When Is a Development Agent or Similar Third Party a Franchisor?

Eleanor E. Vaida Gerhards

The typical franchise system structure involves two levels and two parties: the franchisor that sells the franchise and the franchisee that purchases it. Trends over the past few years suggest, however, that franchisors are increasingly structuring franchise systems into three levels. The addition of a third tier to the franchise relationship creates unique legal issues for a franchise attorney because the duties, rights, and liabilities of the third party are not always apparent. This article will analyze federal and state statutes, rules, regulations, and agency opinions to determine how third parties, particularly development agents, are treated under federal and state franchise law.

This article first outlines the three basic forms of a three-level franchise structure and then summarizes the characteristics of each form. A three-level franchise structure contemplates the contractual involvement of a third party with the franchisor, or both the franchisor and the franchisee, for the purpose of undertaking certain functions typically reserved for the franchisor. Although franchisors have continued to create new titles and functions for third parties to a three-level franchise system, these third parties can generally be divided into three categories: master franchisees; area (or regional) developers; and development agents, also referred to, often interchangeably, as area representatives or regional representatives.[1] For simplicity's sake, this article will refer collectively to the third category as development agents. After discussing these categories, this article analyzes the Federal Trade Commission's Amended Franchise Rule (FTC Rule)[2] and state guidelines to determine how each third party is defined and treated by the FTC and various state regulators. Because of the enormous variation in laws, this article focuses on examining how states treat third parties to determine if and when a third party is a subfranchisor subject to federal and state disclosure and registration requirements.

TYPES OF THIRD-PARTY INTERMEDIARIES

Master Franchisees

The first type of third party to a three-level franchise structure is called a master franchisee. The master franchisee relationship is created when a franchisor enters into a "master franchise agreement" with the master franchisee. The master franchisee often pays a large fee to the franchisor in exchange for the right to offer and sell unit franchises, or subfranchises, to purchasers in a particular geographic territory.[3] The master franchisee then typically enters into unit franchising or subfranchising relationships directly with purchasers. Under its master franchise agreement with the franchisor, the master franchisee is, in most instances, responsible for fulfilling the vast majority of the obligations owed to the unit franchisee and maintains as much or almost as much control over the unit franchises as a franchisor ordinarily would have. In addition to executing unit franchise or subfranchise agreements, the master franchisee is ordinarily authorized to collect franchise fees and royalties and generally has discretion over the franchisee screening process, terminations, renewals, and training. The unit franchisee or subfranchisee does not typically enter into a separate agreement with the franchisor. Through provisions in the master franchise agreement, the master franchisee is required to remit to the franchisor a portion of the fees and royalties it collects.

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A third party that meets the definition of *master franchisee* can also be called a subfranchisor. *Subfranchisor* is explicitly defined under the FTC Rule and all state franchise laws as a franchisor.[4]

Development Agents

The second type of third-party intermediary is the development agent. The role of a development agent is to serve both as a presale agent with respect to the vetting, offering, negotiating, and sale of franchises and as a postsale representative with respect to training and support of franchisees. A development agent, however, enters into a contract only with the franchisor; and, although it may have a considerable relationship with franchisees, its contractual obligations remain with the franchisor.

The concept of privity of contract is a critical distinction between a master franchisee and a development agent under the FTC Rule and many state laws. In a development agent relationship, franchise agreements are entered into directly between the franchisor and each individual franchisee. Although a development agent may evaluate and procure potential franchisees for the franchisor, in most cases it has no authority to make the ultimate decision to sell a franchise. Some development agents will pay a fee to the franchisor for the rights to a territory, similar to a master franchisee arrangement. The development agent frequently receives a portion of the franchisee fee for each unit franchise opened in its territory and is often entitled to a portion of the royalties collected from each unit franchisee. Because the franchisor maintains a greater portion of the responsibility for the unit franchisees, a development agent's share of these fees

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and royalties is often much lower than that of a master franchisee. This arrangement is often desirable for franchisors that wish to penetrate a market quickly but may not be comfortable surrendering the level of control and supervision required for a master franchisee relationship.

As discussed later in this article, a development agent is regarded as a subfranchisor in certain states.

Area Developers

Often confused with the development agent (also known as an area or regional representative, as noted above) is the area developer or regional developer. An area or regional developer is simply a franchisee given the right by a franchisor to open and develop multiple franchises within a fixed geographic location. The franchisor will require the area or regional developer to execute both an area developer agreement, or area representative agreement, and individual unit franchise agreements for each franchise opened in the area or regional developer's territory. The area developer or area representative agreement will outline exactly how many unit franchises must be opened within the territory and in what time period the units must be opened; this is usually referred to as the development schedule. The area developer will own each of the unit franchises opened and may oversee one or a small number of the units within its territory, but it will find managers to run the day-to-day operations of the majority of the units.

