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Editor-in-Chief
Eric H. Karp
Witmer, Karp, Warner & Ryan LLP
22 Batterymarch Street
Boston, MA 02109
617-423-7250
ekarp@wkwrlaw.com

Washington Ruling Raises Area Representative Disclosure Issues

By: David L. Cahn and Jeffrey S. Fabian

Franchise & Business Law Group, Baltimore, Maryland (www.franbuslaw.com)

Many franchisors use two- and three-tiered, multi-unit expansion models to develop their franchise systems. In turn, the relationships between the various parties involved in these models raise questions as to whether they are subject to the requirements of the Federal Trade Commission (FTC) Franchise Rule ("FTC Rule") and the various state franchise registration and disclosure laws. Depending on the rights and duties a franchisor grants to a franchisee under a particular multi-unit expansion model, the franchisee may: (1) have no disclosure or registration obligations; (2) be subject to disclosure in the franchisor's Franchise Disclosure Document ("FDD"); or (3) be required to prepare its own FDD, separate and apart from that of the franchisor, or prepare a "joint FDD" with the franchisor. Further complicating the issue, franchise laws in certain states have not yet been revised or clarified to adhere to the FTC's position on the issue. As with all disclosure violations, failure to adequately and properly disclose all parties involved in the franchise sales process, including intermediate parties, can lead to civil liability, fines and mandatory rescission offers.

Franchisees involved in multi-unit expansion typically fall into one of three classes. First, the term "area developer" is often used to describe a class of franchisees who are granted the right to open more than one franchise in a defined territory in accordance with a development schedule. Area developers are not intermediate parties, but rather are unit franchisees who are granted additional rights (and are subject to additional obligations) to open multiple units. The second class of franchisees is commonly referred to as "area representatives" or "development agents." These third parties act essentially as brokers for the franchisor in exchange for a percentage of the initial franchise fee and royalties paid by franchisees they recruit, and in many situations perform some post-sale obligations on the franchisor's behalf. However, area representatives do not enter into franchise agreements or other agreements with franchisees, and the area representative's direct contractual rights and liabilities reside with the franchisor. The third class of franchisees is generally referred to as "master franchisees" or "subfranchisors." For the most part, these terms describe franchisees who recruit and enter into subfranchise agreements directly with "subfranchisees," and pay fees to the franchisor out of the amounts they collect from their subfranchisees. Master franchises are commonly used for international expansion, though they may be used domestically as well. (The plethora of terms used above demonstrates the need for the franchising industry to agree on standard terms of such intermediaries.)

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321 N. Clark Street
Chicago, IL 60654

A recent case still pending in the Washington State court system demonstrates the complexities and obscurity surrounding the registration and disclosure obligations of franchisees involved in a franchisor's multi-unit expansion efforts, and how the definitions of these parties can be interpreted broadly. Pinchin v. Nick-N-Willy's Franchise Pizza Company, LLC, Bus. Fran. Guide (CCH) ¦ 14,179 (Wash. Ct. App., Jul. 22, 2009) involves a franchisee's claim for rescission of its franchise agreement, based upon the franchisor's failure to disclose its relationship with the area representative who "played a role" in recruiting the franchisee into the Nick-N-Willy's system. The franchisor's FDD did not reference the area representative, and the area representative did not prepare its own FDD. While the intermediate party involved in the case is actually referred to as an "area developer" by the parties and in the decision, the term "area representative" is used to describe the party in this article because it is more consistent with the definitions described above and with industry practice. In other words, while the parties entered into an Area Developer Marketing Agreement, the rights and obligations described in that document are more akin to those of an area representative than an area developer. For example, the intermediate party at issue was responsible for recruiting, screening and interviewing prospective franchisees, and promised the franchisor that it would provide training and support services to franchisees in its geographic territory, but the franchise agreement was entered into exclusively between Nick-N-Willy's and the franchisee. Nonetheless, the trial court determined that the area representative was required to register as a "subfranchisor" with the Washington Securities Division. Accordingly, its failure to register constituted a violation of the Washington Franchise Investment Protection Act, and in addition the franchisor's failure to disclose information about the area representative in its FDD violated that same statute. As a result, the trial court granted the franchisee partial summary judgment, and awarded them the right to rescind their franchise agreement.

Prior to the trial court determining the amount of the franchisee's monetary judgment, Nick-N-Willy's and the area representative filed an interlocutory motion in the Washington Court of Appeals seeking discretionary review of the trial court's grant of rescission. The Court of Appeals denied the motion, citing Nick-N-Willy's and the area representative's failure to meet the "heavy burden" of satisfying the standard for discretionary review. As a result, the trial on the franchisee's claim for damages will go forward, and Nick-N-Willy's and the area representative must wait until a final judgment is entered before appealing the lower court's decisions.

Under the FTC Rule only "subfranchisors" must prepare their own FDDs. To be considered a subfranchisor under the FTC Rule, a party must have, "(1) the authority to enter into a franchise agreement (or another agreement relating to the franchise), and (2) as a result of entering into such an agreement, that party is obligated to perform after the purchase of the franchise is consummated." Amended Franchise Rule FAQ's (FAQ #9). If either of these two elements is absent, the party should not be deemed a subfranchisor under the FTC Rule. An area representative is not a subfranchisor, "unless that person is a party to the franchise agreement (or to another agreement involved in the franchise)." Id. (emphasis in original). Therefore, it appears that the area representative relationship in Nick-N-Willy's is not a subfranchise under the FTC Rule.

