

Dual Branding: the New Franchising Phenomenon

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ONE OF THE more popular means of expansion in today's marketplace is the phenomenon known as dual branding.

The confluence of a saturated marketplace, particularly in the fast food field, and the logic of having two businesses sharing the same real estate and other costs — especially businesses that are complementary and not overlapping (e.g., one lunch-oriented, the other dinner-oriented) — are causing explosive growth in dual branded operations.

The Many Faces of Dual Branding

Dual branded operations can exist in a variety of settings. The classic example is two food concepts at a single site — whether consisting of two separate facilities, two areas (and cash registers or other recording devices) within a single unit (or within a larger structure, such as a highway rest stop), or simply the addition of branded food from one concept to the menu of another concept. Other

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popular examples are C-Stores (i.e., convenience stores) within gasoline service stations, fast food concepts within C-Stores, branded food sold from within a C-Store, and restaurants within hotels.

While the term "dual branding" is commonly used, the concept may also entail the joining of three or more concepts (e.g., a fast food concept within a C-Store, which is itself within a gasoline service station). In this sense, the term "co-branding" may be more accurate. For purposes of simplicity, this article limits itself to the joining of two brands, and, hence, uses only the term "dual branding."

Dual branding may take place between units of two franchised systems, two non-franchised chains, or a franchised system and a non-franchised chain. Even where franchised systems are involved (as will be assumed for the balance of this article), the dual branding may extend to the franchised units, the company-owned units, or both. When franchised units (of even one system) are involved, the term "combination franchising" is sometimes used.

Why Dual Brand in the First Place?

The process of dual branding is driven by business needs and goals. Beyond the search for new sites in a saturated market, and desires for

strengthened product offerings, new dual brand concepts arise due to:

- A desire to add new and proven product lines without the usual research and development process;

- Prospects for improved rates of return where high volume and/or shared costs can be achieved; and

- In the franchise context, the desire to provide value to franchisees by offering something "new" to the franchise system.

Whether these goals can be realized, however, is initially only a matter of speculation, and some dual brand efforts have fallen short on these fronts or encountered other difficulties. For example, labor needs for one branded concept may be significantly different from the needs of the other concept, consumer acceptance of the second brand may not be high, or the conversion may be impractical or otherwise uneconomical.

Structure

One of the early issues to be resolved is the overall structure of the dual brand arrangement.

The first strategic decision is to identify a dual brand partner that has a mix of products (or services), operating systems, and personnel that creates a good match for the company.

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Many companies have found that there are many potential dual brand partners for their systems, and several companies undertake dual branding programs with more than one dual brand partner.

Second, it is necessary to identify the operator of one system (the “host”) (e.g., an oil company licensor of gasoline stations) as the dominant system into which units or products of the other operator of a system (the “entrant”) (e.g., a food franchisor) will be introduced. From this decision will flow many outcomes.

It is also necessary to determine whether the entrant (e.g., food franchisor) will offer franchises directly to franchisees of the host (e.g., service station operators) or whether, instead, the host (e.g., oil company) will be the subfranchisor for the entrant’s (e.g., food franchisor’s) franchises. Another option is to have the host franchisor be a franchise broker, playing matchmaker between its franchisees and the entrant franchisor. In either case, it is likely that the entrant (e.g., food franchisor) will offer franchises directly to the host (e.g., oil company) for its company-owned units.

Various consequences flow from this decision, including which entity will be responsible for registration and disclosure of the dual brand offer, which entity will provide the services and assistance typically provided by the franchisor, and who will be responsible for enforcing the agreement.

Another critical structural decision often made at the earliest stages is to whom the dual brand offers will be made. For example, will only new units (franchised or company-owned) in the host system be opened initially as dual brand outlets? Or, will dual

brand franchises also be offered to existing units which will convert to the dual brand format? The resolution of these questions will shape the agreements and affect the franchise disclosure documents.

Negotiating the Master Agreement

Once the dominant system and approach (i.e., subfranchise or direct) are identified, the process typically begins with the negotiation of a master agreement between the two systems. This document will serve as an “umbrella” agreement, or blueprint, for the dual brand arrangement. Depending upon the structure, numerous additional documents may also be necessary.

For example, various forms of franchise agreements may be necessary so that the entrant can offer franchises — sometimes to the host for its company-owned units, sometimes to franchisees of the host, and, if subfranchising is employed, so that the host can offer franchises to its franchisees. Addenda to these “dual brand franchise agreements” may also be necessary to deal with differences between the establishment of new dual brand units as opposed to the conversion of existing units to a dual brand format. Development agreements (for establishing new dual brand units or conversion of existing single brand units), subfranchise agreements, and addenda to existing franchise agreements which allow for the entrance of the second concept may also be necessary — as are franchise offering circulars.

