

Sub-franchising, Master Franchising and Development Agents

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Introduction

What is a franchise?

Black's Law Dictionary defines a 'franchise agreement' as 'the contract between a franchisor and franchisee establishing the terms and conditions of the franchise relationship'. This relationship grants the franchisee the sole right of engaging in a certain business. 'Business' is defined as a 'commercial enterprise carried on for profit'; therefore, a franchise could be conceived as the means by which many entrepreneurs develop a business.

It is internationally accepted that a franchise is a simple method for expanding a business and distributing goods and services through a licensing relationship between franchisor (the person who grants the licence) and franchisee (the person who uses the licence). Under this type of agreement, the franchisor specifies the products and services that shall be offered by the franchisee to its customers, as well as the operating system, trademarks, brands and support.²

International accepted principles

Although franchises are created by means of a contractual relationship, franchises have more elements that should be considered, including brand value, franchisor support, and the manner in which the franchisee delivers the products or provides the services to customers in accordance with the brand system standards established by the franchisor.

Franchises are vehicles that allow a business to expand in many jurisdictions; such agreements must be written in a business-oriented manner and must contemplate internationally accepted principles of a franchise agreement.

Among the wider known franchise principles are:

- the licensing of a trademark;
- the provision of technical assistance;
- the royalties payment; and
- the provision of standards.

The foregoing principles need to be included in most franchise agreements because many countries do not regulate franchises.

Under Mexican law, franchises are regulated by the Industrial Property Law, and it is considered that a franchise agreement exists when:

- the trademark owner or holder is licensing its trademark to a third party;
- the franchisor provides the franchisee with any kind of know-how or technical assistance; and
- the franchisee acquires the right to produce, sell the products or render services in a uniform manner and with the operative, commercial and administrative methods set forth by the franchisor, so that the products or services provided maintain the same quality, prestige and image.

In addition, in Mexico, all franchise agreements need to comply with certain legal requirements. For example, the delivery of a franchise disclosure document, and the registration of the franchise agreement before the Mexico Trademark Office.

Mandatory information in a franchise agreement

Franchises are not regulated in all countries. If a franchise agreement is executed in a non-regulated franchise jurisdiction, the agreement should meet international business standards applicable for franchises. International business standards on franchising have been developed by countries with robust franchise systems and regulations that require the franchisor to comply with mandatory provisions within the franchise agreement.

For example, in the United States,³ it is mandatory to include in the franchise agreement, among other information:

- training and ongoing support provided by the franchisor;
- assigned territory;
- duration of the franchise agreement;
- franchise fee and total anticipated investment;
- trademark, patent and signage use;
- royalties and other fees;
- advertising;
- operating protocol;
- renewal rights and franchisee termination or cancellation policies; and
- resale rights.

Legal requirements: franchise disclosure documents and registration

In some jurisdictions, before granting a franchise, franchisors must provide to franchisees certain information, which is carried out through the delivery of a disclosure document. The disclosure document must be delivered by the franchisor to the potential franchisee before the date of the franchise agreement. Normally, franchise disclosure documents must reveal to the prospective franchisee the technical, economic and financial information of the franchised business.

Depending on the jurisdiction where the franchised business will be operated, the franchise disclosure document needs to be registered or filed with a state government agency before operating.⁴

Master franchise What is a master franchise agreement?

A master franchise agreement is an agreement executed by and between a franchisor and a master franchisee, whereby the franchisor grants the master franchisee rights to the franchise and licence to: (i) exploit and use intellectual property rights, including without limitation, the trademarks, manuals and know-how (franchise system) to develop, establish and operate franchise units in a specific territory; and (ii) sublicense the trademarks and sub-franchise the system to operate franchise units in that territory. Furthermore, the franchisor provides to the master franchisee technical assistance in connection with the franchised business, and the master franchisee, in turn, provides such technical assistance to its sub-franchisees.

The franchise and licence granted under the master franchise agreement can be non-exclusive or exclusive, although it is usually the latter case, as explained below.

Exclusivity

It is common for franchisors to grant master franchisees exclusive rights over a certain territory to develop, establish and operate the franchised business. In this event, the franchisor grants the master franchisee the exclusive right to develop, establish and operate franchise units within a specified territory, directly or through sub-franchisees. Therefore, no other franchisee may develop, establish or operate the franchised business in the territory covered by the master franchise agreement.

