

Franchise Relationships

A Practical Guidance® Practice Note by Marc Lieberstein and Gabrielle Simon, and updated by Chris Williams-Lopez, Kilpatrick Townsend & Stockton LLP



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This practice note discusses the different kinds of franchise relationships that are most prevalent in the United States, defines and describes the features of such relationships, and discusses the advantages and disadvantages of each relationship. It is estimated that there are some 775,000 franchise establishments doing business in the United States that are collectively generating revenues of approximately \$780 billion and employing over eight million people.

For more information, see [Franchising: An Updated Look at the Basics](#) and [State Franchise Exemptions](#).

The Single-Unit Franchise

In the United States, the overwhelming majority of franchised businesses are “single-unit” franchises. A single-unit franchise is one where the franchisor grants a franchisee the right to operate one franchise unit at a time. Single-unit franchise offerings are regulated under federal and state franchise laws, rules, and regulations, as well as the various individual state business opportunity laws, though exemptions from such rules may apply depending on the size and experience of the franchisor or franchisee. See [State Franchise Exemptions](#). The single-unit franchise relationship is a two-party structure relationship between the franchisor and the franchisee, wherein the franchisee develops, owns, and operates one franchised business location, usually in a designated area.

The advantages and disadvantages of single-unit franchise relationships are set out in the chart below:

Single-Unit Franchise	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Franchisor can easily evaluate the franchisee's suitability for the franchise; test the waters before franchise expansion • Franchisor is able to maintain considerable control over the single-unit franchises • Single-unit franchisees are usually motivated to succeed because failure is not an option after they have invested in the franchise • Can be a smaller or more manageable investment for franchisees; easier to enter the franchise system 	<ul style="list-style-type: none"> • Due diligence can be slow and difficult for the franchisor, especially if it has multiple single-unit franchise offerings to different franchisees • Franchise growth may be inhibited because a single-unit franchisee is generally interested in only one unit due to limited financial resources, a lack of sophistication, and/or is generally risk averse • Single-unit franchisees may be hard to terminate under various state franchise laws or other state unfair competition laws

Multi-unit Franchise Relationships

Since the 2008 market downturn, multi-unit franchising has started to encroach on the popularity of single-unit franchising. The increasing popularity of these franchise relationships thus provides franchisors with more stability and faster growth for their franchises. In a multi-unit franchise, the franchisor grants a franchisee the right to own and operate more than one franchise unit in a designated territory(ies). The following sections discuss three of the most common types of multi-unit franchise relationships:

- The area developer franchise relationship
- The subfranchise/master franchise relationship
- The area representation relationship

The Area Developer Franchise Relationship

A common form of multi-unit franchise relationship is the "area developer" wherein the franchisee/developer pays not only an upfront franchise fee for each franchise location but also an upfront area development fee. In exchange, the area developer obtains the right to develop multiple franchise units within a designated geographic territory according to a development schedule that is usually set out in a separate "area development agreement." The area developer/franchisee and franchisor will enter into separate unit franchise agreements for each new franchise.

The area developer cannot sell the franchise rights to third parties in this two-party relationship structure as the franchisor is contracting directly with the franchisee to develop multiple units. But, in some cases, an area developer is permitted to form affiliates, each of which could own and operate a franchised location. Like single-unit franchise relationships, the multi-unit area developer franchise relationship is governed by federal and state franchise and business opportunity laws, although federal and state law exemptions may be more applicable in the multi-unit franchise relationship where the franchisee is generally a large and/or experienced entity. See [State Franchise Exemptions](#).

The advantages and disadvantages for the multi-unit area developer franchise relationship are set forth in the chart below:

Multi-Unit Franchise – Area Development	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Allows for potential rapid franchise expansion • Expansion is more efficient and consistent with an area developer who knows and operates the multiple units 	<ul style="list-style-type: none"> • Potential failure to meet development schedule • Area developer fails to meet development schedule resulting in negative consequences for franchisor and franchisee

<ul style="list-style-type: none"> • Upfront, nonrefundable fees in exchange for area protection—incentivizes area developer/franchisee to open more units • Area developer becomes more experienced by having multiple units • Less training and support required—saves money for franchisor • Development schedule allows franchisor to maintain considerable control over the one area developer and designated territory • Franchisors can use one Franchise Disclosure Document (FDD) (a mandatory requirement unless the franchisor or franchisee is exempt) for the franchisee who is offered an area development agreement 	<ul style="list-style-type: none"> • If a single-unit operator/franchisee is granted an area development agreement, it may not necessarily result in a good multi-unit operator/franchisee • Franchisor may have less leverage to push through changes to the franchise system • Area development agreement is a separate document requiring time and money to negotiate • Large area developer/franchisee with multiple units may have more leverage over franchisor to mandate changes to franchise system
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The Subfranchise/Master Franchise Relationship

