offering must actually own or have a license for the brand being franchised (including the trademark associated with the brand). States with registration laws require that the person offering a franchise prepare and register an FDD, so effectively, if two companies, even if they are affiliated, want to offer their franchises, they must prepare separate FDDs and separately register.⁷ The effect of such

³ Roark's vast portfolio includes brands like Arby's, Buffalo Wild Wings, Il Fornaio, Anytime Fitness, Massage Envy, Drybar, Orangetheory Fitness, as well as Carl's Jr., Hardees, Green Burrito, Red Burrito (which are owned indirectly by Roark through its portfolio company, CKE Restaurants Holdings, Inc.), and Meineke, Econo Lube N' Tune & Brakes, Maaco, and Take 5 Oil Change (which are owned indirectly by Roark through its portfolio company, Driven Brands).

⁴ 16 C.F.R. § 436, 437 (2007). The full text of the official version of the FTC Franchise Rule is found in the Federal Register, Vol. 72, No. 61 at pages 15444–63 (March 30, 2007).

⁵ FTC, *Franchise Rule Compliance Guide* (May 2008), <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>.

⁶ Illinois is one of a few states with a regulation specifically governing the registration of multiple franchises in one filing. Illinois Administrative Code Section 200.606 requires that the franchises be offered concurrently, the franchises be of similar type, the contractual obligations are similar, and the information can be presented in a non-confusing manner.

⁷ One exception is where two different affiliates offer the same franchise, but in different parts of the country. In that situation one FDD for the two different companies may be possible.

laws, then, is that in order for multiple brands to be offered in one FDD, the franchises must be franchised by the same franchisor.

Additionally, under most disclosure and registration laws, the stated purpose for enacting franchising laws is the protection of prospective franchisees from fraud or misrepresentation. To that end, many franchise disclosure laws, including the FTC Rule, contain language more or less stating that FDDs must be written clearly, legibly, and concisely in a single document using plain English.⁸ Thus, any time a franchisor is considering offering multiple brands in one FDD, the guiding principle in their decision should be whether the FDD will be clear and understandable to, and not be confusing, for a prospective franchisee. State regulators have indicated that whether or not they accept an FDD offering multiple brands depends on whether it makes sense to them and whether they find the document confusing.

2. Minimum Similarities to Warrant Consideration of Multiple Brands in One FDD

Part of the consideration a franchisor should undertake in deciding whether offering more than one brand in an FDD is how different or similar the offerings are. It would be impractical for a franchisor to attempt to offer franchises in completely different industries in one document. For example, offering a full service restaurant concept in the same document as a mobile junk hauling concept would make little sense. One could imagine that the type and substance of the disclosures to be made in offering a franchise that serves food would be very different from the disclosures to be made in offering a franchise that picks up people's junk. Having completely unrelated offerings in one FDD would no doubt confuse prospective franchisees, not to mention state regulators.

From a documentation standpoint, it is practical if the offerings at least have the same or similar forms of franchise agreement. If the forms of franchise agreement were vastly different, various disclosure items would be difficult, though not impossible, to discuss. The franchise agreement typically includes all of the obligations of the franchisee and the franchisor, which are reflected in various items in the FDD, including Items 5, 6, 7, 8, 9, 11, 12, 13, 14, 15, 16, and 17. If the franchise agreements for the multiple offerings imposed completely different obligations, then the FDD may become too long and cumbersome with multiple disclosures having to be made for each topic discussed in the FDD.

3. Brand Specific Disclosure Items That May Be More Problematic

If a franchisor chooses to combine multiple brand offerings into one FDD, there are a several disclosure items in the FDD that may prove more difficult to prepare than other items. In many instances, the franchisor would likely have to separate into different sub-sections within an item the disclosures for each offering. The following list highlights some of the items that may prove more problematic when offering multiple brands in one FDD. Of course, many other items in the FDD require disclosures that may be different between the brands being offered, so this is not an exhaustive list of disclosure items that may be affected.

- **Item 6:** Item 6 requires the disclosure of other fees that must be paid to the franchisor. Regardless of how different the fees are, different tables may be sensible for different brand offerings. It would likely become overly confusing to

⁸ 16 C.F.R. §436.1(d) and (o); FTC, *Franchise Rule Compliance Guide*, *supra* note 3, at 121.

try to list the fees for both franchise offerings together in the same cell of the required table if the fee types and amounts differ significantly. The Franchise Rule does not allow, and state regulators would not accept, any changes to the column headings of the table. Thus, a franchisor could not simply add separate columns to distinguish between the offerings. Also, if the franchisor uses notes at the end of the table, it should make sure that the cross-references and notes do not become too cumbersome and lengthy. If most fees are the same between the different offerings and only a few differ, one way of making clear to prospective franchisees which fees are specific to each system is to name the fee accordingly. For example, if the FDD is for the fictitious Harry's Hot Dogs and Brad's Brats and all fees are the same except for a transfer fee, the transfer fees could be named "Harry's Hot Dogs transfer fee" and "Brad's Brats transfer fee." These could be separate line items next to each other in Item 6.

- **Item 7:** Item 7 requires the disclosure of the estimated initial investment a franchisee must make to open its business. If the amounts are significantly different, it would be advisable to use separate tables for each franchise offering. It's unlikely that the initial investment for two offerings, even if they are similar or in the same industry (e.g., one FDD offering two different full-service restaurants concepts), would be exactly the same. One offering could require more restaurant furniture than another or a special oven that is not required in the other offering, which would mean furniture and fixture costs or equipment costs would differ. If the low and high ranges for each line item and the totals are combined for two brands, the result may be that the low and high investment amounts are misleading for both brands. However, a franchisor could use footnotes to the table to explain the ranges if it chose to combine estimated initial investment amounts in one table (e.g., where the line item in the table for equipment says \$5,000 to \$10,000, the footnote could read, "The range for equipment for Harry's Hot Dogs is \$5,000 to \$8,000. The range for equipment for Brad's Brats is \$7,000 to \$10,000.").
- **Item 20:** Item 20 requires the disclosure of outlets and franchisee information. The rules require that the tables list "the total number of franchised and company-owned outlets for each of the franchisor's last three fiscal years" and states that term outlets "includes outlets of a type substantially similar to that offered to the prospective franchisee."⁹ It could be misleading to a prospective franchisee looking to purchase franchise A to combine the outlets of both franchise A and franchise B. The franchisee would be lacking an accurate and clear sense of how many outlets there are of the specific type he or she is actually going to purchase. One way to avoid this confusion would be for the franchisor to separate the outlet tables into two sections for each specific offering.

On the other hand, the FTC rule allows franchisors to list "substantially similar" outlets, which suggests that if a franchisor offered, for example, two different pizza concepts in one FDD, the franchisor could and perhaps would even be required to list both in one table under the interpretation that the two pizza

⁹ 16 C.F.R. §436.5(t).

concepts are “substantially similar” outlets.¹⁰ The use of footnotes to explain the numbers in such cases would be helpful.

4. Financial Performance Representations

With examiners taking a close look at Item 19 and disclaimers contained therein, franchisors should be careful when it comes to presenting financial performance representations or FPRs. Franchisors that want to offer multiple brands in an FDD must consider whether they can or should combine outlets from both systems in one FPR or whether they can include an FPR about one brand but not the other. The two possibilities present different sets of issues.