However, in certain states, area representatives may fall within the definition of "subfranchisors" even though they do not fit that definition under the FTC Rule. In particular, Hawaii and Illinois appear to continue to treat area representatives as subfranchisors. Washington also appears to do so based on the Court of Appeals' ruling in the Nick-N-Willy's case. Maryland's definition of a "subfranchisor," also leaves the issue open to interpretation, by stating that a subfranchisor includes any party to whom the right is granted, "to sell or negotiate the sale of franchises in the name of or for the franchisor." Md. Bus. Reg. Code Ann. ¤¤ 14-201(c) and 14-201(i) (emphasis added). This definition is substantially similar to that in the majority of franchise registration states, specifically: California, Hawaii, Illinois, Minnesota, New York, North Dakota, Rhode Island, South Dakota (statute uses the term "arranges" rather than "negotiates"), Washington and Wisconsin. The Illinois Franchise Disclosure Act also retains the "or negotiate" component in its subfranchisor definition despite recent amendments. The Washington trial court pinned its decision on the "or negotiate" language in this definition, and found that this disjunctive clause allows a party to act as a subfranchisor without actually selling a franchise or entering into an agreement with the franchisee.

California previously followed the approach taken by the trial court in the Nick-N-Willy's case; however, in 2008, the California Department of Corporations abandoned this position in favor of the FTC's new stance. In expressly adhering to the FTC's approach, California's current position is that, "[t]o be a subfranchisor, a development agent must have the authority to enter into a franchise agreement; i.e., be a party to the franchise agreement, and as a result of entering into the agreement, be obligated to perform franchise obligations;" and that, "[p]erformance of post-sale obligations required by the franchise agreement, without more, does not make a development agent a subfranchisor." Franchisors, Subfranchisors and Development Agents, Ca. Dept. of Corporations Release No. 18-F at 3 (Feb. 1, 2008) (emphasis in original).

So, once a party's role and relationship is determined, what are its disclosure obligations?

As noted above, the answer for area developers is easy, because they have no disclosure obligations. Franchisors with area developers must identify the area developers as franchisees in Item 20, but they may not identify area developers separate and apart from the list of individual unit franchisees.

Master franchisees clearly meet the definition of a "subfranchisor" on the federal level and under all state franchise registration and disclosure laws. As discussed above, in certain states area representatives may also meet this definition. Subfranchisors must prepare their own FDDs, and all franchisors must properly disclose their subfranchisors in their FDDs. The subfranchisors' and the franchisor's FDDs (or the parties' joint FDD) must, at a minimum, include: Item 1 through Item 4 disclosures for both parties; separate Item 20 tables for each subfranchisor and the entire franchise system; and, financial statements for both parties in Item 21.

For area representatives, under the FTC Rule, there are no disclosure obligations. However, a franchisor who contracts with area representatives must include disclosures in its FDD sufficient to put prospective franchisees on notice of the existence of the franchisor's area representatives, and of the services that the area representatives will perform on behalf of the franchisor. Under the FTC Rule, this information should be provided in Item 1 of the franchisor's FDD. In addition, if the area representative will have management responsibility relating to the sale or operation of franchises, it must be disclosed in Items 2, 3, and 4, and if it will have an active role training then disclosure in Item 11 may also be necessary. However, the authors have been informed by one state franchise examiner at the Maryland Attorney General's Office that area representatives who do not qualify as subfranchisors may only be identified in the list of franchisees included as an exhibit to the FDD.

Therefore, under the FTC Rule, it is unlikely that the area representative in the Nick-N-Willy's case was obligated to prepare its own FDD. However, it seems reasonably clear that Nick-N-Willy's was obligated to disclose its relationship with the area representative in its FDD. In addition, ambiguities existing under the Washington Franchise Investment Protection Act arguably suggest that the area representative was obligated to prepare its own FDD. At a minimum, it appears that franchisors will be well served to include Item 2, 3 and 4 disclosures regarding area representatives in state-specific versions of their FDDs for Washington. In addition, until the law is more settled on this issue, area representatives in Washington, as well as in other states, like Hawaii, Illinois and Maryland, whose laws contain similar "subfranchisor" definitions, should consider preparing their own separate FDDs or joint FDDs with their franchisors.

While the Nick-N-Willy's case is yet to be finally resolved, the proceedings to date appear to be a warning shot directed at franchisors and area representatives who fail—even in good faith—to disclose their relationship to prospective franchisees. In states like Washington where the definition of a "subfranchisor" is arguably broader than the definition under the FTC Rule, these parties may face additional registration and disclosure obligations.

From a public policy point of view, requiring state-specific disclosures concerning area representatives seems consistent with the goals of federal and state franchise sales regulation. However, the uncertainty concerning whether such area representatives are required to register as franchisors does not appear consistent with

such policy objectives, given the recent issuance of the revised FTC Rule and other attempts to harmonize franchise sales requirements on a national basis. Accordingly, one can only hope that NASAA and the franchise registration states will follow California in taking steps to clarify the intent and reach of their subfranchisor regulations.

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