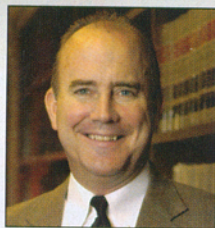


# EXPANSION OPTIONS: Multi-Unit and Third-Party Arrangements

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## OVERVIEW

Although some in the franchise community may use different nomenclature for these programs, the three most common forms of multi-unit and third-party franchising are area development, master franchise and development agent arrangements. There are other forms of multiple-unit franchising, certainly (such as additional unit development programs, "multi-pack" deals and joint ventures), but most franchisors who have ventured into this manner of expansion have utilized one of these three structures.

## Three Most Common Forms of Multi-unit Franchising

### Area Development

**Definition.** Under an area development program, the franchisee is generally referred to as an area developer and the agreement signed is an area development agreement (a.k.a., multiple unit development agreement). There typically is an area development fee, a designated territory and no subfranchising; that is, the area developer (or a related party) may only open and operate units for its own account pursuant to separate franchise agreements with the franchisor. There also is a minimum development schedule.

**Advantages.** Area development programs provide all of the general advantages of multiple-unit franchising, such as the potential for accelerated growth with less investment or capital demands upon the franchisor. In addition, area development programs may lead to additional cost savings for the franchisor due to the fact that area developers typically have prior experience with the system and no franchisor sales staff is needed for designated territories. Another advantage over master franchise and development agent programs is a greater degree of direct control over the franchisee and the development of the territory. Finally, an area development program offers a competitive sales alternative to the single-unit franchise offering.

*Selection of the master franchisee is an extremely crucial endeavor.*

**Challenges.** One of the most significant challenges applicable to area development, certainly, and to all multiple-unit expansion programs generally, is under-development. As discussed later in this article, statistical evidence tends to show that development schedules are rarely achieved. Knowing that should caution franchisors to think smaller territories.

Adopting an area development program for expansion of the system creates other concerns, such as the difficulties in managing multiple-unit franchisees, who at least believe they have, and who may in fact have, more power and influence than single-unit franchisees. A franchisor must also understand that a good single-unit operator often may not be a good multiple-unit operator.

## Master Franchise

**Definition.** Under a master franchise program, the franchisee is generally referred to as a master franchisee (a.k.a. subfranchisor) and the agreement signed is a master franchise agreement. There typically is a development fee, a designated territory and a minimum development schedule. However, the master franchisee is granted not only the right to open and operate units directly, but also the right to grant third parties the right to open and operate units under subfranchise agreements with the master franchisee. The master franchisee, and not the franchisor, is obligated to service the system in the designated territory.

**Advantages.** The most significant advantage to a master franchise program is that the master franchisee, rather than the franchisor, is responsible for developing and supporting the system and brand within the designated territory. Typically, there is a large, nonrefundable development fee, often adding a substantial immediate boost to the franchisor's revenue, with the potential for a steady stream of royalties without substantial on-going obligations. This type of program is well-suited for international development, as the person responsible for development and support of the brand in the designated territory, the master franchisee, is typically far more knowledgeable, experienced and connected in the culture and business of the designated territory.

**Challenges.** Often the good news can also be the bad news. While transferring to the master franchisee the obligation to develop and support the brand in the designated territory is a huge financial advantage of a master franchise program, it also can be a significant disadvantage due to the franchisor's substantial loss of control over the system resulting from this transfer of responsibility. Accordingly, selection of the master franchisee is an extremely crucial endeavor. The risk is significant underdevelopment of the territory. Another disadvantage is the difficulty in enforcing system standards because of this delegation of virtually all operational responsibility to the master franchisee.

The franchisor will also have to anticipate and plan for its response to a master franchisee's failure to meet its development schedule. Finally, no matter how diligent the franchisor is in vetting potential master franchisees, there are always the risks attendant to delegating such significant operational responsibility to an entity lacking in prior experience with the franchisor's system and brand (especially in international settings).

**A prospective multi-unit franchisee must have the appropriate capital, infrastructure and management skills to operate the business.**

## Development Agent

**Definition.** Under a development agent arrangement, the franchisee or licensee is generally referred to as a development agent (a.k.a. area/regional director) and the agreement signed is a Development Agent Agreement. There typically is an initial fee, a designated territory and a minimum development schedule (for referrals and/or actual units opened). The development agent is usually not permitted to subfranchise, but is tasked to refer prospective franchisees to the franchisor and may be obligated to provide certain services to unit franchisees within its designated territory, such as training, site selection, grand opening assistance and on-going support. The development agent may also receive the right to open and operate units for its own account under separate franchise agreements with the franchisor. The development agent typically receives a portion of the initial franchise fee for referrals within its designated territory, and a portion of royalties for providing services to franchisees.

**Advantages.** The greatest advantage of a development agent program is the potential it creates for rapid growth without relying on the resources of just one area developer. Through this type of expansion program and unlike a master franchise program, the franchisor retains ultimate control over who

becomes a franchisee. It also allows the franchisor to reduce the resources committed for sales and field staff in the designated territory.

**Challenges.** Again, as with all multiple-unit expansion programs, the most significant concern is the potential for underdevelopment of the territory by the development agent. In addition, under a development agent program, the franchisor must remain involved in the sales process and is responsible for all obligations in the franchise agreement. However, the franchisor will have less knowledge of the day-to-day support provided to franchisees, which not only poses a threat to the success of such franchisees, but also exposes the franchisor to liability for nonperformance by the development agent. In addition, a development agent program may also increase franchisor liability for development agent activities during the sales process.