Indefinable Third Party

Part of the confusion in labeling three-level franchise structures originates from the fact that such labels are often used interchangeably or incorrectly by franchisors as well as the legal community. The confusion grows when the FTC and state regulators define and regulate these third-party arrangements differently from one another. For example, the term *area franchise* is often used to described the master franchisee or subfranchisor arrangement under state law, but it is not a term used under the FTC Rule.[5]

In addition, innovative franchisors continue to create new structures that do not easily fit into one of the foregoing three-level franchise system categories. For instance, franchisors increasingly operate under a hybrid area representative/developer system. In this hybrid structure, a third party enters into an agreement with a franchisor to purchase development rights to a particular geographic territory. The agreement contains a quota setting forth the number of franchise outlets that must be sold within the territory by a certain deadline. However, it often offers flexibility by providing that the third party can meet the quota by owning, opening, and operating the franchise units itself or by selling the rights to open outlets to individual franchisees.

Each three-level franchise arrangement has different legal consequences, so it is important that a franchise structure be designed with an understanding of how that structure is likely to be categorized by the FTC Rule and various state laws. Without knowing the legal implications of each arrangement, the parties may create unintended duties or undertake unintentional responsibilities. A franchise attorney must be aware of how the FTC and state regulators analyze these relationships because the labels chosen by the parties will not govern the parties' rights and duties or their treatment under the various applicable laws and regulations.

Why Involve a Third Party?

Although the legal status of these arrangements can be confusing, there are numerous reasons why a three-level franchise structure may benefit a franchise system. Third parties often pay franchisors a significant fee for the rights to develop or sell in a certain territory. A franchisor can expand its business into areas that it might not otherwise have the capital or resources to enter by itself. There are a number of other benefits in addition to increased revenue and enhanced growth.[6] In many cases, the third party will have greater familiarity with the geographic area, which provides the franchise system with enhanced knowledge of the real estate, marketplace, and opportunities for franchisees. However, despite the benefits, three-level franchise systems also create legal ambiguities that should be clarified before making a decision to use them. The first task of the franchisor or franchise attorney is to determine the type of structure that will best suit the franchisor in question and then analyze the treatment of that structure under federal and state law.

FEDERAL AND STATE FRANCHISE DISCLOSURE

A frequent question raised by franchisors interested in utilizing a three-level franchise structure is whether federal and state franchise laws require disclosure, registration, or both. Critical questions may include (1) whether a franchisor must disclose the third party in its Franchise Disclosure Document (FDD), (2) whether the third party is subject to federal and state franchise disclosure and registration laws, and (3) whether the third party must disclose the franchisor's applicable information in its FDD if it is subject to federal and state franchise laws.

FTC Rule

When the amended FTC Rule was released in January 2007, it did not provide extensive guidance for attorneys representing three-level franchisor clients.[7] As attorneys began drafting the new form of disclosure document, it soon became apparent that further direction from the FTC and state regulators was necessary. Under the FTC Rule, *franchisor* is defined as "any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors."[8] The definition continues by stating that "a 'subfranchisor' means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance."[9]

Although it was clear from the FTC Rule that the definition of *franchisor* included subfranchisors, it was not clear what type of third party would meet the definition of *subfranchisor*. An FTC staff opinion clarified the definition of *franchisor* soon after the release of the FTC Rule.[10] The staff opinion is in question-and-answer form and queries, among other things, whether a development agent should be treated as a subfranchisor under the FTC Rule.[11] The FTC replied by stating that a development agent party is not a subfranchisor unless "that person is a party to the franchise agreement

(or to another agreement involved in the franchise)."[12] The staff opinion added that this requirement was applicable "regardless of the name given to the person, be it 'development agent,' 'area developer,' or 'regional developer.'"[13]

The FTC's staff answer to the question of defining *franchisor* was formulated by analyzing the definitions of *subfranchisor* under the FTC Rule. According to the FTC, the description of a subfranchisor as a "person who functions as a franchisor by engaging in both pre-sale and post-sale performance" encompasses two requirements.[14] These two requirements consist of the subfranchisor having (1) the authority to enter into a franchise agreement or similar agreement with franchisees, and (2) postsale performance obligations to such franchisees as a result of entering into the agreement.[15] The FTC states in the staff opinion that the power to enter into franchise agreements and perform postsale obligations is unique to a franchisor. When the franchisor delegates these duties and responsibilities to a third party, then that third party has assumed the role of a franchisor.[16] The focus under the FTC Rule is whether the third party essentially functions as a franchisor.

