

Structuring a Multi-unit Franchise

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A multi-unit franchise owner can structure its operations in a number of ways, but one approach in particular often makes a lot of sense: a developer entity that acts as the parent company for the individual franchise locations.

First some background. Many franchisors seek out franchisees who want to open three or more units. One approach is to sign a development agreement in which the developer commits to open an agreed-upon number of franchise units in a defined territory over a specified period. In exchange, the franchisor agrees not to open a company-owned unit or to grant a franchise to anyone else in that territory while the development agreement remains in effect.

In most franchise systems, the developer opens each franchise under a separate franchise agreement. The multi-unit developer typically signs the development agreement and the first franchise agreement at the same time. Each subsequent franchise is then opened pursuant to a separate franchise agreement. The development agreement typically ends when the developer signs the franchise agreement for the last franchised unit promised in the development schedule. Territorial exclusivity in the development agreement ends, but the more limited territorial protection in the individual franchise agreements remains in effect.

One approach: form a developer entity

One approach that can work well for a typical multi-unit franchisee is to form a limited liability company ("LLC") to sign the development agreement and act as the parent company for each individual unit entity. For illustration purposes, let's call this parent company the "Developer LLC." Each franchise would be owned and operated by a separate "Franchisee LLC" under its own franchise agreement, and the Developer LLC would be the sole member of each Franchisee LLC. From a tax point of view, each LLC would be a pass-through entity so the profits or losses of each Franchisee LLC would become the profits or losses of the Developer LLC and, in turn, of its member or members.

This structure has several advantages over using a single franchisee entity. Benefits for the Developer LLC include the following:

- It limits the Developer LLC's liability with respect to each franchised unit to the amount invested in that unit.
- The Developer LLC's operating agreement can facilitate investment in the Developer LLC by new members.
- The operating agreement of each Franchisee LLC can facilitate investment into that particular franchise by new members. For example, a Franchisee LLC might want to give its operations manager for that specific unit an ownership interest in that entity in order to reward and motivate the manager.

- The Developer LLC can employ people to provide common services to all or some of the unit franchises, so that they are not bound to a specific unit.
- The Developer LLC can more easily sell off or close down one or more of the Franchisee LLC units.
- Each Franchisee LLC can more easily report its revenues separately and accurately.

This structure also has benefits for the franchisor:

- The franchisor can easily track the performance of each franchise unit individually, as financials and tax records are prepared separately for each Franchisee LLC business.
- It simplifies the franchisor's right of first refusal on the sale of a Franchisee LLC business.
- It facilitates the termination or nonrenewal of one franchise agreement without terminating others.

Variations and related considerations

To facilitate the use of individual franchisee entities, franchise agreements commonly contain provisions that require the franchisee entity to state in its organizational documents that its activities are confined solely to owning and operating the franchised business.

Franchisors commonly require the owners of a franchisee entity to sign personal guarantees of the franchisee's obligations. If the owner is a Development LLC, the franchisor may want guarantees both from the Development LLC and from its owners.

Variations are common. For example, if the developer is an individual who plans to open just three units without bringing in other investors, the simplest approach would be for that person to sign the development agreement individually rather than forming an entity to be the developer. He or she could be the sole member of each Franchisee LLC. The developer would have rights and obligations vis-à-vis the franchisor, but with little legal risk to third parties such as a landlord, suppliers or customers. Unlike a franchised unit, the developer in this case has no operating business.

Of course, many multi-unit owners acquire their locations over time without signing a development agreement. The structural suggestions presented here apply equally well to a multi-unit franchisee who lacks a development agreement.

Franchisors should also keep the entity issue in mind when signing up new franchisees, regardless of whether they are part of a development group or operated by a single-unit owner. Before each new agreement is signed, the franchisor should verify that the entity has actually been formed and that its name is correct. Entity searches are easily done on state websites. If the search yields no result, the franchisor should ask the prospective franchisee for evidence that the entity was formed.

Franchisors should also be sure that no franchisee entity uses the franchisor's trademark as part of the entity's name. Use of the trademark could make ownership confusing to third parties, even to the extent that the franchisor might be sued or investigated together with the franchisee for the franchisee's wrongful acts. A franchisee's use of the franchisor's trademark in the franchisee's company name would also require the franchisor to go to the trouble of ensuring that the franchisee changes its company name upon a termination or nonrenewal. To avoid this, most franchise agreements prohibit the franchisee from using the franchisor's trademark as part of the franchisee entity's name.

Structuring a multi-unit franchise takes thought and planning. Doing so is worthwhile. A well-structured system allocates risks appropriately and facilitates growth and system change over time.

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