## Critical Issues Regarding Multi-Unit Franchising

The remainder of this article describes a number of critical issues associated with all three forms of multi-unit franchising, and how franchisors should address these issues.

### Is Multi-Unit Franchising Right For You?

For many franchisors, multi-unit franchising may be the next logical step in the expansion of their system. This is not to say, however, that it is a step to be taken lightly or that it is a practical option for all franchisors. Before venturing down the multi-unit path, it is imperative that franchisors conduct the internal and external due diligence necessary to analyze whether multi-unit franchising makes economic and business sense for their system. In conducting their analysis, each franchisor should focus on where its system is in its evolutionary process, what goals multi-unit franchising will help satisfy, whether there are unique aspects of its system or industry that may impact its multi-unit development plans, and whether it has

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the resources and infrastructure to support its plans. If a franchisor decides to move forward after completing its analysis, the franchisor should create a comprehensive expansion plan that details the form or forms of multi-unit franchising it intends to use, and the short- and long-term goals of each.

Too often, however, franchisors turn to multi-unit franchising not as part of a comprehensive expansion plan, but in reaction to enthusiastic inquiries from prospective franchisees (or even a single prospective franchisee). This is particularly true in the international arena. More than likely, all U.S. franchisors who have been around for any length of time have been approached by foreign prospects who, for a large up-front fee, want to acquire the development rights for a particular county or countries. While this type of offer may be tempting to a franchisor, even to one whose short- or long-term plans never envisioned international expansion, the franchisor should, at a minimum, conduct the analysis described above before accepting it. Almost all franchisors can point to an instant where, in retrospect, they wish they had stuck to their original expansion plan.

### **Choosing the Right Multiple-unit Franchisee.**

This is probably the single most important factor in determining the success of a particular multi-unit arrangement. So how do you pick the right franchisee? While there is no magic formula, there are certainly important factors to consider and additional requirements a franchisor can impose.

Obviously, a prospective multi-unit franchisee must have the appropriate capital, infrastructure and management skills to operate the business. A franchisor should ask the prospective franchisee to submit financial statements, a detailed business plan and any other materials that will demonstrate it satisfies these requirements. A franchisor may also want to conduct (and hire third parties to conduct) more extensive background checks and due diligence to learn more about the prospective franchisee and his management team. Because multi-unit franchisees are granted development rights within desig-

nated territories, it is important that a prospective franchisee really knows the territory he desires to purchase. This is particularly true in foreign countries. Franchisors must also determine whether a prospective multi-unit franchisee (and its related companies) are already involved in franchising with other brands. While a prospect with such involvement may have a wealth of experience and a proven track record (the positive), the same prospect may be unable or unwilling to devote the time necessary to develop a particular brand due to commitments to other brands (the negative). Generally, the more information a franchisor collects on prospective multi-unit franchisees, the more informed its decisions will be.

## **Historically most development schedules are too aggressive.**

### **Setting Minimum Development Schedules.**

Franchisors should set minimum development schedules that are reasonable, keeping in mind that historically most development schedules are too aggressive. In a telling 2005 study by Arturs Kalninof, Ph.D. at the Cornell University School of Hotel Administration, it was reported that of the 142 master franchise relationships between U.S. restaurant franchisors and their international master franchisees observed by the author, only 55 (39 percent) were still in effect at the end of their development periods, and only 6 (11 percent) of the franchisees involved had met their development schedules.

To help ensure that development schedules are reasonable, franchisors should conduct meaningful due diligence and get in-depth business plans from prospective franchisees. Even with this information, however, it still may be difficult to determine what is "reasonable." Accordingly, a franchisor may want to consider dividing the development period into intervals and negotiating in good faith a separate development schedule for each interval. Franchisors may also want to consider imposing minimum performance standards as a condition to the development of additional units.

### **Enforcing Minimum Development Schedules.**

It is not uncommon for franchisors to simply let key development dates on minimum development schedules come and go without notifying franchisees. This leads franchisees to believe that they have been granted an extension. Even with a strong anti-waiver provision, which is a must for all multi-unit agreements, this is not a smart approach. Instead, each franchisor should adopt a policy regarding the enforcement of development schedules and when and how extensions or renegotiations may be allowed. For each development schedule default, a franchisor should acknowledge the default and either exercise its rights or agree in writing to an extension or modification of the development schedule. In addition to termination, franchisors may also want to consider other penalties for missed development schedule deadlines, such as fees, loss of exclusivity, or loss of some portion of the franchisee's designated territory.

### **Terminating Multi-Unit Franchises.**

Typically, multi-unit franchises are more difficult to terminate than single-unit franchises. There is often more money at stake, the franchisees are more sophisticated and have greater bargaining power, and the issues are more complex due to the structure and length of the relationship. It is imperative that a franchisor's multi-unit agreements, as well as the subfranchise agreements of any master franchisee, specifically address the grounds for termination and what happens upon termination of the relationship. Franchisors with international prospects should also take the time before entering into multi-unit agreements to determine how their termination and post-termination rights may be impacted by applicable laws in foreign countries. ■

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