Would it be clear and unambiguous to combine the two or to have one and not the other? Combining two or more brands into one FPR may be misleading and confusing. Doing this may require a fair amount of footnoting to help a prospective franchisee distinguish when an amount provided is reflective of just one brand or of all brands. Likely, there is no confusion if a franchisor clearly states that it is only including an FPR for one brand and excluding the FPR for the other brand. However, doing so raises the question of whether including an FPR about one brand but not the other is essentially presenting a subset. The FTC Franchise Rule¹¹ and NASAA Franchise Commentary on Financial Performance Representations¹² allow for the use of subsets, so long as the subset share a particular set of characteristics.¹³ In an FDD that contains two or more offerings, there is a good argument that providing an FPR for one brand and not the other is reasonable, accurate, and not misleading, so long as the franchisor makes clear in the Item 19 that it only contains an FPR for one brand and not the other. Still, if the brands are similar, which is a likely situation if a franchisor is even trying to offer more than one brand in an FDD, a franchisor may consider whether a prospective franchisee may assume, rightly or wrongly, that the FPR for one brand is representative of the other. In that case, it may be the best practice to include an FPR for all brands if one is to be included at all.

5. Pros and Cons of Having Multiple Brands in One FDD and Options for Presentation

Even if a franchisor believes it can offer multiple brands under one FDD, there may be practical reasons a franchisor may or may not want to. Below are some of the pros and cons of, and practical suggestions for, offering multiple brands in one FDD that a franchisor considering doing so may want to keep in mind.¹⁴

Franchisors may find that having one document that includes all of its offerings may be helpful for franchisees who may not yet have decided which specific brand they want to operate

¹⁰ *Id.*

¹¹ FTC, *Franchise Rule Compliance Guide*, *supra* note 3, at 87.

¹² NASAA, *Financial Performance Representation Commentary* (May 8, 2017), 19.12, <http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf>.

¹³ NASAA, *Financial Performance Representation Commentary*, *supra* note 12, at 19.12; FTC, *Franchise Rule Compliance Guide*, *supra* note 3, at 87-88.

¹⁴ For a more in depth discussion of some of the issues summarized here, see Alan R. Greenfield, Theresa Leets and Karen B. Satterlee, *Franchise Disclosure Challenges for Large, Sophisticated or Multi-Brand Franchise Companies*, ABA 37th Annual Forum on Franchising W-15, at 23-24 (2014).

and can look at several options in one document. Having one FDD may also be administratively easier on and more efficient for the franchisor and its sales staff. A sales person would not have to worry about sending the wrong FDD because the FDD would cover all brands. Also, it may streamline the sales process. Imagine that a franchisee is interested in one brand offered by a franchisor that owns multiple brands. The franchisor provides the FDD and the clock begins on the disclosure period. A week into the waiting period, the franchisee learns that the franchisor owns a similar brand that it thinks would be a better fit. The franchisor would have to provide the FDD for the other offering and the clock restarts. Furthermore, the registration process could be less costly and time consuming if a franchisor was able to register just one document offering multiple brands.

However, offering multiple brands in one document can become confusing for the prospective franchisee and difficult to implement for the franchisor, particularly if the offerings are very different. Where, for example, the personnel of one brand are different than another, or the litigation and bankruptcy histories are extensive and do not coincide, or the initial fees or initial investments differ between brands, the disclosures may become too cumbersome and confusing to use just one FDD. If a prospective franchisee may find an FDD containing multiple brands confusing, a state examiner may very well think the same. This may result in any cost savings going out the window should a state examiner have many comments or many rounds of comments on a confusing FDD or even require the franchisor to split one FDD into several before he or she will register such offerings. Another downside for franchisors and a benefit to franchisees of including multiple brands in one FDD is that a franchisee can more easily compare offerings. If one brand has more beneficial provisions to a franchisee (e.g., lower royalty rate or longer term) than the other, a franchisee will be more likely to catch those differences and may try to negotiate items it may not have noticed with separate FDDs.

B. Co-branding

Up to this point, this paper has primarily discussed the issues that arise when one franchisor or group of franchise entities own multiple brands. While that is often a necessary premise for co-branding, it is not the same thing. “Co-branding” typically means that two or more brands are operated out of the same location. There are many examples of co-branding in franchising: Dairy Queen and Orange Julius, Great American Cookies and Marble Slab Creamery, KFC and Taco Bell, Milex and Mr. Transmission, and Schlotzsky’s and Cinnabon.¹⁵

While franchisors have found many advantages with co-branding, many have also found that the challenges and issues may outweigh the benefits. Some of the benefits are obvious: combining a cookie and an ice cream concept can help with seasonality issues the brands may suffer individually, while a breakfast/snack concept with a lunch concept increases the customer flow throughout the day. These benefits can be achieved without increasing lease cost and without any significant changes to staffing levels. Another potential benefit of co-branding not tied to the day-to-day operations is that it may be a relatively easy way of increasing the number of locations for the two brands – basically, a two for one: the franchisor only needs to sell one franchise, yet increases store count for two brands. Potential down-sides include customer

¹⁵ Several articles in franchise publications address co-branding. See e.g. *New Franchises Team Up and Make Co-branding Work*, Jason Daley, Entrepreneur, <https://www.entrepreneur.com/article/223144> *The Benefits of Co-Branding for Franchisees*, Barbara Moran-Goodrich, Franchising World, August 2013, <https://www.franchise.org/the-benefits-of-co-branding-for-franchisees-0> and *Operating a Co-Branded Franchise Efficiently and Effectively*, Kelly Roddy, Franchising World, July 2013, <https://www.franchise.org/operating-a-co-branded-franchise-efficiently-and-effectively-0>

confusion, brand dilution and substandard products and customer service. Whether a co-branding arrangement will be doomed or successful depends on factors such as: (1) how complementary the different brands are; (2) clarity of the co-branding value to consumers; (3) ease of combining the brands' offerings at one location; and (4) the efficiency of communication and decision making amongst the brands' management teams.¹⁶

1. Co-branding Affiliated Brands

Most examples of co-branding can be found among brands under common ownership. Many of the potential administrative issues with co-branding go away or are alleviated when the brands are owned by the same franchisor or group of companies. It is typically easier to share back office functions and support and resolve operational issues when the ultimate owner is the same for both brands.

A review of some of the co-branded franchise offerings available today shows that there are many different approaches that franchisors can take to co-branding.

For example, Schlotzsky's and Cinnabon have been co-branding for a number of years. The Schlotzsky's FDD makes clear that operating a Cinnabon Express Bakery is a requirement to operate a Schlotzsky's, but the brands still have separate FDDs and franchise agreements that the Schlotzsky's franchisees have to sign. The Schlotzsky's FDD contains many disclosures about Cinnabon though: Item 1 includes an extensive discussion of the Cinnabon concept; Item 5 contains information about Cinnabon initial fees; Item 6 describes that royalties are calculated on Cinnabon sales as well as Schlotzsky's; and Item 7 includes Cinnabon's initial fee and includes, as one line item, all the additional expenses to open a Cinnabon. Interestingly, Item 19 only mentions that Cinnabon revenue is included to the extent the restaurants included in the FPR operate a Cinnabon within the Schlotzsky's location, but it does not specify which ones do. Also, Item 20 is silent on Cinnabon locations or which of the Schlotzsky's locations included are co-branded. The franchise agreement makes no mention of Cinnabon at all.