The master franchisee's exclusivity rights may be limited by the parties, for example, the franchisor may reserve for itself the right to operate company-owned units or businesses under the franchised brand, or the exclusivity can be subject to the compliance of certain other obligations by the franchisee (eg, complying with the development schedule).

It is common to include provisions in master franchise agreements that allow the franchisor to terminate the master franchisee's exclusivity rights in the event of the latter's breach of its obligations. In this event, the franchisor may thereafter have the right to enter into agreements with third parties to continue to expand the franchised business within the territory.

Obligations of the franchisor

In our experience, the main obligations of the franchisor in a master franchise agreement are the following:

- grant a licence to use and exploit all intellectual property related to the franchised business;
- provide the master franchisee with the know-how, technical assistance, services and necessary training to develop, establish and operate the franchise, in the terms agreed by the parties;
- provide to the master franchisee with the materials, manuals, guidelines and other documents related to the operation of the franchise;
- if applicable, provide the master franchisee with a list of equipment, supplies, approved suppliers, list of products, and other materials necessary or required to open and operate the franchised units; and
- if exclusivity is granted to the master franchisee, the franchisor shall not grant to third parties the right to operate the franchised business within the protected territory during the term of the master franchise agreement.

Obligations of the master franchisee

During the term of the agreement and thereafter, franchisees must protect the confidentiality of the franchisor's confidential information disclosed during the term of the master franchise agreement, as well as the operations and activities carried out under the agreement.

Other than the foregoing, in our experience, the most common obligations of master franchisees under master franchise agreements are the following:

- pay royalties and fees in the amounts and terms agreed by the parties;
- use trademarks and any other intellectual property as agreed by the parties;
- permit the franchisor to inspect the premises of the franchised units to verify their due operation;
- attend and comply with all training programmes and other related requirements;
- operate the franchised units exclusively under the proprietary marks of the franchisor and under no other name, in strict conformity with the franchisor's standards, manuals or specifications;
- maintain the insurance coverage required by the master franchise agreement;
- participate in any applicable customer loyalty programmes, promotions, gift certificates, gift card programmes and marketing and advertising and promotional programmes or plans; and
- provide the franchisor with reports and any information requested by the franchisor.

Development schedules under master franchise agreements

Master franchise agreements often contain a development schedule, which compels the master franchisee to develop a specific number of franchised units in a specific period of time. Master franchise agreements often include default, termination and monetary penalties for the franchisee for non-compliance of the development schedule.

Furthermore, it is common to include provisions in master franchise agreements that allow the franchisor to terminate the master franchisee's exclusivity rights in the event the master franchisee fails to comply with the development schedule, or even to terminate the agreement without responsibility.

Sub-franchising

Pursuant to the industry's standards, a franchisor often confers on the master franchisee the right to grant sub-franchises and to sublicense the trademarks and the use of the system to operate franchised units in a specific territory to a third party called the sub-franchisee.

A sub-franchise agreement is an agreement entered into by and between a master franchisee and a sub-franchisee, whereby the master franchisee grants the sub-franchisee a sub-franchise and sublicense to exploit and use franchisor's intellectual property rights, including, without limitation, trademarks, manuals and know-how to establish and operate a franchised unit in a specific territory.

Under sub-franchise agreements, a master franchisee collects fees and royalties and may have the responsibility of recruiting, training and supporting sub-franchisees within a specific territory.

Master franchisees' obligations in connection with its sub-franchisees

Sub-franchise agreements must reflect the main terms and conditions included in the master franchise agreement, or even the form of sub-franchise agreement may be attached to the master franchise agreement as an exhibit thereof. Additionally, the franchisor may reserve the right to approve the sub-franchisees and the location in which each sub-franchised business will be developed and may dictate the economic relationship between the master franchisee and its sub-franchisees, including royalties and any other fees.

The most common obligations of a master franchisee in connection with its sub-franchisees are the following:

- provide the franchise disclosure document to the prospective sub-franchisee before the execution date of the corresponding sub-franchise agreement, complying with any applicable specific time period;
- execute sub-franchise agreements with the sub-franchisees, either using its own format or the form of agreement included in the master franchise agreement;
- provide sub-franchisees with know-how, technical assistance, services and training to operate the franchise;
- supervise the sub-franchisee's units to verify their adequate operation;
- transfer the sub-franchise agreements to the franchisor in the event of the expiration or termination of the master franchise agreement, or include provisions regulating such possibility in the sub-franchise agreements; and
- ensure that the sub-franchisees comply with their obligations and hold the franchisor harmless for any of their acts or omissions.