Before undertaking the often extensive negotiations and documentation associated with dual branding, most franchisors will limit their focus to the master agreement and, in some cases, a separate test unit agreement. Set forth below — under the headings “Operations” and “Agreements” —

are descriptions of the types of factors that need to be taken into account in drafting the master agreement, as well as the underlying dual brand franchise agreement(s). This article also highlights — under the heading “Disclosure” — the types of offering circulars that may be required, and the nature of the information that may be needed in those documents. The test agreement — described immediately below — raises its own set of concerns, as the test program needs to stand on its own in case the test results indicate that the arrangement should not go forward.

Test Program

In general, as the name implies, a test program is often implemented as a means to work out the kinks in a dual brand operation. A test program should be designed to:

- Determine whether the economics work;
- See if labor, equipment, and other needs are compatible;
- Develop operational techniques for preparing, offering, and selling the dual brands side by side;
- Develop manuals, training programs, and other guidance that will be necessary for the training of unit operators; and
- Enable executives and other employees of the two systems to develop a strong working relationship.

Prior to commencing the test program, the two systems must establish the parameters for the test. The dual brand “partners” must decide on the duration of the test period, the number of units to be tested, and the goals or benchmarks of the test. The goals or benchmarks could be based on revenue, costs, or other factors. The companies should also decide whether the test units will be in, or at, franchisee-

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owned facilities, or units owned by the company or the franchisor. Many pilot programs are conducted at company-owned locations, as this facilitates control over the project, and reduces the risk of lawsuits if the test is not satisfactory.

If, based on the results of the test program, one or both parties do not wish to move forward with the dual brand program, the parties need a “separation” strategy. This strategy should include pre-determined decisions regarding: (a) whether the test units will continue to operate as dual branded outlets, and if so, for how long; (b) when the units must de-identify and cease affiliation with the other brand; and (c) who pays for these “re-conversion” costs.

Operations

The operational issues that permeate dual branding are no less diverse than those encountered by a start-up franchise system. These issues may be more complicated, however, because they have to be layered over, or grafted onto, an existing franchise system. Space does not permit us to discuss all potential issues, or even a limited number of issues in an in-depth manner, but some of the operational issues that will need to be dealt with from both business and legal perspectives are the following:

■ **Construction / development / remodeling of the units.** The dual brand partners must mutually determine precisely those elements of one system that will be exported to the other. From this determination flows such decisions as the equipment, trade dress, and decor that will be utilized at the dual brand location, the remodel-

ing that is necessary, and the associated costs to the unit operator.

■ **Manuals for dual branded operations.** While both systems are likely to have operating manuals, a new manual (or addenda to the host's and/or entrant's operating manuals) should be developed to describe and direct the dual brand operations. This “dual brand manual” may be written during the test phase, and should be the result of joint and collaborative efforts between the parties.

■ **Training.** Training is also likely to be a joint effort between the two systems. Early on, the entrant must perform training; at later stages, particularly with larger hosts, the host will likely be responsible for training its own franchisees or unit managers in the techniques of running the entrant system's business. The host franchisor must be able to integrate the training programs of the two systems into a unified program.

■ **Division of fees.** Most dual brand arrangements call for a division of initial fees, royalty fees, and advertising fees. The franchisor of the entrant system would like to be paid an initial fee from the unit operator (either a franchisee or the host franchisor). At the same time, the host franchisor may want a portion of the fee, often as compensation for any servicing or training, and/or for permitting the unit to be dual branded.

The ongoing fees, typically royalties and sometimes advertising contributions, will be based on sales of products from the unit, and it can get dicey as to which franchisor is entitled to what percentage of the fees. In many cases, royalties from sales of products of the host system (e.g., burgers and fries) are paid to the host franchisor, and royalties from the sale of products of the entrant system (e.g., Mexican food) are paid to the entrant franchisor.

A problem may arise over universal products such as beverages, or combination products such as “combo” meals. Elaborate formulas may be devised for dividing the fees from these products, but these formulas are useful only if the point-of-sale cash register or computer system is able accurately to segregate such product sales information. Also, the payment mechanisms and the timing of the payments should be coordinated. For example, the two systems should attempt to harmonize one system's monthly payment requirement with the other systems's weekly obligation.