The FTC staff opinion attempts to interpret the FTC Rule by providing a bright-line test for determining when a third party is deemed a subfranchisor and, thus, a franchisor. According to the staff opinion, when a third party executes an agreement with a franchisee and provides some form of postsale support, then the third party is a franchisor subject to the FTC Rule. The FTC Rule requires privity of contract between the third party and the franchisee. Based on this interpretation, it is clear that a master franchisee is a franchisor as well. It is also fairly clear that a standard development agent is not a franchisor subject to the FTC Rule. Although a development agent agreement generally imposes significant postsale support requirements on the third party, a development agent does not execute the franchise agreements with the unit franchisees.[17]

The legal status of a three-level franchise structure can be confusing, but such a structure may benefit a franchise system for many reasons.

The first step is to determine whether the third party will be deemed to be a franchisor under the FTC Rule. To do so requires the client to determine if the third party is or will be in privity of contract with the unit franchisees. Privity of contract can result if the third party directly executes a franchise agreement with the unit franchisee or executes a similar agreement with the unit franchisee that imposes postclosing requirements on the third party. If privity of contract with unit franchisees exists, then the third party is a franchisor under the FTC Rule, and the franchise attorney must move forward with determining how to properly disclose the third party.

Mechanics of Disclosure

The staff opinion helps to clarify when a third party is defined as a franchisor and subject to the FTC Rule, but it does not assist a franchise attorney in determining how a third party deemed to be a franchisor (by virtue of being a subfranchisor) should be disclosed by a franchisor or how or if a third party should disclose itself. The FTC Compliance Guide (Compliance Guide) released in May 2008 assists in answering many of these questions.[18]

In accordance with the Compliance Guide, both a franchisor and a subfranchisor must prepare an FDD.[19] "Both the franchisor and any subfranchisor are responsible for each other's compliance with the amended [FTC] Rule and are jointly and severally liable for each other's violations."[20] This joint liability places the burden on both parties to guarantee that the disclosures in an FDD are correct.[21] The Compliance Guide states that as to certain disclosures, both parties are required to supply the information to assure the accuracy of the FDD.[22] For instance, information required in Items 1–4 should always be supplied by both the franchisor and subfranchisor, and this requirement is expressly reiterated under the Item 1 specific guidelines.[23] In addition, both the franchisor and subfranchisor must include financial statements.[24]

Despite this joint liability, a level of ambiguity still remains. The Compliance Guide informs franchisors that some required disclosures may only need to be supplied by one of the parties.[25] For example, the FTC states under the Item 21 specific guidelines that a subfranchisor's financial information "becomes material in order to provide prospective franchisees with the opportunity to assess that person's financial condition."[26] The information to provide under the Item 20 disclosures, however, leaves some discretion to the franchisor and franchise attorney. Although the subfranchisor is required to provide both the franchisor's and subfranchisor's Item 20 information, the franchisor must only provide the information if "its statistics differ materially from the subfranchisor's statistics."[27] There are no additional guidelines to assist a franchisor in determining whether its statistics may differ materially from the subfranchisor's statistics. A franchise attorney would therefore be prudent to use the general materiality standard. If the omission or disclosure is likely to affect a franchisee's decision to purchase the franchise, then the information should be included.[28]

The last discussion point related to subfranchisor disclosures appears in the Compliance Guide's section entitled "Instructions for Preparing Disclosure Documents."[29] The guide simply states that the FDD must "include the same information required of the franchisor for the subfranchisor, to the extent applicable."[30] Although both parties are jointly and severally liable for any disclosures, the FTC does not appear to mandate that one party be responsible for preparing the disclosures over the other.

The North America Securities Administrators Association (NASAA) provides more definitive guidelines in its 2008 Franchise Guidelines (NASAA Commentary).[31] Under the NASAA Commentary, a franchisor is not permitted to list separate charts in Item 20 for area developers. *Area developer* is defined by the NASAA Commentary as a "franchisee who receive[s] the right

to open multiple outlets."[32] Because an area developer does not meet the FTC Rule definition of a subfranchisor, its information is not required or permitted to be disclosed in Item 20. A franchisor's contractual arrangements with area developers should, however, be disclosed as applicable in other items where disclosure is appropriate.[33]

The NASAA disclosure guidelines are identical for both area developers and development agents. A franchisor is not required under the FTC Rule to disclose development agent information in Item 20 because this form of third party also does not have a contractual relationship with franchisees and is therefore not a subfranchisor for FTC Rule purposes.[34] Therefore, under the NASAA disclosure guidelines, a development agent arrangement must be disclosed and explained under appropriate sections of the FDD, but a development agent does not require the extensive disclosure mandated of a master franchisee because it does not meet the definition of a subfranchisor under the FTC Rule.