Development agents

Concept of a development agent

A development agent is, from a legal perspective, an agent of a franchisor in a specific territory where an agency agreement is executed to regulate this relationship; in such instance, no franchise is granted by the franchisor.

For example, and pursuant to the Mexican Commerce Code, an agency agreement is a commercial mandate in which a principal requests an agent to perform a mercantile act on the former's behalf. This relationship may be agreed in writing or verbally, but in the latter case, it needs to be ratified in writing before the agreement's performance is completed. In this regard, this kind of agreement sets forth a spontaneous and temporary relationship between the principal and the agent, in the understanding that once the agent has performed the relevant mercantile act or agreement, the principal will be able to commence a new business relationship.⁵

Having a development agent provides the franchisor with a way of expanding its franchise within a specific territory, since the agent is responsible for marketing and selling new franchises in a territory, plus the agent usually helps the franchisor understand the territory's market and laws. Furthermore, the agent may provide training and ongoing support to franchisees. The foregoing, of course, is on the understanding that the agent will be compensated for these services through a commission.

Area developers versus development agents

An area developer is a person or company that executes a development agreement with the franchisor. Under this agreement, the franchisor grants the area developer the right to develop the franchised business in a defined territory with the understanding that to open a franchise unit, a specific franchise agreement must be executed. Usually, the

developer, directly or through a joint venture with a third party, executes the franchise agreement. Development agents, on the other hand, do not execute a franchise agreement with the franchisor or the potential franchisee; a franchise agreement is executed between the franchisor and the corresponding franchisee proposed by the development agent, who in turn would be entitled to receive a commission.

Is a master franchisee considered a development agent?

A master franchisee is not considered a development agent. The main difference between the two figures is that a development agent will never operate a franchise; that is, it will not be granted a franchise and the right to operate a franchised business, which the master franchisee can do, either directly or by granting such right to a sub-franchisee.

Is a sub-franchisee considered a development agent?

A sub-franchisee is not considered a development agent; a sub-franchisee is granted the right to operate the franchise and may use trademarks and other intellectual property rights of the franchisor, while a development agent will never have those rights. Development agents will only carry out certain acts connected to the expansion of the franchised business on behalf of the franchisor.

Benefits of having a development agent

Having a development agent may provide the franchisor with several advantages, including the following: (i) obtaining knowledge and advice in connection with the franchise market and laws in the applicable territory, which can facilitate the brand's expansion; (ii) having a point of contact in the territory to promote the relevant franchised business; and (iii) if so desired by the franchisor, having the development agent carry out certain activities usually performed by the franchisor, such as inspection visits, training and providing technical assistance.

Benefits of being a development agent

A development agent has several benefits over franchisees. For example, its liabilities and obligations are limited to compliance with the acts entrusted by the franchisor, without assuming liabilities or obligations derived from the operation of the franchised business. In addition, even without these responsibilities, it receives a commission for each franchise agreement entered into by and between the franchisor and the corresponding franchisees proposed by the development agent.

Commonalities and differences

Master franchises, sub-franchises and development agents all have their own particularities. We analyse their commonalities and differences below.

Commonalities

As previously described, sub-franchising is the term used to describe the relationship between a master franchisee and the unit sub-franchisee. This right usually arises from the rights granted in a master franchise agreement, but it is not the rule. Therefore, master franchise and sub-franchise agreements are intrinsically linked to one another and they have more commonalities. On the other hand, agency agreements for development agents have fewer commonalities with the above indicated agreements, since those are not considered franchise agreements.

Notwithstanding, these three kinds of agreements all have as a purpose the development and expansion of the business of the franchisor in a certain territory. Furthermore, compliance of development schedules may be required in master franchising and sub-franchising, although it is not common in sub-franchise agreements.

Finally, development agents and master franchisees may provide technical assistance and training to franchisees, although development agents will not be entitled to use trademarks or operate the franchised units.

Differences

Notwithstanding the above, master franchises, sub-franchises and development agents have more differences than similarities.

The main difference between sub-franchising, master franchising and development agents is that sub-franchise and master franchise agreements grant a licence and franchise to use and exploit intellectual property rights, and technical assistance and know-how are provided. Meanwhile, development agents execute an agency agreement, whereby no licence or franchise is provided.

Master franchisees are usually required to comply with certain development schedules of franchised units, which may be operated solely by the master franchisee or by its sub-franchisees. It is uncommon for development agents to have to comply with a development schedule, although it is common to include specific goals for agents in the corresponding agency agreement.