■ **Advertising.** The two systems must decide who has control over the development and placement of advertising which refers to the two brands. This leads to issues such as:

◆ Does the dual brand outlet contribute to the host system advertising fund, the entrant system advertising fund, or both?

◆ Is the unit required to belong to and/or contribute to a cooperative? and

◆ What is the revenue upon which the fees or contributions will be calculated?

Another advertising issue to be resolved is the extent to which one system has review and approval rights over dual brand advertising created by dual brand franchisees or by the other franchisor. The master franchise agreement should describe the rights and obligations of the two franchisors, and the dual brand franchise agreement should specify to whom the franchisee will make contributions, and to whom the franchisee will look for review, guidance, and approval of advertising.

■ **Computer and information systems.** The two systems need to focus on, and then resolve, issues related to the compatibility of their

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computer and point-of-sale (POS) systems, the information generated by POS systems, the use of this information by one or both of the franchisors, and the requirements to be imposed on dual brand operators with respect to upgrades and improvements in the computers and POS systems.

■ **Field supervision and reports.** A store operator (whether a franchisee or a manager) may face the difficult task of serving two masters. If the field representative of one system instructs the unit owner or manager to do something a particular way, and the field representative of the other system provides conflicting guidance or instructions, the unit may be paralyzed by the conflicting advice.

Consequently, the two systems should decide which system will be responsible for supervising units and enforcing system standards.

Also, the franchisor of the system that is not supervising the units may be entitled to reports from its dual brand partner concerning dual brand unit operations. The nature, scope, and frequency of the reports should be determined in advance.

The master agreement (and, in certain respects, the unit agreements) should clarify which entity will provide: (a) training; (b) construction and/or remodeling assistance; (c) the manual; (d) product and supplier approvals; and (e) other advice.

■ **Approval products and supplies.** To the extent possible, both systems should work together to have common approved products and approved suppliers. The benefits of common sources include no duplication of services, the possibility of larger volume discounts, and minimizing the number of deliveries to,

and payments by, the individual dual brand units.

Agreements

As noted above, one of the early issues to consider is the overall structure of the arrangement. From that decision flows various results and other issues, such as the number and nature of the agreements, and the parties to the agreements. Many of the operational issues described above raise legal concerns which must be addressed in one or more of the agreements. Some other more purely legal issues which must be dealt with in the agreements are the following:

■ **Exclusivity and encroachment.** First and foremost, the establishment of dual brand outlets must not violate any exclusivity granted to existing single brand outlets of either brand.

Dual brand programs often spawn other agreements. Both companies should ensure that dual brand issues are addressed consistently in them all.

After the territorial issues regarding existing units are resolved, the parties should address the exclusivity or protection granted to the dual brand operators. For example, what is the size of the protected territory (is it the same as, or different than, that granted to single brand operators of the entrant concept)? And, what sort of sales or distribution activities will not occur within the territory of the dual brand outlet?

A further complication may arise with respect to area developers of either the host or entrant franchisor who have preexisting rights to develop single brand units in an area in which dual brand franchises will be established.

A close examination of both systems' contracts before the test period begins should lead to a rational approach to exclusivity when drafting the unit agreements.

■ **Development and ownership of joint or dual branded products.** Franchise systems are not static, and neither are dual branded systems. Franchisors should expect that new product development will be generated by the dual brand franchisees, and possibly the host franchisor (particularly as it tries to integrate the second-brand operations into its own).

The agreement(s) should clearly address which entity will own the new developments, particularly after the expiration or termination of the dual brand program.

■ **Trademark control.** Each franchisor must have the right to review and approve the use of its mark by its franchisees (and, if applicable, subfranchisees).

The agreements will specify these rights, including which entity is responsible for handling and settling litigation, trademark disputes, and infringement actions.

■ **Transfer restrictions.** At the individual unit level, the host franchisor may not want to deal with more than one entity or franchisee. In this case, the dual brand franchise agreements should state that the franchisee cannot sell its business without a contemporaneous sale of the same interests in the host franchised unit to the same purchaser.

Other transfer restrictions may be appropriate in light of the needs of the
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dual brand situation. These may include modifying a right of first refusal in one franchise agreement so it conforms to the other system's franchise agreement, or imposing conditions for a consent to a transfer that are the same under, or at least consistent between, both agreements.

■ **Default and termination.** An issue to be resolved at the outset is whether a default with respect to the operation of one part of the dual brand outlet will be a default under the franchise agreement concerning the other part of the outlet.

In general, to preserve the host system's control over the unit, the dual brand franchise agreement, as well as an amendment to the host system franchise agreement, could specify that while the second or entrant brand franchise may be terminated without terminating the host franchise, the entrant franchise must be terminated if the host franchise is terminated.

