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Franchisors, Subfranchisors and Development Agents

The purpose of this Release is to provide some clarity around the issue of whether certain business services surrounding a franchise relationship cause the entity providing those services to be deemed a subfranchisor, thereby requiring registration with the Department of Corporations (Department). Now is an appropriate time to issue this clarification, since the Federal Trade Commission (FTC) has adopted amendments to the federal franchise rules, and has also provided some guidance on this and other issues.

One objective of the FTC in adopting amendments to the federal franchise rules in 16 C.F.R. Part 436 (Part 436) was to "respond to changes in new technologies and market conditions in the offer and sale of franchises." A market condition that the Department must increasingly consider is the use by franchisors of persons referred to as "development agents," also referred to as "area developers" and "regional developers" (collectively referred to herein as "development agents"). Neither Part 436 nor the California Franchise Investment Law (section references are to the CFIL unless otherwise noted) provides a definition of these terms.

If the activities of a development agent are equivalent to those of a "subfranchisor", the development agent must comply with the franchise registration or exemption requirements in Section 31110. (Section 31010 provides that where the term "franchise" is used in the CFIL, "franchise" includes "subfranchise".)

Section 31008.5 defines "subfranchise" to mean:

...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 or on behalf of the franchisor.

This section distinguishes "franchise brokers" and "franchise sellers" from "subfranchisors" by adding:

A contract or agreement that is a franchise does not become a subfranchise merely because under its terms a person is granted a right to receive compensation for referrals

to a franchisor or subfranchisor or to receive compensation for acting as a sales representative on their behalf.

While numerous Commissioner's Opinions discuss the issue, there continues to be substantial uncertainty as to whether development agents are "subfranchisors" as defined in Section 31008.5, and required to independently comply with CFIL registration and exemption requirements. Part of that confusion may stem from the fact that there is no uniform set of services a development agent provides. Franchisors may use development agents in different ways depending on the assessment of needs by a particular franchisor.

The definition of "franchisor" in Part 436, and the FTC's position concerning "subfranchisors" are instructive in analyzing subfranchisor/development agent questions.

"Franchisor" is defined in 16 C.F.R. Section 436.1 to mean:

... any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. For purposes of this definition, a "subfranchisor" means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance.

Although the preceding definition of "franchisor" includes a conclusory definition of "subfranchisor", there is no elaboration in Part 436 of the pre-sale activities and post-sale performance necessary for subfranchisor status.

The absence of precise definitions for "subfranchisor", "development agent" and related terms in the amended Rule resulted in requests for clarification from the FTC. In response to these and other questions, the FTC published "Amended Rule FAQs." (The FTC staff noted that the questions and answers had not been reviewed, approved or adopted by the Commission, and they are not binding on the Commission. The answers and opinions, however, are those of the FTC staff charged with enforcement of the Franchise Rule.)

Question 9. of the "Amended Rule FAQs" asks:

Should "development agents" be treated as subfranchisors because they provide post-sale services to franchisees, and, thus, must include financial statements and other information in the disclosure document?

The FTC staff's answer is:

No. Even if a person performs post-sale on behalf of a franchisor, that person or entity is not a "subfranchisor" under the amended Rule unless that person is a party to the franchise agreement (or to another agreement involved in the franchise). This is true regardless of the name given to the person, be it "development agent", "area developer", or "regional developer." (underscoring added)

After discussing the inclusion of the term "subfranchisor" within the term "franchisor" in the amended Rule, the staff continues:

Thus, a “subfranchisor” is a person “who functions as a franchisor;” by use of the qualifying phrases “grants a franchise” and “participates in the franchise relationship,” the amended Rule clarifies that in order to be considered a subfranchisor, a party must have - as a franchisor has - (1) the authority to enter into a franchise agreement (or another agreement relating to the franchise), and (2) as a result of entering into such an agreement, that party is obligated to perform after the purchase of the franchise is consummated.

The role of a subfranchisor is materially different from that of a broker, for example, because a broker typically is not a party to the franchise agreement and does not have post-sale contractual obligations to franchisees. ... (underscoring added)

The FTC staff concludes by quoting from the amended Rule’s Statement of Basis and Purpose.

(T)he term ‘subfranchisor’ is limited in the Rule to circumstances where the subfranchisor steps into the shoes of the franchisor by selling [franchises] and performing post-sale obligations. ...

The Department’s view is consistent with the above-stated interpretation provided by the FTC staff. In summary, a franchisor or subfranchisor that uses of the services of a development agent can consider the following guidelines in determining whether the development agent is in fact a subfranchisor.

- (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.

Even though circumstances may lead to the conclusion that a development agent falls outside the definition of a subfranchisor, this does not relieve a franchisor, or subfranchisor, using the services of the development agent from fully disclosing their arrangement with the development agent to potential franchisees in the Uniform Franchise Offering Circular or Franchise Disclosure Document.

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