Dairy Queen and Orange Julius also co-brand but use a different set-up. The Dairy Queen FDD discloses that Orange Julius has offered Dairy Queen the right to offer certain Orange Julius beverage products in the Dairy Queen locations that satisfy the requirements of the co-branded program. There is no separate initial fee charged, but there are certain marketing fees set forth in Item 6. Information about the Orange Julius required purchases is included in Item 8. The two brands have separate marketing programs, but they are coordinated. Item 12 includes information about the Orange Julius franchises that are offered separately from the co-branded program. The franchise agreement includes a few miscellaneous mentions of Orange Julius. The impression given by the FDD and franchise agreement is that Orange Julius is only a required product that Dairy Queen franchisees have to carry, as opposed to a separate brand.

The Schlotzsky's/Cinnabon and Dairy Queen/Orange Julius co-branding models, at least based on their FDDs, are at the two different ends of the co-branding spectrum. While the co-branding franchises reviewed in preparation of this paper all seem to consider one of the two brands as the primary and the other one as the secondary brand, with Schlotzsky's/Cinnabon, the two brands seems almost on equal footing. With Dairy Queen/Orange Julius it is clear that

¹⁶ Barbara Moran-Goodrich, *The Benefits of Co-Branding for Franchisees*, International Franchise Association (August 2013), <https://www.franchise.org/the-benefits-of-co-branding-for-franchisees-0>.

Dairy Queen is the primary brand of the two. Orange Julius is almost akin to a required product offering, and it almost seems incidental that the brand is under common ownership with Dairy Queen. Keeping separate agreements for the two brands, or making sure that one of them is secondary and not very integrated into the franchise agreement is likely a well-thought out decision: if one of the two brands would be sold at a later point it, makes it much easier to accomplish that sale if the franchisees' franchise agreements for the two brands can be easily separated.

2. Co-branding With Third Party Brands

Co-branding with third party brands is much less common than affiliate co-branding. However, in many ways, co-branding third party brands is no different than co-branding commonly owned brands. The way the co-branding arrangement works could range from full integration of two brands on equal footing, to the scenario of a primary brand that is required to carry some products from a second brand.

With third party brand co-branding, however, the logistical challenges that arise with affiliate co-branding are amplified. A review of the disclosures made by the affiliate co-branded programs listed above provide a glimpse into the potential issues and the need for coordination between the two different franchisors that may not be desirable. For example, presumably each brand has its own form of franchise agreement. While these likely cover the same types of issues, chances are they are not treating the issues the same way. For example, gross revenue may be calculated differently under the two brands. The permitted use of the marketing fund may be different. Renovation, remodeling, inspections, record keeping and reporting may all be handled differently. Defaults and post-termination obligations may be different and conflicting. Transfers and rights of first refusals may be handled differently. It is not the purpose of this paper to delve into how to resolve these types of issues. Rather, the listing of issues is intended to illustrate the different issues that may arise if two brands under different ownership were to co-brand and to show why co-branding in its more integrated form is rare. Co-branding that is closer in form to requiring a franchisee of one brand to carry a product from another franchisor is likely a little bit easier to negotiate between franchisors and arguably would not require the same degree of disclosure about the secondary brand.

3. FDD Disclosure Items Affected by Co-branding

Assuming a more complete integration of the two brands, from a franchise disclosure perspective, who owns the brands changes little as far as the types of disclosures that will be required to be made in the FDD. Thus, the following review applies to both affiliate-owned brands and to third party co-branding. It should be mentioned, though, that third party co-branding complicates the FDD preparation immensely and will require close cooperation between the different brand owners.

To begin with, even in a very integrated co-branding situation, typically one of the two brand owners will be the franchisor. If for no other reason, the presumption is that there is one franchisor who issues the FDD. When the brands are equal in importance, having two FDDs and separate franchise agreements may be appropriate. As mentioned above, even when the brands are not of equal importance it may make sense to keep the FDDs separate, especially if it is likely that one of the brands may be sold at some future point.

There is no true guideline for how to prepare an FDD for co-branded franchise programs, and as already mentioned, the variety in how these programs are put together is

great. Consequently, the FDD drafter will have to use some discretion in determining what disclosure items warrant discussions for both of the brands. Items affected by co-branding may include:

- **Item 1:** Information about both franchisors would typically be included. To some extent, this is no different than the disclosures required from franchisors that are franchising under multiple brands or are owned by a parent who also franchises under other brands. For example, the prior business experience of each franchisor and the number of franchisees for each other franchise program would have to be disclosed.¹⁷
- **Item 2:** At least when the co-branding program is very integrated, it may make sense to discuss management of both franchisors in Item 2.
- **Items 3 and 4:** Unless separate FDDs are being provided for each brand, including relevant disputes and bankruptcy information for both brands is a precautionary measure that franchisors should consider.
- **Item 7:** Preparation of the estimated investment numbers will require consideration of both brands. Even when separate FDDs are being provided to the prospective franchisee, it is advisable to at least include a line item in the FDD that includes the total estimated expenses additional to those for the primary brand represented in the FDD.
- **Item 8:** The disclosures about required purchases and the franchisor's officers should be expanded to include information about the franchisors and affiliates of both brands.
- **Item 12:** Having exclusive territories for co-branded franchises certainly adds a level of complexity to FDD drafting and frequently cannot be offered for practical reasons. If either or both of the brands being co-branded have non-cobranding locations with exclusive territory rights, granting an exclusive territory to the co-branded locations may be just about impossible (and co-branding in itself may be impossible or significantly limited by the exclusive territory rights of existing franchisees). Irrespective of the territorial rights being granted, the FDD should describe the limitations imposed on the co-branded location by both of the brand offerings. The FDD should also describe the development plans of both franchisors.
- **Item 13:** The primary marks of both brands need to be disclosed. Item 13 would also need to include information about any trademark licensing arrangement between the two franchisors.
- **Item 14:** Similar to Item 13, the copyrights (and if applicable, patents) and any licensing arrangements of both brands must be disclosed.

Other items may also be affected by co-branding. For example, presumably Items 9 and 17 will

¹⁷ 16 CFR 436.5(a)(7).

have to be amended to reflect the changes to the franchise agreement and other agreements due to the co-branding arrangement.

4. Practical Suggestions

When deciding how to structure a co-branding arrangement it may be worth considering how material change amendments will affect sales. Especially for larger brands, or for franchisors with multiple brands, material change amendments may be a frequent occurrence. For a more integrated co-branding program, this may be a significant issue. If co-branding increases the number of potential material change amendment situations because of the franchisors' size or for other reasons, it may be worth considering a less integrated franchise program, or one where separate FDDs will be provided, so as to reduce the regulatory burden on each of the franchisors.