Also, the two franchisors must clarify the events that trigger termination, and the post-termination obligations.

■ **Term and renewal.** The term for the second/entrant brand should be no longer than, but may be coterminous with, the term of the host franchise. Also, renewal rights and obligations must be coordinated so that, for example, the operator does not have a right to renew the entrant concept but not the host concept.

■ **Lease issues and lease restrictions.** Before granting a dual brand franchise, the unit operator and the franchisor must remove any restrictions in the lease concerning the operation of the unit (for example, a use restriction permitting only a convenience store, and not permitting a fast food restaurant).

Also, if the entrant's standard franchise agreement provides for the franchisor to take an assignment of the lease upon termination, changes to the agreement or the lease may be necessary to avoid this loss of a premises from the host's system.

■ **Non-competition covenants.** Trade secrets and confidential information are likely to be provided by the entrant franchisor to the host franchisor and to the dual brand franchisee. In some cases, confidential information of the host will be provided to the entrant. Therefore, the parties and the agreements need to specify the appropriate confidentiality obligations and non-competition covenants for both in-term and post-termination situations. These covenants may be imposed on: (a) the dual brand franchisee, (b) the host franchisor, and (c) the entrant franchisor.

Also, if either franchisor is contemplating other dual brand arrangements with other partners, the covenants must be drafted with special clarity to balance the interests that require protection with the interests in expansion.

If the dual branding program spawns numerous agreements (and experience indicates that it often does), it is important for the attorneys and the executives at both companies to assure themselves not only that the array of dual branding issues are addressed, but also that they are addressed in a manner consistent from one agreement to the other.

Disclosure

The offer of dual brand franchises raises a host of franchise disclosure issues.

■ **Who makes and receives disclosure?** An early question is who is to provide, and who is to receive, the UFOC. The entrant franchisor will, in many cases, be required to provide a

UFOC to the host franchisor and to the dual brand franchisees. Depending on the agreements, either one or two UFOCs may be appropriate.

Also, if the host franchisor will be a "subfranchisor" of the dual brand, the host franchisor must provide a UFOC to the dual brand franchisees concerning the entrant's concept. On the other hand, if the host franchisor is a franchise broker, it will need to assure delivery of the entrant franchisor's UFOC to the franchisee.

For offers of dual brand franchise rights to a new franchisee, the franchisee may receive a UFOC from the entrant franchisor, and a UFOC from the host franchisor.

Regardless of the arrangements, both franchisors must cooperate to ensure that a UFOC is accurately prepared, and to coordinate the franchise sale efforts.

■ **What must be disclosed?** Another question concerns what must be disclosed. The answer depends on the various permutations of the dual brand arrangement. A detailed response is beyond the scope of this article, and in any event, the disclosures may be very system-specific.

Nonetheless, a prospective franchisee generally should receive information about:

- ◆ The entrant franchisor and, if applicable, the host subfranchisor;
- ◆ The details of the dual brand franchise;
- ◆ The estimated investment;
- ◆ The impact of the dual brand operations on the host operations; and
- ◆ Rights reserved by the entrant franchisor to open other (single and dual brand) units in any territory granted to the dual brand franchisee.

In short, the franchisor must disclose material information necessary for a prospective franchisee to make

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an informed decision to convert, or start, a dual brand operation.

■ Exemptions, amendments.

Finally, there may be registration and disclosure exemptions, and there may be ways to amend an existing UFOC (that offers single brand franchises) to include the relevant aspects of, and agreement for, dual branding.

Conclusion

Only time will tell whether the concept of dual branding has a permanent place in certain industries and systems. It is likely to fit certain indus-

tries' needs, and not others — and, within a particular industry, to work for some companies, but not others. Where it works, it is apt to be a prime vehicle for growth, and the marketplaces of the future are apt to be full of dual branded operations.

Franchisors who are not yet involved in dual branding should carefully evaluate their system and industry to determine if it should be embraced. Any franchisor already involved, or who gets involved, should carefully evaluate if the arrangements are structured properly, and if adequate documentation exists to protect the company from those hopefully rare — but nevertheless inevitable — situations in which a well-intentioned dual brand relation-

ship unravels.

The complications are sufficiently great, and the possibilities of “doing it wrong” sufficiently likely, that it is not possible to overstate the need for forethought in setting up a dual brand system, including the planning of the business structure, as well as the need for experience and thoroughness in drafting the required and extensive legal documentation. ■

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