The NASAA Commentary clearly defines the disclosure requirements of a subfranchisor or master franchisee.[35] According to the NASAA Commentary, a subfranchisor's FDD must include two sets of Item 20 charts.[36] One set of charts must list all individual outlets in the entire system, and the second set of charts must list only those outlets that belong to unit franchisees of the subfranchisor.[37] A listing of all the subfranchisors in the system by each individual subfranchisor in the franchise system is not required.[38]

Based on the most recent guidance from the FTC and the NASAA, a franchise attorney drafting a subfranchisor's FDD should include, at least, (1) franchisor disclosures in Items 1–4; (2) the franchisor's financial statements in Item 21; and (3) franchisor disclosures in Item 20, including two sets of charts for both the franchisor and the subfranchisor. A franchise attorney should also include information pertaining to area developers or development agents in a franchisor's FDD only to the extent required to disclose the contractual relationship. Although these guidelines offer some assistance, they do not address individual states' treatments of master franchisees, development agents, and area developers, which are discussed in further detail below.

STATE-SPECIFIC GUIDELINES

In addition to complying with the FTC Rule, franchisors desiring to implement three-level franchise systems in states with franchise disclosure and registration laws need to consider their laws as well. Because each state's franchise laws may define *subfranchisor* differently than the FTC Rule does, a third party may not fall within the definition of a subfranchisor under the FTC Rule but be deemed a subfranchisor under certain state laws.

It is not difficult to determine the registration and disclosure requirements of certain three-level franchise systems under various state laws. No state defines an area developer as a subfranchisor, and no state neglects to define a master franchisee as a subfranchisor. As detailed in the next section, however, analysis of certain state laws, regulations, and regulator opinions shows that often a development agent is a subfranchisor subject to state registration and disclosure laws. This is true even though a development agent is not defined as a subfranchisor and required to disclose under the FTC Rule. To date, only one state has reexamined its position on subfranchising since the implementation of the FTC Rule to harmonize it with federal regulation.

California

In February 2008, California stepped forward and issued a release to clarify the meaning of *subfranchisor* under the California Franchise Investment Law.[39] In its release, the California Department of Corporations first took notice that the California Franchise Investment Law did not define *development agent*, *area developer*, or *regional developer*.[40] It acknowledged that the proliferation of three-level franchise structures constituted a change in market conditions that must not be disregarded or ignored.[41] Based on the ambiguity concerning these third-party arrangements, the California department stated that it was necessary to issue a release providing guidance to interested parties that offer and sell franchises within the state.[42] Under California law, a subfranchise is defined as "any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, for consideration given in whole or in part for that right, to sell or negotiate the sale of franchises in the name and on behalf of the franchisor."[43]

Prior to the issuance of its release, the department determined if a subfranchising relationship existed by focusing on whether consideration was paid to a franchisor for the right to sell or negotiate the sale of franchises.[44] The department would decide that a development agent was a subfranchisor without analyzing whether it was in a contractual relationship with the franchisee.[45] This led to a number of development agent relationships being construed as subfranchisor relationships for two reasons.[46] The California definition requires no privity of contract; and a development agent's duties almost always include the vetting, procuring, or negotiation of franchise sales in some fashion. For instance, in one opinion, the California Commissioner of Corporations held that an agreement constituted a subfranchise relationship because the development agent was granted the right to "sell or negotiate the sale of franchises in the name or on behalf of the franchisor" and collect a portion of the franchise and royalty fees.[47] No emphasis was placed on whether the development agent stepped into the shoes of the franchisor or was a party to the franchise agreement.[48] The commissioner only asked whether the development agent was involved in the sales process and paid the franchisor for the right to be involved in that process. In another opinion, the commissioner held that a subfranchise relationship existed where a franchisee (B&J West Coast) entered into a franchise agreement with franchisor Ben & Jerry's Vermont (B&J Vermont) to acquire the rights to operate Ben & Jerry's franchises within an undeveloped area of California.[49] The franchise agreement granted B&J West Coast the right to sell, assign, or transfer such portions of its franchise agreement as it desired to allow new franchisees the right to develop within the undeveloped territory.[50] B&J Vermont would then approve the new franchisee and execute a franchise agreement with the purchaser.[51] Again, the California commissioner gave no weight to the fact that the franchisor and the purchaser were the contracting

parties. The commissioner stated that "it is of no consequence that an assignee acquires certain rights and obligations by executing a separate franchise agreement with B&J Vermont rather than B&J West Coast."[52] The commissioner ruled B&J West Coast a subfranchisor and subject to the California franchise registration and disclosure requirements.[53]

The approach in California changed with the issuance of the 2008 release. The department reviewed the FTC's definition and interpretation of *subfranchisor* and decided to revise its approach to make it consistent with the FTC interpretation provided in the staff opinion and Compliance Guide.[54] The change was supported by the California State Bar Franchise Law Committee, which had one year earlier submitted a white paper to the department proposing that the California Franchise Investment Law be amended explicitly to exclude a development agent from the definition of a subfranchisor.[55] In its proposal, the committee argued that the lack of privity or direct contractual relationship between the development agent and franchisee precludes a finding that a subfranchise structure exists.[56]

Attorneys representing a three-level structure must determine if the third party will be deemed a franchisor under state and federal law.