III. MULTIPLE OPERATING MODELS

A. Full Service, Kiosk, Satellite, Mobile, and Non-traditional Venues

Up to this point, the models and variations discussed in this paper are relatively unusual. A much more common occurrence is that one brand offers different variations of its offering. That franchisors offer one or more variations on their standard franchise offering has become so commonplace that it may not even qualify to be discussed in a paper on complex FDD disclosures. It has long been common in the restaurant industry to offer different models to unit franchisees, but the practice is by no means limited to restaurants. Providing different offerings can be a function of available real estate and customer preferences and expectations. For example, restaurants in an urban setting rarely have a drive-thru, and smaller footprints may be desirable in high-rent areas or areas where the expected customer count is too low to sustain a full-sized location. Likewise, modifying the standard model may allow entry into locations such as food courts, stadiums, airports and other non-traditional venues that would be impossible to penetrate without modifying the model. Whatever the reason, when the variation in the franchise offering is more in the nature of the location the franchisee will operate out of, rather than what the franchisee will offer from that location, the variations are typically dealt with in one FDD, as opposed to separate FDDs.¹⁸

1. Challenges With Disclosing Many Different Models in One FDD

There are several disclosures in the FDD that have to be adjusted and considered when the franchisor offers different operating models. Some of them are more easily dealt with than others. For example, in Item 1, when describing the franchise offered, it is typical to disclose the different operating models available. This is a good place to establish on a high level how the different operating models differ and to set forth defined terms that will then be used for the rest of the FDD. Item 5 is another item that often has to be adjusted to address different operating models, but that typically does not cause many issues. While the initial fee may vary depending on the particular operating model a prospective franchisee may choose, this is no different than disclosing other initial fee variations that are common. For example, many

¹⁸ Franchisors are of course free to have separate FDDs for different offerings. Most franchisors choose to only have one FDD though, whenever possible. There are several reasons for this. Prospective franchisees may not yet know at the time of disclosure which particular model will suit them best. Keeping track of what FDD should be given to what prospect may be complicated. Also, the cost of preparing and filing FDDs increases with each additional FDD that needs to be prepared.

franchisors will reduce the initial fee payable for franchises developed pursuant to an area development agreement or may offer discounts in certain locations or to certain types of franchisees (e.g., to veterans). Of course, if the franchisor has a large number of operating models even “simple” disclosures such as those mentioned above can get hard to read. By way of example, the Subway FDD spends almost 5 pages going through the different models it offers to prospective franchisees. It behooves franchisors with very varied franchise systems to take a very systematic approach to the FDD drafting. For example, in each item, franchisors may want to address the common features of the system first and then address each of the system variations in the same order (e.g., always address the full-service option first, then the no-drive through option, then the kiosk option, and finally the mobile option).

A much trickier item to address when the franchisor has multiple operating models is Item 7. Because cost is likely to vary considerably between the different models, it rarely makes sense to use one table to address all the different models. Instead, typically each model will have its own chart and its own footnotes. This makes for a lengthy disclosure item, but one that is easier to read.¹⁹ Another option that is sometimes used is one table for all the different models, but small, additional tables for add-on options that franchisees may add to the standard offering at their option.

Typically, Item 20 will not distinguish between the different operating models a franchisor offers.

2. Financial Performance Representations

Financial performance representations in FDDs that cover multiple operating models are a little bit more complex than when there is only one operating being disclosed. However, properly drafted such FPRs are possible. The concerns are very similar to the ones discussed above in Section II. A. 4., which discusses FPRs in FDDs for multiple brands. Assuming the franchisor wishes to include separate FPRs for the different operating models, it is important to make very clear exactly to which operating model each FPR relates. The requirement that the franchisor has a reasonable basis for the FPR of course applies, and the franchisor will have to consider whether it is possible to include an FPR for certain operating models while not for others and whether it is possible to create combined FPRs that cover the performance of multiple operating models.

3. Practical Suggestions

Many of the issues with including multiple operating models in the same FDD are the same or similar to disclosing multiple brands in one FDD – the more the operating models differ, the harder it is to create an FDD that is easy to read and follow. For most systems, the franchisor starts with one operating model, which then gets adopted to others. Consequently, the similarities in the franchise agreement for the different models are typically significant and the trick is more about making sure that the multitude of operating models does not make the FDD overwhelming or disorganized and hard to read.

There has been no mention of non-traditional venues above. This omission is purposeful. Non-traditional venues are those that differ from the standard types of locations that

¹⁹ Use of multiple charts may sometimes also be used when the franchisor solicits many conversion franchisees. This is common in the disclosure documents for health clubs; for example, the FDD will include one initial investment chart for new locations that are built out from scratch and another chart for conversion locations.

franchisees would operate in. They are venues that have unique operating conditions, such as airports or stadiums, or that offer a closed setting of some other kind, such as a school or hospital. Though a franchisor could certainly include these offerings in their standard FDD, they are typically quite different and more likely the franchisor will prepare a separate FDD for these – if one is prepared at all. Because of the particular nature of the non-traditional venues, it is very common that the prospective franchisees for these venues are also non-traditional: they are often highly sophisticated operators that often times will fall within one or more available exemptions. For example, they would frequently qualify for the fractional franchise exemption. As a result, franchisors may forego preparing an FDD at all for non-traditional venues.

B. Area Development

Area development arrangements typically involve a person being granted the right to open and operate multiple units of a franchise within a defined geographic area. The area developer generally signs an area development agreement with the franchisor specifying the number of units to be developed and the development schedule for opening such units, and then signs individual franchise agreements with the franchisor for each unit.

1. Multi-Unit Commentary

NASAA's Multi-Unit Commentary specifically allows franchisors to offer area development franchises in the same FDD as it offers unit franchises because it sees area developers as unit franchisees with the right to open more than one unit franchise.²⁰ The Multi-Unit Commentary covers disclosure issues relating specifically to five items: Item 1, 11, 12, 17, and 20.

As to Item 1, the Multi-Unit Commentary requires that a franchisor must disclose in Item 1 whether the area development will be required to sign the franchisor's "then-current form of franchise agreement," as opposed to the form of franchise agreement in place when the area developer signed the area development agreement. For Items 11 and 12, a franchisor must disclose, if applicable, if the franchisor will "determine or approve the location of future units and any territories for those units, and that its then-current standards for sites and territories will apply."²¹ This is typically accomplished by disclosing the approval process in detail and having a schedule or exhibit or some other form of attachment to the franchise agreement containing a blank space for the address of the unit, which can be filled out later. Item 17 requires disclosure of the terms of the agreement governing the offering – here, franchisors should also consider using two different tables, as the terms and conditions of the franchise agreement likely differ materially from those of the area development agreement.

Separate tables for Item 20 are prohibited, since area developers merely receive the right to open multiple units of a franchise. Instead, as set forth in the NASAA Multi-Unit Commentary, "Table Nos. 1-4 in Item 20 focus on outlets actually opened and closed," while "Table No. 5 in Item 20 focuses on unit franchise agreements actually signed and franchised outlets actually expected to be opened in the upcoming year."²² The tables are "not structured to cover area development agreements signed, or area developers entering or leaving a

²⁰ NASAA, *Multi-Unit Commentary*, *supra* note 1, at AD 0.1.

²¹ *Id.*

²² *Id.* at AD 20.1.

franchise system.”²³ But while the tables are not structured to take into account area developers, the lists of franchisees required by Item 20 must denote, in a footnote when applicable, when a franchisee is an area developer.

2. Disclosures in Separate Tables for Area Development Programs

In addition to the Item 20 tables, there are various other tables in other items that may be affected by the inclusion of an area development offering. These include Item 6, 7, 11, and 17. As to Items 6 and Item 7, franchisors will need to include separate tables listing the other fees and estimated initial investment for a unit franchise and the area development franchise. The fees required under the area development agreement do not include the variety of fees that are typically required for each unit under the franchise agreement. The latter may include royalties, technology fees, renewal and transfer fees, or training fees that simply do not apply to the area development offering. Similarly, the training table in Item 11 may be different for the area development versus a unit franchise offering, or it may not even be necessary for the area development offering (as most franchisors do not provide training to area developers) since the training is typically geared to how to actually run the franchised business – something that the area developer does not actually get the right to in its area development agreement.