Another form of multi-unit franchise relationship is frequently styled as a “subfranchise” relationship, but it can also be known as a “master franchise” relationship. The subfranchise/master franchise relationship can take many forms and has several variations, but regardless of the label, in most subfranchise/master franchise relationships, the franchisor is essentially granting the subfranchisor or master franchisor the right to offer franchises to prospective subfranchisees (i.e., it’s a three-party structure).

Generally, in this relationship the subfranchisor/master franchisor pays a large upfront franchise and development fee, along with a continuing royalty fee (usually a percentage of the royalty payments received by the subfranchisor from the subfranchisees). In exchange, the franchisor usually grants the subfranchisor/master franchisor the right to:

- Develop multiple franchise units itself
- Subfranchise out the right for multi-unit development (e.g., enter into an area development agreement or
- Grant unit franchises or unit subfranchises according to a development schedule within a designated territory pursuant to a separate “subfranchise agreement.”

In some situations, the subfranchisor itself is required to develop and operate a certain number of franchise units before it is able to subfranchise. For each new franchise that a subfranchisor/master franchisor grants to a subfranchisee, a new separate subfranchisee agreement is required. The franchisor is not a party to the subfranchisee agreements, but usually the franchisor reserves approval rights before execution of any subfranchisee agreement. A franchisor who establishes such subfranchise relationships also typically reserves the right to step in to oversee the subfranchisees if the subfranchisor/master franchisor is in default or if the franchisor-subfranchisor agreement terminates.

The advantages and disadvantages of the subfranchise/master franchise relationship are set forth below:

Multi-Unit Franchise – Subfranchise/Master Franchise	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Minimal/lower franchisor expense—subfranchisor/master provides initial and ongoing training and support to subfranchisees • Potential for faster expansion of franchise • Franchisor role is limited—reliant on subfranchisor/master to properly develop and support the brand 	<ul style="list-style-type: none"> • Same as Area Developer with regard to potential failure to meet development schedules • Subfranchisee is unable to meet development schedule resulting in negative consequences for franchisor, subfranchisor, and subfranchisee

<ul style="list-style-type: none"> • Well-suited for a franchisor seeking to expand the franchise abroad due to reliance on subfranchisor/master local experience and knowledge in the foreign country • Franchisor receives upfront fees and flow of income without having to perform substantial ongoing obligations • Franchisor is not a party to the subfranchisor/master subfranchisee/master franchisee franchise agreement 	<ul style="list-style-type: none"> • Franchisor may need to step in if subfranchisor relationship terminates • Because subfranchisor provides development, operations, and other support to subfranchisees, franchisor does not have as much control over the subfranchise relationship (e.g., development, fees, branding, and enforcement) • In overseas situations, franchisor must rely on foreign subfranchisor who the franchisor may not know and upon whom the franchisor must rely without the ability to always have close supervision • Due diligence is strongly suggested but not always reliable • Franchisor and subfranchisor have dual obligations regarding franchise registration and franchise disclosure requirements in the U.S. and in foreign jurisdictions, subject to exemptions • Franchisor and subfranchisor have dual obligations regarding franchise registration and franchise disclosure requirements in the U.S. and in foreign jurisdictions, subject to exemptions
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Area Representation Relationship

The third form of multi-unit franchise relationship is area representation. Similar to the subfranchise/master franchise relationship, the area representation relationship is a multi-party franchise structure wherein the franchisor grants a third party—usually not a franchisee, but who could be a franchisee—the right to stand in the shoes of the franchisor and recruit, train, find franchise locations, provide field support, etc. for franchisees in a designated territory. The area representative pays a large upfront fee in exchange for this grant, and generally is governed by an area representative agreement that specifies the geographic territory and mandates a particular development schedule. In exchange, the area representative receives a percentage of the franchise fees and/or royalties paid to and earned by the franchisor from the franchisees recruited by the area representative. An area representative may also be granted the right to develop unit franchises within the designated territory.