The committee also reasoned that including development agents within the definition of a subfranchisor could actually defeat California's purpose of protecting prospective franchisees because it might mislead a franchisee.[57] Registration may lead a franchisee to believe it had contractual rights against the developer in the event of any future claims. Franchisees do not have any direct contractual rights against a developer, however, because their franchise agreement is with the franchisor.[58]

This year, the California department abandoned its previous position and adopted the view of the FTC and also set forth its own list of guidelines to use when determining whether a development agent is a subfranchisor.[59] Regardless of California's specific guidelines, the release clarified a frustratingly ambiguous area of franchise law in California.

Unfortunately, this exercise has not yet been undertaken by any other state. Thus, a franchisor must examine on a state-by-state basis whether its third-party arrangement constitutes a subfranchise relationship. The approach and interpretation used by California prior to its release is not atypical. Unless and until all states adopt the FTC Rule's definition of *subfranchisor*, a franchise attorney must thoroughly review the franchise law of each state in which franchises will be offered. As set forth below, a number of state laws are ambiguous on the subject or remain committed to treating development agents as subfranchisors.

Hawaii

Hawaii appears to treat development agents as subfranchisors, but the state's reasoning is murky. Hawaii defines *subfranchisor* as a grantee to an area franchise.[60] *Area franchise* is defined as an agreement between a franchisor and subfranchisor where the subfranchisor is granted the right to sell or negotiate the sale of franchises.[61] The position taken by the Hawaii Business Registration Division in early advisory opinions implies that it follows California's pre-2008 release conclusion that development agents are treated as subfranchisors. No recent guidance, however, is available, and those early opinions are difficult to fathom.

For instance, in one opinion, the Hawaii division ruled that a development agent was a subfranchisor where the development agent only identified qualified buyers and received an ongoing royalty from approved purchasers.[62] The development agent was not a party to the franchise agreement, had no right to negotiate the terms of the franchise agreement without prior authorization from the franchisor, and did not have authority to close deals or collect fees.[63] The request for an advisory opinion from the franchisor made logical and compelling arguments but was unsuccessful in convincing the division. The division examined only the language in the franchisor's agreement with the development agent, which granted to it "the right to sell, on [f]ranchisor's behalf, tune-up center franchises."[64] The division then ruled that it fit the definition of *subfranchisor* under Hawaii law.

Even more interesting is an order requiring a single-unit franchisee that sold its franchise but remained directly responsible for upholding all the terms and conditions of the franchise agreement to be registered as a subfranchisor.[65] The division was unrelenting in its view that the selling franchisee was a subfranchisor under Hawaii law.[66] These opinions are fairly outdated, but no recent interpretations on the subject exist. Therefore, a franchisor utilizing a three-level franchise structure with a third party fitting the description of a development agent in Hawaii should be aware that the division may find a subfranchise relationship to exist.

Illinois

As in Hawaii, the definition of a subfranchise under the Illinois Franchise and Disclosure Act is nearly identical in substance to the definition of a subfranchise under California law.[67] A subfranchise can exist as soon as a franchisor sells the third party a right to negotiate sales of unit franchises.[68]

The development agent need not completely step into the shoes of a franchisor to be deemed a subfranchisor under Illinois law. A development agent is required to disclose and register under the act if the agreement with the franchisor requires the development agent to service the unit franchises "despite the lack of direct privity between the subfranchisor and subfranchise."[69] Illinois law requires registration of both the franchisor and the subfranchisor when "both the franchisor and subfranchisor have performance obligations to the subfranchise, whether such obligations are set forth in the franchise agreement or other written document or arise as a matter of practice."[70] If, however, the franchise agreement is solely between the franchisor and the unit franchisee and the franchisor has "primary performance obligations" to the unit franchisee, then the development agent must "verify the information in the [franchise registration]

application relevant to the subfranchisor."[71] What obligations give rise to a requirement for registration by a development agent is not clear. Therefore, it is important to recognize the likely need for a development agent to register as a subfranchisor under Illinois law any time that the third party is providing services to a unit franchisee.