C. Area Representation Arrangements

Except for the area representation arrangement, the various franchise models described in this paper are geared towards the franchisor expanding its network of locations without the capital investment and risk involved in opening new location. The area representative model, on the other hand, is aimed at reducing the franchisor’s burden with respect to network expansion in another way: by outsourcing the recruitment of franchisees and/or some of the franchisor’s obligation to support its franchisees to the area representative.

NASAA defines an area representative arrangement in the Multi-Unit Commentary as involving “a person that is granted, for consideration paid to the franchisor, the right to solicit or recruit third parties to enter into unit franchise arrangements with the franchisor, and/or to provide support services to third parties entering into unit franchise agreements with the franchisor.”²⁴ Area representatives often go by other names, and are sometimes confusingly referred to as area developers. Even the FTC has, in its FAQ to the FTC Franchise Rule, referred to area representatives as development agents, regional developers, and – very confusingly – as area developers.²⁵ This of course does not change the nature of the area representative arrangement or how it should be treated for disclosure and registration purposes.

Importantly, if the area representative is involved in the solicitation of prospective franchisees, the area representative does not actually enter into the franchise agreement with the prospective franchisee: franchisors who use area representatives are not creating master franchise arrangements. Instead, in this regard the area representative is acting as a franchise

²³ *Id.*

²⁴ *Id.* at Definitions.

²⁵ FTC, *Amended Franchise Rule FAQ No. 9* (July 2014), <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs>. The FTC concludes that because an area representative is not a party to the franchise agreement or, typically, any other agreement with the franchisee, it is not a master franchisee/subfranchisor.

seller or third party franchise broker. Though not relevant to the preparation of the franchisor's area representative FDD it is worth noting that area representatives are considered subfranchisors/masterfranchisees under several state laws and may be required to prepare and register their own FDDs.²⁶

1. Drafting a Separate FDD for an Area Representation Franchise Offering Versus an Individual Franchise Offering

It is very common for area representatives to also be franchisees of the franchisor. The area representative's franchised location may, for example, be used for training of franchisees in the area representative's region. Thus, it would not be remarkable for someone to think of the area representative's responsibilities aside from operating as a franchised location as add-ons and therefore to want to combine the area representative FDD with the unit franchise FDD. Setting aside the fact that the Multi-Unit Commentary quite clearly prohibits this, that line of thinking is flawed in other ways. Because while it is true that area representatives are also often franchisees, its obligations in performing the role of area representative are quite different from those it performs as a franchisee. Certainly there are some FDD disclosures that will overlap between a unit franchise offering and an area representative offering for the same franchised brand, but most of them will differ: the fee structure will be different, the investment obligations will be different, the training will be different, the territorial rights and obligations will be completely different, and so on.

In this regard, the area representative offering is no different than that for a franchisor who offers both master franchises and unit franchises: neither can be combined in one FDD.²⁷

2. Area Representatives As "Franchise Sellers"

As mentioned above, when area representatives are involved in the solicitation of new franchisees, they act as franchise sellers or third party brokers. As such, franchisors should prepare and submit franchise seller forms for their area representatives as they do for other persons involved in the franchise sales process. Where the area representatives are entities, the same applies for the employees and officers of the area representative. As further elaborated below, disclosures regarding the area representative and its employees and officers (if an entity) must be included in Items 2, 3, and 4 and these persons should also be listed on the receipt page of the unit franchise FDD.²⁸

In addition, the state laws of New York and Washington require registration of franchise brokers. Consequently, when a franchisor uses an area representative model in either of those states and the area representative is involved in the solicitation of new franchisees, the area representative may have to register as a franchise broker. It is worth noting that while area representatives may fall within the state legislation of franchise brokers, that does not make all franchise brokers area representatives. Typically brokers are not area representatives because, as opposed to area representatives, they do not pay any consideration to the franchisor.

²⁶ For a more detailed review of state law registration requirements, see Eleanor E. Vaida Gerhards, *When Is a Development Agent or Similar Third Party a Franchisor?*, 29 Franchise L.J. 2 (Fall 2009).

²⁷ NASAA, *Multi-Unit Commentary*, *supra* note 1, at SF 0.1.

²⁸ *Id.* at AR 23.0.

3. Multi-Unit Commentary

The NASAA Multi-Unit Commentary contains several Q&As for area representative arrangements. The first, and defining one for disclosure purposes, is the prohibition against combining unit franchise offerings and area representative offerings in one FDD.²⁹ In AR 0.1, NASAA made clear that there are too many differences between these two offerings to combine them in one FDD. In addition to the disclosures themselves, the agreements to be entered into between the parties are different.

When a brand uses area representatives, it is not only the area representative FDD that is affected. The unit franchise agreement also needs to reflect certain information about the area representatives that the franchisor has granted rights to. In many ways, the unit franchise FDD is more affected by the use of area representatives than the area representative FDD itself.

Some of the disclosures required by the Multi-Unit Commentary will affect both the Area representative FDD and the unit franchise FDD. For example, in Item 1 of its area representative FDD, the franchisor must point out that it also offers unit franchises (and the unit franchise FDD must include information about the area representative offering).³⁰

The unit franchise FDD, however, is much more affected. Information about the area representatives that make up part of the franchisor's support network for franchisees will need to be interspersed throughout the unit franchise FDD. This includes information about area representatives in Item 2, if the area representatives are granted rights relating to the sale or operation of franchises, and consequently also in Items 3 and 4.³¹ Likewise, when training is provided by area representatives, this information must be disclosed in Item 11.³²

A few of the commentaries regarding area representatives relate to the financial arrangements between the franchisor and its area representatives and the obligation and right to disclose those in the unit franchise FDD. For example, the franchisor is not required to disclose in the unit franchise FDD the financial arrangement between it and its area representatives.³³ The commentary makes the point that the FTC Franchise Rule does not call for this disclosure and actually expressly prohibits additional disclosures.³⁴ Rebate disclosures in Item 8, on the other hand, may cover rebates received by area representatives, but the franchisor is not required to find out about whether its area representatives have received rebates or not.³⁵ With respect to revenue derived by area representatives or its affiliates from

²⁹ *Id.* at AR 0.1.

³⁰ *Id.* at AR 1.0.

³¹ *Id.* at AR 2.0-4.0. Note that if area representatives are not granted management responsibility with regard to the sale or operation of franchises, this fact must be disclosed in Item 1, according to AR 2.0. Where the area representative is a legal entity, information about its directors, officers, and employees or agents who have management responsibility also needs to be included in Items 3 and 4, according to AR 3.0 and AR 4.0.

³² *Id.* at AR 11.1.

³³ *Id.* at AR 0.2.