Conceptually, development agents will never have the right to sub-franchise. The right to sub-franchise is normally granted to a master franchisee. Sub-franchisees shall operate the unit, but are usually not granted the right to sub-franchise.

Another important difference is that master franchisees normally have the right to collect and receive the franchise fees from sub-franchisees, and the duty to in turn pay a portion of such fees to the franchisor, while sub-franchisees are obliged to pay such relevant fees to the master franchisee. Conversely, the development agents are entitled to receive a commission directly from the franchisor for the acts they carry out on the franchisor's behalf.

Exclusivity is another relevant issue in these agreements. Exclusivity rights over a territory are usually granted to master franchisees and development agents. Meanwhile, sub-franchisees are usually granted a radius of protection only, where other franchisees may not operate a franchised unit.

Overview

Risks that franchisors may face

The misuse by the franchisee of the requirements to use the trademarks, intellectual property, confidential information, manuals and guidelines provided by the franchisor for the operation of the franchised units is quite relevant for franchisors and one of the most significant risks franchisors may face. If any intellectual property or information is misused, or the customer service of the franchised units do not meet the franchisor's standards, the goodwill, reputation and image of the franchisor and its business may be seriously affected, and this may result in economic losses.

Confidentiality is also a very important issue for franchisors. The unauthorised disclosure of information by a franchisee and the use of this information for purposes other than the operation of the franchise agreement is also a significant risk for the franchised system. These issues need to be handled carefully in the applicable franchise agreement.

When entering into a franchise agreement with a franchisee, a franchisor needs to bear in mind that if the parties include certain provisions in the franchise agreement by error that may be interpreted as constituting or creating a

labour relationship between the franchisor and the franchisee's employees, and if a claim is filed, the courts have sufficient authority to determine that the franchisor could be an employer of the franchisee's employees. This risk needs to be considered in the applicable franchise agreement, and the parties should agree that the franchisee shall indemnify the franchisor for any lawsuit filed by the franchisee's employees against the franchisor.

Additionally, the franchisor must foresee the compliance of the franchisee to file and obtain the required licences and authorisations for the establishment, development and operation of the franchised units. If the franchisee fails to obtain any licence or authorisation for the above purposes, the franchised unit premises may be subject to closure by the authorities and the franchisor may face indirect economic losses.

Finally, granting a master franchisee with exclusivity over a certain territory may lead to major risks for the brand's expansion if the master franchisee does not comply adequately with its obligations under the applicable agreement.

How to protect the franchisor from breaches by its sub-franchisee, master franchisee or development agent
Including specific provisions in the applicable agreement

In most jurisdictions, franchisors and franchisees are free to agree on most issues as a result of the principle of contractual freedom. Therefore, all franchise agreements may include any provisions the parties agree on, provided that they comply with the applicable laws related to franchise agreements, including the general principles of commercial contracts, and do not violate public policy or moral standards. It is important for the franchisor to adequately regulate in the applicable agreement any issues that are essential to the franchised business and its system, for example, confidentiality, use of intellectual property, anti-corruption practices and principles, indemnities, and covenants not to compete, among others.

Guarantee documents

The franchisor may require the franchisee, as a protective measure, to grant the guarantees that may be necessary for the franchisee's compliance with its obligations under the franchise agreement. For example, it is common for franchisors to request that the franchisee's principals personally guarantee the franchisee's obligations, through the execution of a joint obligation agreement.

Multiplicity of agreements Development agreement

The parties may execute a development agreement along with the applicable franchise agreements. Signing two separate agreements can provide the franchisor with additional protection as it may terminate any of them as needed, and may include cross-termination provisions that would allow the franchisor to terminate one agreement if the franchisee breaches its obligations under the other agreement.

Lease agreements

The franchisor may have additional protection in the event that a franchisee breaches any of its obligations if it also leases or subleases the premises where the franchised business is operated. This means that the franchisor will have the authority to evict the franchisor from the premises, particularly if cross-termination provisions are included in both the lease and the franchise agreement. However, this alternative may not be used by foreign entities acting as franchisor, since it may have adverse tax consequences; it is more designed for Mexican entities acting as franchisors.

Conclusions

Franchise agreements may include any provisions the parties agree on as long as they do not contravene the applicable laws, public policy and good morals.

Master franchising, sub-franchising and agency agreements for development agents are all efficient means for a franchisor to expand its business into a territory, as they allow the parties to agree any provisions they deem necessary to regulate their relationship; choosing a specific business model depends on the operation and the franchisor's needs.

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