Virginia

This spring, the Retail Franchising Act Rules of Virginia were amended to incorporate the new concepts set forth by the FTC Rule, including the deletion of the term *UFOC*.[72] Virginia also revised the rules to clarify registration and disclosure requirements for three-level franchise systems.[73] The revised Virginia rules state that a master franchisee is a subfranchisor; a master franchisee usually requires a separate registration (or exemption); and a master franchisee must disclose in its registration the required information about the master franchisor as well as the same information concerning the franchisor, to the extent applicable.[74]

The revised rules do not, however, give any further guidance to franchise attorneys with respect to how *master franchisee* is defined. Virginia was one of the first states to amend its state franchise rules to incorporate the new FTC Rule but yet did not chose to provide further guidance on the subfranchisor issue.

Washington State

Washington appears to explicitly require the registration of development agents.[75] The Washington franchise law defines *subfranchisor* as a "person to whom an area franchise is granted."[76] *Area franchise* is defined as "any contract or agreement between a franchisor or subfranchisor whereby the subfranchisor is granted the right to sell or negotiate the sale of franchises in the name or on behalf of the franchisor."[77] Again, the focus under the Washington statute appears to be on the rights granted to the subfranchisor and not the contractual relationship between the subfranchisor and the franchisee. This is confirmed in the Washington State Department of Financial Institutions Interpretative Statement, which broadly construes this definition.[78] In the statement, the department ruled that a subfranchisor must be registered (or exempt from registration) if the subfranchisor "offers or sells or is a substantial factor in arranging the offer and sale of a franchise."[79] This "substantial factor" language broadens the definition of a subfranchisor more than in any other state examined. This interpretation is also consistent with the last department opinion letter.[80] In the letter, HUS, Inc., a master regional franchisee, requested confirmation from the department that it was not required to register under the Franchise Protection Act of Washington.[81] According to HUS, the duties of a master regional franchisee included recruiting and procuring potential unit franchisees and acting as a "facilitator for the flow of information" between the franchisor and the potential unit franchisee.[82] Master regional franchisees did not have authority to negotiate or enter into contracts with unit franchisees. Despite the fact that HUS lacked the authority to negotiate or execute franchise agreements, the department found that HUS was a subfranchisor required to register under the Washington act. The department stated that the term *negotiate* in the definition of an area franchise "includes activities such as the solicitation and qualification of potential franchisees."[83]

Although the definition of *subfranchisor* under Washington law is interpreted broadly, it may not encompass all forms of development agents. In an unpublished opinion, the Washington Court of Appeals held that an area franchisee was not required to register under the Washington act where the area franchisee provided ongoing support and training to other unit franchisees within its territory in exchange for a portion of the royalties and initial franchise fees of the unit franchisees.[84] In this case, the area franchisee played no role in the initial franchise offer, sales, or negotiation process. Therefore, the area franchisee did not receive consideration for the "right to sell or negotiate the sale of franchises" as defined by the Washington law.

This distinction may have little practical application for most franchisors. In most cases, a development agent agreement is drafted to impose both preopening and postopening obligations on the development agent. The recruitment of potential unit franchisees is likely one of the most important duties of a development agent. Therefore, most development agent arrangements will still require registration under the Washington act.

Remaining Registration States

Research of the laws, regulations, and opinions of the remaining registration states did not provide guidance that would assist a franchisor or franchise attorney in determining whether their regulators require the registration of a development agent. Because the remaining state franchise agencies have never chosen to make this issue a priority or set forth additional rules on the subject, those states may well adopt the FTC Rule, Compliance Guide, and NASAA Commentary when interpreting the definition of a subfranchisor. At this time, however, their positions are unclear.

CONCLUSION

It is imperative that a franchise attorney representing a three-level franchise structure determine whether the third party at issue will be deemed to be a franchisor under the FTC Rule and under the state laws of each and every state where the structure will be implemented. A franchisor's failure to properly disclose or register under federal and state law can result in serious consequences. Penalties may include fines, injunctions, orders to rescind franchise agreements, and other types of equitable relief. Thus, before a franchisor client decides to implement a three-level franchise structure, it should understand the implications of its decision; and each party to the arrangement should be fully aware of its legal obligations.

ENDNOTES

1. *See* Stuart Hershman & Andrew A. Caffey, *Structuring a Unit Franchise Relationship, in* FUNDAMENTALS OF FRANCHISING 51, 54 (Rupert M. Barkoff & Andrew C. Selden eds., 3d. 2008).

2. Federal Trade Commission, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.

3. Will Woods, Jacqueline Vlaming, and John Dring outlined the three-level franchise system in "Three-Level Franchise Systems: Area Reps and Development Agents: Do They Make Sense for the Franchise System You Represent?" at the International Franchise Association Legal Symposium (2008).