³⁴ *Id.*

³⁵ *Id.* at AR 8.0.

required unit franchisee purchases or leases, a franchisor must disclose that information for its affiliates to the extent the revenue arrangement was set up by the franchisor or the franchisor otherwise knows about it.³⁶

Item 20 is an item that deserves special mention, as it could seemingly become extremely complex, both for the area representative FDD and the unit franchise FDD. An Item 20 including charts for both of the franchisor's programs could be quite complex and confusing for prospective franchisees. Thankfully NASAA has made it simple for franchisors. The area representative FDD only needs to disclose information about the area representative program given that the area representative offering and unit franchise offering are not "substantially similar."³⁷ Likewise, information about the transfer, sale, or termination of area representative franchises does not have to be disclosed in the unit franchise FDD Item 20, though the unit franchises operated by area representatives are not exempt from disclosure in the unit franchise FDD.³⁸

4. Practical Suggestions

When a franchisor uses area representatives only in certain parts of the country, the FDD may be hard to understand for prospective franchisees who do not know whether or not their location will fall in the territory of an area representative. In those situations, it may make sense to move the information about the area representatives to an addendum or to state-specific addenda. This is expressly permitted by the Multi-Unit Commentary when the franchisor only uses area representatives in certain states or areas.³⁹ The information about the area representatives would then be put into the state addenda for the state or states in which they operate, or into a general addendum for all area representatives. However, the franchisor may not cherry pick and include information about some area representatives in the state addenda while including information about others in the body of the FDD. Likewise, franchisors cannot use the addendum model to hide information about the franchisor. For example, if the franchisor has decided to include area representative information in state addenda and such information includes litigation disclosures with respect to litigation in which the franchisor is a named party, then the franchisor still needs to disclose the litigation in the body of the FDD.⁴⁰

D. Master Franchising

In master franchising or subfranchising, a person is granted the right to grant unit franchises to third parties typically within a given geographic area. The subfranchisor typically signs a master franchise or subfranchisor agreement with the franchisor, pursuant to which the subfranchisor is granted a territory in which it may operate or subfranchise to third parties the

³⁶ *Id.*

³⁷ *Id.* at AR 20.0.

³⁸ *Id.* at AR 20.1.

³⁹ *Id.* at AR 0.3. Note, however, that a franchisor who uses area representatives throughout the country cannot simply move information about the area representatives to an exhibit because the large number of area representatives would make the unit franchise FDD cumbersome and confusing. The Multi-Unit Commentary only permits franchisors this option when the area representative system is used regionally.

⁴⁰ *Id.*

right to operate franchises. The subfranchisor will usually have obligations to provide support services to subfranchisees that would normally be provided by the franchisor and will sign a franchise agreement with the subfranchisee. Under the FTC Franchise Rule, anyone offering a franchise must do so pursuant to an FDD. In registration states, anyone offering a franchise must register such offering. Since subfranchisors offer franchises to subfranchisees, they are required to register their offerings separately from the franchisor's registration (if any).

1. Responsibility of Drafting the FDD and Including the Franchisor's Information in the Subfranchisor's FDD

An initial drafting question that master franchisors and subfranchisors must answer is who is tasked with preparing the FDD. The FTC Rule and state franchise disclosure laws do not specify between the two who should prepare the FDD. It leaves to the master franchisor and subfranchisor to determine between themselves the allocation of responsibility of preparing the FDD. Most master franchise agreements place this obligation on the subfranchisor. However, the FTC Rule does make franchisors and subfranchisors jointly liable for the preparation of disclosure documents.⁴¹

In preparing the FDD, one issue that a subfranchisor may face is that it must include information about the master franchisor in the FDD in addition to information about itself. As noted in the FTC Compliance Guide, "[s]ome of the required disclosures may need to be supplied by the subfranchisor only or by the franchisor only" while "[i]n other instances, both the franchisor and subfranchisor must supply the information so that the required disclosure is accurate."⁴²

When tasked with preparing the FDD, subfranchisors must therefore coordinate with the master franchisor to obtain the master franchisor's disclosures. Master franchisors will oftentimes subfranchise different areas to different subfranchisors. They may retain the rights to grant franchises directly in other areas or to further grant subfranchises to others in unassigned areas, in which case the master franchisor would still prepare their own FDDs. In such cases, a subfranchisor will likely be able to obtain the necessary information for its own FDD annual update from the master franchisor's FDD annual update. If the franchisor is delayed in finalizing its own documents, however, that may delay a subfranchisor's ability to finalize its own FDD for registration and a subfranchisor may face the risk of missing its registration deadline. Some master franchisors and franchisees have addressed this issue by having the master franchisee's fiscal year end after the master franchisor's fiscal year end so that the master franchisor can finalize its updated FDD before the master franchisee must update.

Several FDD items and attachments require both master franchisor and subfranchisor disclosure. These include Items 1, 2, 3, 4, 8, 11, 12, 13, 14, and 20 and the audited financials. As to Item 20, the FDD must include the outlets of both the master franchisor and the subfranchisor as separate charts. But keep in mind that the outlets include only those outlets of a type substantially similar to that offered to the prospective franchisee – in the majority of cases, this is the unit franchise. So a master franchisor would need one FDD to offer subfranchises and a completely separate FDD to offer unit franchises (the latter of which the master franchisor would also have to furnish to a subfranchisor if that subfranchisor also

⁴¹ FTC, *Franchise Rule Compliance Guide*, *supra* note 3, at 17.

⁴² *Id.*

operates its own unit franchises).⁴³ Similarly, subfranchisors are required to include the audited financials of the master franchisor in addition to their own audited financials and must depend on the master franchisor and its auditors to issue their financials in time to meet its own registration deadlines. Often, auditors will not issue their auditor's consents without seeing a final FDD from the master franchisor; for a subfranchisor, this means that they must prepare the FDD and supply the FDD to the master franchisor, whose auditor will then issue the consent. Again, one way of addressing this issue is by having the master franchisor's fiscal year end prior to that of the master franchisee, such that the master franchisor will likely have finalized its FDD updated before the master franchisee has to update its FDD. All of these things will take time and communication, so it behooves a subfranchisor to start the process early and try to keep the lines of communication open with the master franchisor.

2. Foreign Franchisors Entering the U.S. Using Master Franchising

For many years, master franchising was the structure of choice for foreign businesses looking to expand into the United States, but it has slowly become less and less popular. Foreign franchisors entering the U.S. were not always registered, as some would look for applicable registration exemptions to enter the U.S. market. The FDD issues for foreign franchisors are primarily the same issues that U.S. master franchisors face, e.g., who is responsible for drafting the FDD, what information and how to include disclosures relating to the foreign master franchisor in the U.S. FDD, primarily in Items 1, 2, 3, 4, 8, 20, and 21. Financial statements must be in U.S. GAAP, which may impose additional time and cost on a foreign franchisor.

Foreign master franchisors should also remember that they have liability for their U.S. subfranchisor's compliance with the FTC Franchise Rule and its preparation of FDDs, as well as with compliance with state franchise laws. A master franchisor is responsible for the subfranchisor's statements and representations in the FDD (more on this in Section III.D.3 below).

3. Multi-Unit Commentary

NASAA's Multi-Unit Commentary has provided useful answers for many questions faced by franchisors and subfranchisors throughout the years, some of which are highlighted here. First and foremost, the Multi-Unit Commentary clarified that a master franchisor could not use the same FDD to offer subfranchises as it does to offer unit franchises, since subfranchising and unit franchising create very different relationships and agreements. The reason given is the same guiding principle discussed in Section II as to why a franchisor may not be able to offer two brands in one FDD: it would be confusing to combine two offerings into one FDD.