Significantly different from the subfranchise relationship, the area representative is not a party to the franchisor-franchisee franchise agreements, and in this way the area representative could be considered an independent contractor/agent for the franchisor. The agreement between a franchisor and area representative may not be one directly governed by federal and state franchise laws (e.g., when the area representative is merely an agent of the franchisor and does nothing more than provide franchisee leads to the franchisor). But, federal and state franchise/business opportunity laws may still mandate that a franchisor register and/or prepare an FDD before offering and/or selling franchises via an area representation relationship (e.g., when the area representative is providing additional services and support on behalf of the franchisor to the franchisees). In the 14 registration states, the franchisor is still required to first register its franchise and submit its FDD to the state franchise regulators before offering to sell or selling franchises in those states itself or via an area representative relationship. And, at a minimum, the franchisor must disclose its area representative relationships in the FDD for as long that relationship is in effect.

The advantages and disadvantages of an area representation relationship are set forth below:

Multi-Unit Franchise – Area Representation	
Advantages	Disadvantages
<ul style="list-style-type: none"> • Potential rapid and efficient growth of franchise • Upfront nonrefundable payment of fees, in exchange for designated territory incentivizes growth of the franchise • Franchisor does not need to invest in sales efforts to find franchisees • Franchisor reduces spending on resources for recruitment, training, site selection, and other presigning franchisee costs • Franchisor signs the franchise agreement and thereby maintains considerable control over the franchisee and franchise development • The area representative relationship may not be considered a franchise—resulting in less regulatory compliance 	<ul style="list-style-type: none"> • Same as Area Developer with regard to the potential failure to meet development schedules resulting in negative consequences for franchisor • Franchisor is potentially liable for the activities of its area representative during the sales process (e.g., misrepresentations made by area representative to the franchisee) • Franchisor still required to be involved in sales process because it makes final decision regarding which prospects become franchisees • Franchisor may still be ultimately responsible for providing all initial and ongoing support to unit franchisees under franchise agreement even though area representative obligated under area representative agreement

There are other nontraditional franchise relationships (e.g., relationships that include private equity, trusts, publicly held companies, ESOPs, nonprofit entities, or joint ventures) but these are outside the scope of this practice note. The single-unit and multi-unit franchise relationships described above are the most prevalent kinds of franchise relationships in the United States. Each has their own advantages and disadvantages, and each should be considered depending on (1) the situation a franchisor finds itself in financially and (2) the value and goodwill that can be attributed to the franchisor brand.

Related Content

Practice Notes

- [Franchising: An Updated Look at the Basics](#)
- [State Franchise Exemptions](#)
- [Franchising under State Franchise Laws](#)
- [State Franchise Registration Forms & Resources Chart](#)
- [Franchising under the Federal Trade Commission Franchise Rule](#)
- [Franchisees and Prospective Franchisees Considerations](#)
- [State Websites for Franchises and Business Opportunities](#)
- [Company-Owned versus Franchisee-Owned Stores: Issues to Consider](#)
- [Franchise Law Exemptions](#)
- [Franchise Whole Business Securitization](#)

Templates

- [Area Development Agreement](#)
- [Franchise Agreement \(Unit Franchise\)](#)
- [Franchise Disclosure Document](#)
- [Sale and Transfer of Franchised Business Agreement \(Assignment, Assumption, and Consent Terms\)](#)

Checklists

- [Franchise Agreement Term Sheet](#)

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Marc Lieberstein is the co-chair of the Franchise Group and Retail & Consumer Goods industry team. His practice focuses on intellectual property licensing and franchising in the retail/consumer goods and services areas, fashion/apparel and accessories, food and beverage, and commercial/industrial design, including the drafting, negotiation, and enforcement of license and franchise documents and agreements, as well as implementation of branding and commercialization objectives for clients via licensing and franchising. In conjunction with the services above, Marc counsels clients on creating effective strategies for procuring, protecting, and enforcing their global intellectual property assets. Marc has also participated in and used alternative dispute resolution forums such as arbitration and mediation to enforce intellectual property rights and resolve license and franchise contractual disputes. Marc frequently lectures and writes on intellectual property and franchise issues for a variety of intellectual property and franchise organizations and publications, including International Trademark Association (INTA), New York State Bar Association Intellectual Property Section, and the American Bar Association Forum on Franchising, *The Franchise Lawyer*, *Franchise Law Journal*, *National Law Journal*, *IP Strategist*, *The New York Law Journal*, *Practical Law*, *The Licensing Journal*.

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