4. 16 C.F.R. § 436.1(k). The following states explicitly define *franchisor* by including subfranchisors in the definition of *franchisor*: 15 Ill. Comp. Stat. Ann. § 705.3, Bus. Franchise Guide (CCH) ¶ 3130.03; Mich. Comp. Laws § 445.1502(2(5)), Bus. Franchise Guide (CCH) ¶ 3220.02; Minn. Stat. Ann. § 80C.01, subdiv. 6, Bus. Franchise Guide (CCH) ¶ 3230.01; Or. Rev. Stat. Ann. § 650.005(6), Bus. Franchise Guide (CCH) ¶ 3370.01; R.I. Gen. Laws § 19-28.1-3(j), Bus. Franchise Guide (CCH) ¶ 3390.03; Va. Code Ann § 13.1-559, Bus. Franchise Guide (CCH) ¶ 3460.03. New York defines *subfranchisor* by stating that a subfranchisor "shall be considered a franchisor." N.Y. Gen. Bus. Law § 681(b)(17), Bus. Franchise Guide (CCH) ¶ 3320.02.

5. *See* Haw. Rev. Stat. § 482E-2, Bus. Franchise Guide (CCH) ¶ 3110.02; Md. Code Ann., Bus. Reg. § 14-201(c), Bus. Franchise Guide (CCH) ¶ 3200.01; Mich. Comp. Laws § 445.1502(2(6)), Bus. Franchise Guide (CCH) ¶ 3220.02; Minn. Stat. Ann. § 80C.01, subdiv. 7, Bus. Franchise Guide (CCH) ¶ 3230.01; N.Y. Gen. Bus. Law § 681(b)(6), Bus. Franchise Guide (CCH) ¶ 3320.02; N.D. Cent. Code § 51-19-02(2), Bus. Franchise Guide (CCH) ¶ 3340.02; Or. Rev. Stat. Ann. § 650.005(6), Bus. Franchise Guide (CCH) ¶ 3370.01; Wis. Stat. Ann. § 553.03(2), Bus. Franchise Guide (CCH) ¶ 3490.02.

6. Carrie Pipes, *How Area Developers and Franchisors Work Hand in Hand to Grow the Organization* (Aug. 9, 2004), www.franchising.com/articles/62.

7. *See* David J. Kaufmann & David W. Oppenheim, *Highlights and Analysis: The Revised Federal Trade Commission Franchise Rule*, Bus. Franchise Guide (CCH) ¶ 6085, 9129-102 (stating that "we look forward to the forthcoming FTC Franchise Rule Compliance Guides' assistance in further defining, and delineating among, franchise brokers, subfranchisors, other species of 'franchise sellers' and what their distinct obligations are under the revised FTC Franchise Rule").

8. 16 C.F.R. § 436.1(k).

9. *Id*.

10. Amended Franchise Rule FAQs, 72 Fed. Reg. 15,511 (Mar. 30, 2007).

11. *Id*.

12. *Id*. In the staff opinion, the FTC used the requirement that a person be a party to a contract to narrow and define the scope of a subfranchisor. *Id*. The FTC was not, however, willing to make this concession when the FTC was urged to revise the definition by a commenter prior to the FTC Rule release. *See* Fed. Trade Comm'n, Amended Franchise Rule Statement of Basis and Purpose, 16 C.F.R. pt. 436, at 15,462, n.173 (2007). The FTC stated that the commenter's suggested change was unwarranted. The FTC feared that using only this factor to define *subfranchisor* could inadvertently sweep third-party brokers and agents within the definition. *Id*.

13. 72 Fed. Reg. 15,511.

14. *Id*.

15. *Id*.

16. *Id*. Although the FTC staff opinions set forth in the FTC Rule Q&As are helpful guidance, it is critical to note that they are not authoritative rulings of the FTC.

17. The staff opinion also makes reference to a discussion set forth in the portion of the FTC Rule's Statement of Basis and Purpose. Under Item 21, the FTC states that a subfranchisor is a third party that essentially "steps in the shoes" of the franchisor. 72 Fed. Reg. 15,511 (citing 16 C.F.R. pt. 436, at 15,511). The FTC Rule states, for instance, that a broker who has no postsale commitments is not a franchisor simply because the individual is called a subfranchisor by the three-level franchise system. *Id*.

18. Federal Trade Commission Franchise Rule Compliance Guide (May 2008). Again, any guidelines provided in the FTC Compliance Guide are not binding on the FTC. *Id*. at ii.

19. *Id*. at 17.

20. *Id*.

21. *Id*.

22. *Id*.

23. *Id.* at 29.

24. *Id.*

25. *Id*. at 17.

26. *Id*. at 114.

27. *Id*. at 18.