Following the initial preparation, the master franchisor and subfranchisor must be cognizant of the update and amendment process for subfranchises. The Multi-Unit Commentary makes it clear that if a master franchisor has a change in circumstances that reflects a material amendment to the FDD or if it amends its own FDD, then the subfranchisor most likely has an obligation to amend its own FDD to update the disclosures relating to the master franchisor.⁴⁴ Of course, franchisors and subfranchisors need to make sure they keep

⁴³ NASAA, *Multi-Unit Commentary*, *supra* note 1, at SF 20.0.

⁴⁴ *Id.* at SF 0.3.

each other updated regarding material changes.

4. Practical Suggestions

As previously noted, the FTC Rule makes both the franchisor and the subfranchisor liable for the preparation of an FDD and for each other's disclosures. For both parties, it is important to include strong indemnification provisions to minimize the liabilities as much as possible. It is important to keep the lines of communication open between franchisors and subfranchisors; considering the amount of time it takes to update an FDD on an annual basis and with deadlines for registration renewal to meet, all parties would be best served if they clearly communicated timing issues and remained cooperative.

E. Joint Ventures, Licensing, and Other Distribution Models

The operating models described above are all very varied, but generally there is no discussion about whether they constitute franchises. The conclusion that the arrangement is a franchise is not always as clear with respect to joint ventures, license agreements, and even distribution agreements. None of these relationships are typically set up to be a franchise. Yet, not infrequently, they may be. The franchise regulatory issues that arise with these relationships typically is not related to what particular sections of the FDD are impacted by the FTC Rule or state disclosure laws, but rather the threshold question of whether they constitute a franchise at all.

While typically the parties don't intend these relationships to be a franchise, they may satisfy the definitional elements of a franchise under the FTC Rule or under state franchise laws. There are a number of papers that have addressed the issue of the "accidental franchise" and analyze the nuances of the franchise definition.⁴⁵ For purposes of this paper, it is sufficient to look to the definition under the FTC Franchise Rule:

Franchise means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

- (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
- (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
- (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to

⁴⁵ See e.g. Mark A. Kirsch and Rochelle B. Spandorf, *The Accidental Franchise*, ABA Forum on Franchising, October 10-12, 2001 and Kenneth R. Costello, Beata Krakus and Kristy L. Zastrow, *From License Agreement to Regulated Relationships: The Accidental Franchise*, ABA Forum on Franchising, October 14-16, 2009.

make a required payment to the franchisor or its affiliate.⁴⁶

When thinking about what constitutes a joint venture, license, or distribution relationship, it may be more or less obvious that the relationship is also a franchise. On one end of the spectrum, the joint venture may be the least obvious.

In a joint venture, two or more parties pool resources and either set up an actual legal entity or act as a de facto partnership. Frequently, these relationships are not franchises, but there is the potential that they may be. For example, where one party is contributing its trademark and know-how and the other party is contributing working capital and will be performing the majority of the activities to be undertaken by the joint venture, their respective contributions to the joint venture start to inch increasingly closer to meeting the three elements of a franchise: the first party allows the second party to use the trademark and know-how in exchange for doing the actual work required; the first party is then paid for the use of the trademark and know-how in the form of dividends – or royalties in the franchise setting. It can feel counterintuitive that two parties who form an entity together could also be creating a franchise, but neither the FTC Rule, nor the state franchise disclosure laws specify the form that the agreement can or cannot take to be a franchise under the regulation and laws. The existence of a legal entity in which both “franchisor” and “franchisee” are parties does not get the parties out from under the franchise laws.

It is often easier to understand why a license arrangement is a franchise. When two parties enter into a license agreement, it is typically clear that the first and third elements of the franchise definition – the trademark license and the fee for use of the trademark – are satisfied. The somewhat trickier element to analyze is the second element. The type of controls that only exist to protect the “franchisor’s” trademark rights are not sufficient to satisfy the second element in the franchise definition. However, oftentimes there need not be much more in order to meet the criteria for the second element. For example, according to the FTC Compliance Guide the following are examples of significant control by the franchisor over the franchisee:

- site approval for unestablished businesses;
- site design or appearance requirements;
- hours of operation;
- production techniques;
- personnel policies;
- promotional campaigns requiring franchisee participation or financial contribution;
- restrictions on customers; and
- locale or area of operation.⁴⁷

Significant types of assistance, according to the FTF Compliance Guide include:

- formal sales, repair, or business training programs;
- furnishing management, marketing, or personnel advice;
- furnishing system-wide networks and website; and
- furnishing a detailed operating manual.⁴⁸

⁴⁶ 16 C.F.R. 436.1(h).

⁴⁷ FTC, *Franchise Rule Compliance Guide*, *supra* note 3, at 3.

The FTC also considers requirements that the franchisee service or repair products outside of warranty work, maintain certain inventory, or display certain goods as examples that potentially constitute significant control.⁴⁹

Another source of guidance can be found in the California Commissioner's Release 3-F.⁵⁰ It elaborates on what factors are indicative of a marketing plan being imposed and suggests that the franchisor's control over terms of payment by customers, credit practices, warranties and representations vis-à-vis customers are all indicative of a marketing plan. Likewise, franchisor's control over the site selection, trade names used by the franchisee, franchisee's advertising, signage, suppliers and appearance of its location are other factors to be considered.⁵¹

It is enough that some of these example factors are present in order for the license agreement to potentially be considered a franchise. License agreements are often a sliding scale from pure trademark licenses to something much closer to a "true" franchise, and while it may be unusual for all of the above examples to be present in a license agreement, it would not be unusual to see some of them. For example, the trademark owner may have certain requirements for how the licensee displays the licensed products, how marketing and advertising is handled, and to whom or where the licensee can sell.

Distribution agreements typically will meet the first element - the trademark licenses.⁵² As explained in the previous paragraph, the second element of the franchise definition is easily met and most manufacturers will assert at least some control over how their distributors offer and sell the products. Many of the common license agreement controls are also present in distribution agreements. However, with distribution agreements, when properly structured, it is typically the third element – the franchise fee – that is the saving grace. The bona fide wholesale price for reasonable amounts of goods does not constitute a franchise fee.⁵³ Therefore, for distribution agreements, it often becomes a question of whether the distributor was required to pay anything else in addition to the products it had to purchase. It may be tempting for manufacturers to charge fees for required training programs or marketing materials. Often the minimum payment exemption will be helpful to manufacturers ensuring that their distributors are not franchisees, as these additional payments would often be low and not necessarily incurred all at the beginning of the relationship. However, manufacturers need to understand and carefully analyze the potentially applicable laws to make sure they do not fall

⁴⁸ *Id.*

⁴⁹ *Id.* at 4.

⁵⁰ Gary Mendoza, *Commissioner's Release 3-F: When Does an Agreement Constitute a "Franchise"*, <http://www.dbo.ca.gov/Commissioner/Releases/3-F.asp>.

⁵¹ *Id.*

⁵² Distribution agreements will often fall within some of the laws that colloquially are referred to as "franchise relationship statutes." While many of these laws are limited to franchise agreements, that is not always the case. Also, in some instances the definition of a "franchise" under these statutes may be so broad that in practice distribution agreements are covered. See, for example, the New Jersey relationship statute. See N.J. STAT. ANN. § 56:10-3.

