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SPECIAL ISSUES

FOR AN

AREA DEVELOPER

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SPECIAL ISSUES FOR AN AREA DEVELOPER

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 Franchise Rule requires 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 developments 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.

There will usually be a number of terms contained in the area development rights agreement that are identical to, or substantially similar to, those terms contained in the franchise agreement. Hopefully, as part of your review and negotiation of the terms of the franchise agreement, you have already addressed these issues from a fairness perspective and have negotiated an Addendum to Franchise Agreement[1]. In addition, there are issues and terms that must be addressed to make the relationship between the franchisor and the area developer more equitable. A corresponding Addendum to Area Development Rights Agreement will contain these negotiated provisions. These special contract issues include the following:

A. ORGANIZATIONAL STRUCTURE; PURCHASE OF FIRST FRANCHISE

The franchisor may require an area developer to also purchase a single-unit franchise that will become his or her showcase unit and training facility. You should have been given the franchisor's form of FDD for a single-unit franchise and area development rights. You should negotiate purchasing area development 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. You should also have the right to have investors in individual franchise units provided you retain a controlling interest in the business entity owning the unit.

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

B. YOUR PERSONAL GUARANTY

The franchisor will probably ask that you, and your spouse if you are married, sign the Area Development Rights Agreement personally. This means that your personal assets are at risk as to the monetary obligations of the area developer 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 should be a business entity and not you personally. Note that none of the franchisor's principals personally guarantee the obligations of the franchisor. Try to limit your guaranty of the agreements to the confidentiality and noncompetition provisions.

C. 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.

D. 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 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 franchise 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.

E. 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.

F. 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.

G. 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.

H. **CROSS-DEFAULT**

The typical area development rights agreement contains a provision in the default section stating that a default under any other agreement between the area developer and the franchisor (for example, a franchise agreement) is also a default under the area development rights agreement. Additionally, a default under the area development 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 and each franchise agreement stands on its own. Do not accept a cross-default provision. Otherwise, it would have a "domino effect" and jeopardize everything!

I. **YOUR OPTION TO RENEW**

The term of an area development 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 area developer 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 for an additional term subject to you and the franchisor negotiating in good faith a new performance schedule based on demographic, economic and other conditions existing at that time. If the parties cannot agree, the issue will be submitted to binding arbitration.

J. YOUR SALE OF RIGHTS

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

M. REDUCED ROYALTY FEES

There may be economies realized by the franchisor in providing its services to all of the franchise units you own and operate. In addition, there may be certain functions that you handle that reduce the services provided by the franchisor. If this is the case, you may consider negotiating that the royalty fees of all your franchise units be aggregated and applied against a reduced sliding scale of royalties as gross revenues increase. Two of your best arguments for reduced royalty fee are that this serves as a greater incentive to you to increase sales and also that the franchisor costs to provide its incremental services as gross revenues increase are reduced. While some franchisors already have a sliding scale of royalties, many do not.

N. LIMIT OTHER FEES

Each area development 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 and related franchise agreements, don't allow these fees to multiply just because you are a multi-unit franchisee. Limit these fees to something reasonable in the aggregate.

O. FORCE MAJEURE

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

P. CO-TERMINUS AGREEMENTS

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

Q. OTHER ISSUES

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

Conclusion

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

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