28. *See* 16 C.F.R. pt. 436, at 15,455 (2007) (discussing the concept of materiality).

29. Compliance Guide, *supra* note 18, at 123.

30. *Id*.

31. NASAA Commentary on 2008 Franchise Registration and Disclosure Guidelines, Bus. Franchise Guide (CCH) ¶ 13,995.

32. *Id*. at 20.2.

33. *Id*.

34. *Id*. at 20.3.

35. *Id*. at 20.4.

36. *Id*.

37. *Id*.

38. *Id.*

39. Preston DuFauchard, Cal. Dep't of Corps., Franchisors, Subfranchisors, and Development Agents (Release No. 18-F Feb. 1, 2008).

40. *Id*.

41. *Id.*

42. *Id*.

43. *Id*. (citing Cal. Corp. Code § 31008.5).

44. We Care Hair, Op. Cal. Dep't of Corps. Comm'r 92/2F, File No. OP 6254F, 1992 Cal. Sec. LEXIS 3 (Sept. 30, 1992).

45. *Id*.

46. A number of the agency opinions use terms such as *area representative*, *regional representative*, *area subfranchisor*, and *regional subfranchisor*. For simplicity's sake, this article will continue to use the term *development agent* to describe the relationship although the term used by the state agency or franchisor may be different.

47. *Id*.

48. *Id*.

49. Ben and Jerry's, Op. Cal. Dep't of Corps. Comm'r 92/1F, File No. OP 6161F, 1992 Cal. Sec. LEXIS 1 (Feb. 7, 1992).

50. *Id*.

51. *Id*.

52. *Id*.

53. *Id*.

54. *Id*.

55. *See* Cal. State Bar Franchise Law Comm., Regulation of Development Agents (proposed white paper) (May 9, 2007).

56. *Id.*

57. *Id.*

58. *Id.* The committee also argued that "requiring audited financial statements of development agents actually exacerbates this concern, suggesting that a franchisee can look to the development agent for its damages or losses." *Id*. A franchisee may still attempt recovery as a third-party beneficiary to the development agent agreement.

59. DuFauchard, *supra* note 39. These guidelines are as follows: "(1) The analysis of subfranchisor status should emphasize functions performed by the person providing the services, rather than the title assigned to that person. (2) Performance of post-sale obligations required by the franchise agreement, without more, does not make a development agent a subfranchisor. (3) Persons who are granted the right to receive compensation for referrals to a franchisor or subfranchisor or for receiving compensation for acting as sales agents are not parties to the franchise agreement. (4) Persons who do not perform post-sale obligations required by the franchise agreement are not subfranchisors. (5) To 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." *Id*.

60. Haw. Rev. Stat. § 482E-2, Bus. Franchise Guide (CCH) ¶ 3110.02.

61. *Id*.

62. Op. Haw. Bus. Registration Div., 1989 Haw. Sec. LEXIS 46 (Aug. 11, 1989).

63. *Id*.

64. *Id*.

65. Op. Haw. Bus. Registration Div., 1989 Haw. Sec. LEXIS 35 (May 24, 1989).

66. *Id*.

67. See Cal. Corp. Code § 31008.5 (defining *subfranchise* as "any contract or agreement between a franchisor and subfranchisor whereby the subfranchisor is granted the right, for consideration given in whole or in part for that right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor"); 815 Ill. Comp. Stat. § 705/3(4) (defining *subfranchise* as "any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, in consideration of the payment of a franchise fee in whole or in part for such right, to service franchises or to sell or negotiate the sale of franchises").

68. 14 Ill. Admin. Code. § 200.702(c), Bus. Franchise Guide (CCH) ¶ 5130.52.

69. *Id*.

70. *Id*.

71. *Id*.

72. *See* Commonwealth of Va. ex rel. State Corp. Comm'n, 2008 Va. Sec. LEXIS 26 (Case No. SEC-2008-00027).

73. Va. Code Ann. § 5-110-80.

74. *Id.*

75. Bus. Franchise Guide (CCH) ¶ 5470.75 (citing Wash Rev. Code §§ 19.100.010–.040).

76. *Id.*

77. *Id.*

78. *See* Wash. State Dep't of Fin. Insts., Franchise Act Interpretive Statement FIS-01 (Jan. 1, 1991), at www.dfi.wa.gov/sd/franchiseinterpretive01all.htm.

79. *Id*.

80. Washington Securities Division Opinion Letter, File No. E-13951, 1989 Wash. Sec. LEXIS 241 (Dec. 7, 1989).

81. *Id*.

82. *Id*.

83. *Id*.

84. Johnson v. Mail Boxes Etc., USA, Inc., 2000 Wash. App. LEXIS 389 (2000), Bus. Franchise Guide (CCH) ¶ 11,803.