⁵³ 16 C.F.R. 436.1(2).

into the franchise trap.⁵⁴

1. Drafting a Separate FDD for Specific JV Relationships

Joint venture arrangements that are not intended as a way around franchise laws are often one-off arrangements that inadvertently get caught in federal or state definitions of a franchise. As such, the would-be franchisor may have to prepare and register an FDD without the potential benefit of using the same FDD and registration in connection with entering into additional joint venture arrangements. In other words, the entire cost of franchise compliance may have to be allocated to the one joint venture.

If the “franchisor” intends to enter into several joint ventures, however, the regulatory burden may not be so different. By their nature, in a joint venture, each party is contributing something to the partnership. If the something contributed by the “franchisee” differs, most likely what the “franchisor” is contributing will also differ each time. As a result, the “franchisor” may find itself drafting separate FDDs for each joint venture it enters into.

2. Practical Suggestions

It behooves practitioners to remember that the generic definition of a “franchise” used earlier in this chapter is not the actual definition in any statute or regulation. When analyzing if a relationship model close to the traditional franchise model has crossed the line to franchising, it is important to remember to look at the actual statutes that may apply to the relationship being analyzed. The results may be different under different statutes.

For example, under the New York franchise statute, a franchise is defined as:

a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or

(b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is

⁵⁴ For example, while the FTC Rule minimum payment exemption exempts arrangements where the “franchisee” pays no more than \$570 up through the first 6 months of operation the threshold amount and the time during which the amount is paid, is not the same under state laws. By way of example, in Illinois the dollar threshold is \$500 and there is no time limit on the payment. This is something Mitsubishi learned the hard way in *To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 152 F.3d 658 (7th Cir. 1998) when a disgruntled terminated forklift dealer sued Mitsubishi for violation of the Illinois franchise act and was awarded damages in excess of \$1,000,000. There had been no franchise fee paid in the traditional sense, but the dealer had paid a little bit over \$1,000 during the course of a relationship that lasted more than 10 years.

required to pay, directly or indirectly, a franchisee fee.⁵⁵

The FTC Rule, on the other hand, defines a franchise with the more typical three elements: the trademark license, the marketing plan, and the required payment.

Already, it is obvious that the definitions are different. But the differences don't end there. Under the FTC Rule, where a franchisor controls the franchisee's location and the franchisee has to pay rent to the franchisor, rent is considered a required payment, triggering the third element of the federal franchise definition.⁵⁶ Under the New York statute, on the other hand, rent is expressly excluded from the definition of required payments.⁵⁷

Another option to consider when dealing with these types of relationship models is whether any exemptions are available. Just as great attention to detail is required when determining whether these models are franchises in the first place, the same is true when determining whether exemptions apply.⁵⁸ Exemptions are state specific and can vary significantly. Even with exemptions that are available in many states, such as the fractional franchise exemption, the devil is in the details. For example, under the FTC Rule, a fractional franchise exemption applies when:

a franchise relationship that satisfies the following criteria when the relationship is created:

(1) The franchisee, any of the franchisee's current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business; and

(2) The parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation.⁵⁹

But in California, the exemption applies when:

(a) For at least the last 24 months prior to the date of sale of the franchise, the prospective franchisee, or if the prospective franchisee is not a natural person, an existing officer, director, or managing agent of the prospective franchisee who has held that position with the prospective franchisee for at least the last 24 months, has been engaged in a business offering products or

⁵⁵ N.Y. GEN. BUS. LAW § 681(3).

⁵⁶ FTC, *Franchise Rule Compliance Guide*, *supra* note 3, at 4-5.

⁵⁷ N.Y. GEN. BUS. LAW § 681.7(d)

⁵⁸ *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws*, Leslie D. Curran and Beata Krakus, editors (2017).

⁵⁹ 16 C.F.R. 436.1(g).

services substantially similar or related to those to be offered by the franchised business.

(b) The new product or service is substantially similar or related to the product or service being offered by the prospective franchisee's existing business.

(c) The franchised business is to be operated from the same business location as the prospective franchisee's existing business.

(d) The parties anticipated, in good faith, at the time the agreement establishing the franchise relationship was reached, that sales resulting from the franchised business will not represent more than 20 percent of the total sales in dollar volume of the franchisee on an annual basis.

(e) The prospective franchisee is not controlled by the franchisor.

(f) The franchisor files with the commissioner a notice of exemption and pays the fee prescribed in subdivision (f) of Section 31500 prior to an offer or sale of such a franchise in this state during any calendar year in which one or more of those franchises are sold.⁶⁰

In addition to the obvious fact that California requires the franchisee to operate the fractional franchise from the same location as the franchisee's other business while the FTC Rule does not, a difference that can often have a bigger impact on determining applicability of these exemptions is that the federal rule only looks to the first year of the franchisee's operation to determine whether the 20% threshold has been exceeded, while in California the 20% threshold applies throughout the franchise relationship. In other words, if the franchisee and franchisor expect a slow ramp-up of the fractional franchise but eventually expect it may be a more significant part of the franchisee's business the FTC Rule exemption may apply, but the California state exemption would not.

IV. CONCLUSION

The FTC and NASAA have both spent a lot of time and effort trying to create uniformity in franchise offerings. On the one hand, one can of course say that they accomplished their goals as the rules apply equally to all franchisors and there is at least some guidance to help franchisors understand how to apply these rules in complex situations. When the rules are correctly applied and implemented by franchisors and their counsel, prospective franchisees should be getting a certain degree of information to help guide them in their decisions to buy a franchise. On the other hand, if goal of uniformity is to enable any degree of comparison shopping for prospective franchisees, one has to question whether the goal has been achieved. As can easily be gauged from this paper, there is so much variation in franchise concepts themselves as well as the models used to offer franchises, that the uniformity in format rarely brings uniformity in content, and the reader of FDDs has to be quite sophisticated to be able to

⁶⁰ CAL. CIV. CODE § 31108.

discern the difference between the offerings and do any real comparison shopping. Keeping in mind that franchising is not one industry but a business model applied across industries, and a model with almost endless variations at that, it may be that greater clarity and uniformity than we already have is neither achievable, nor desirable.

LULU CHIU GOMEZ

Lulu Chiu Gomez is Counsel for the California Department of Business Oversight's Securities Regulation Division. She serves as the Young Lawyers' Division Liaison to the Governing Committee of the ABA Forum on Franchising. Ms. Gomez received her B.A. in Political Science from the University of California, Berkeley and her J.D. from UCLA School of Law.

BEATA KRAKUS

Beata Krakus is a partner of Greensfelder, Hemker & Gale, P.C., and part of the firm's Franchising & Distribution Practice Group. She works with franchisor clients in domestic and international franchise transactional matters, as well as related areas such as distribution and sales representative arrangements, and other commercial contracts. She has advised, structured, and prepared franchise programs for many different franchise concepts including real estate brokerages, hotels, restaurants, and fitness and personal health systems.

Prior to joining Greensfelder, Ms. Krakus was an associate with Sonnenschein Nath & Rosenthal LLP. She also practiced in Warsaw, Poland with the Swedish law firm of Magnusson Wahlin.

Ms. Krakus is a member of the Governing Committee of the ABA Forum on Franchising and also serves as the Information Officer for the organization. She has served as an Associate Editor for *The Franchise Lawyer*, has herself written articles for the *Franchise Law Journal* and other franchise law publications, and has spoken repeatedly at the ABA Forum on Franchising and International Franchise Association Legal Symposium. She is recognized by International's Who's Who of Franchise Lawyers and by Chambers USA and Chambers Global.