DUAL BRANDING:
Legal Structures and Choices
Operational and Other Issues

by

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OPERATIONAL AND OTHER ISSUES

Dual branding - the association of two or more already well recognized trademarks in a synergistic retail setting designed to benefit each - is one of the fastest growing areas in franchising. Numerous systems are learning that they're significantly more effective in presenting their products and services to the public when they do so in association with another brand.

While the business advantages of dual branding are being made more and more clear to Franchisors, some of the mechanics involved in setting up relationships and negotiating deals remain murky for those who haven't been involved in the field. The businesspeople who will be structuring these relationships, or proposing them at the corporate level, need to have a basic understanding of the strategic alternatives available to them and not leave such "details" to the lawyers.

I wanted to use this memo to pass on to you what I've learned, both in the area of general structure and business/legal issues in this area, as well as what some of our clients have learned from an operational and practical standpoint.

Note that much of the discussion is in terms of food service, where dual branding has been most common, but that the same principles apply to many different types of businesses.

The memo is divided into four major sections:

1. A discussion of the business considerations driving dual branding or combination franchising,
2. An overview of the alternative structures that can be used,
3. A review of test programs (almost always used in this area), and
4. Some basic considerations when negotiating dual branding arrangements.

THE BUSINESS BASIS FOR DUAL BRANDING

Dual branding (or combination franchising as it is often called when one or both participants are franchised systems), is simply one example of a broadening trend toward strategic alliances. American business has been following the lead of Japanese and European companies in recognizing the advantages, at the retail level, of **long-term** relationships with strategic partners.[1] Note that by long-term I mean a substantially longer time frame than is typical in American business: In

[1] There has been a 4-fold increase in such alliances at the retail level in the U.S. since 1987. — IFA 1996 Legal Symposium.

Japan, the average term of a strategic alliance is 11 years.

There are 4 primary drivers that explain the increased use of dual-branding, particularly in food service; consumer needs, "Tenant" franchise system[2] needs, "Host" franchise system needs and real estate considerations. After all, **if dual branding doesn't offer significant advantages, at the retail level and with measurable positive financial impact, as demonstrated through a controlled test program prior to roll-out, the deal shouldn't be done**.

CONSUMER NEEDS

Since these factors are obvious and are common to most existing stand-alone food service operations, we can cover them quickly. Consumers face reduced time, need for increased convenience, want a wide series of food product choices without extensive searching for an outlet, will trigger purchases based on recognized brand identity but want separate presentation of each concept for enhanced recognition and reduced confusion.

Dual branding, presenting more than one food product line in close association, can answer each of these needs.

TENANT FRANCHISE SYSTEM NEEDS

From the standpoint of the Tenant system, dual branding offers opportunities to reach additional distribution points (and thereby build revenues) without the investment involved in independent operations, generating improved per unit volume (especially where additional outlets can be supplied from existing units) and return-on-investment. Perhaps more important, the additional outlets may offer entry into day-parts or other market segments currently under-accessed.

HOST FRANCHISE SYSTEM NEEDS

For the Host franchise system, similar benefits can result, including drawing in customers who would not normally visit the unit, who would not normally visit during a particular day-part or who may buy products not normally sold in such increased volume. For example, C-stores at gas stations (with a male-heavy customer base and a disproportionate volume of sales in beer and cigarettes), which have added a wider range of product, have observed a changed customer profile *i.e.* increased visitation by women and children and improved sales of bread, milk and similar items, without reductions in volume of their existing product lines.

In addition, the "halo" effect of increased sales of the Host's core product line can result from the customers who are drawn in by the Tenant's products.

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[2] A bit of terminology: the "Host" system is the system in which the other system's units will be operated. The system which is operated within the Host units is the "Tenant" system. If a Dunkin' Donuts is operated inside a Subway, Dunkin' Donuts is the Tenant system and Subway is the Host.

Obviously, a Host system will need to see incremental sales increases (or significant benefits from cost-sharing) to justify moving into or beyond a test agreement.

On the other hand, issues of compatibility and possible "cannibalization" of sales must be faced by both systems, and are of particular concern to the Host, especially if the Host unit is franchised.

From the Tenant's standpoint, issues of speed of service and customer service and satisfaction levels will have to be studied and resolved. Do operations at a "Host" facility, possibly using the Host's personnel, raise any questions of cross-training, personnel qualifications, customer access, etc.? In addition, possible problems can arise in areas of product or supplier exclusivity (who supplies the coffee and what happens if one chain has a relationship with Pepsi and the other with Coke?)

REAL ESTATE CONSIDERATIONS

Real estate matters can be a primary driver in many dual franchising operations. Limited availability of AAA locations may be solved through an alliance with a partner holding attractive properties. While dual branding operations may not generate the volume levels of stand-alone units, the reduced costs (and the fact that such units might never have been placed in operation without dual branding), can yield improved profits for Franchisees, as well as the Host and Tenant systems.

Obviously, the maturing marketplace in foodservice is characterized by increased competition, narrowing margins (at least in some segments) and a diminished availability of top-quality sites.

Dual branding can, in the best of circumstances, address each of these business realities, allowing superior strategic positioning, heightened visibility to the consumer and reduced cost factors. Operation at a single site, whether through two separate but side-by-side facilities, two distinct areas (and cash registers) within a single facility or the sales of branded products as an additional product line at existing (otherwise unchanged) units may provide some or all of the business benefits identified above.

Alternative marketing venues can include complimentary brands in similar sized and presented units, operation of food service units within convenience and other stores (as well as gas stations) and outlets in hotels, motels, institutional settings, etc., either in an "Express" format or as near to full sized units. In each case, the hope is for a synergistic reaction in which each brand receives the benefits of increased revenues, reduced per unit costs or both.

Beyond the search for new sites and means of presenting a product to the consumer, dual branding can (at least in theory) allow a chain to add additional product without the time and investment normally necessary. Higher combined volumes and shared costs can result in improved levels of return on investment.

Properly presented to an existing franchise system (particularly in saturated markets), the possibility of additional outlets made available through dual branding can allow growth within the system, rather than making the best operators look elsewhere for new places to invest their assets and energies.

Additionally, association with an existing brand name piggy-backs the existing recognition factor of one brand onto the operations of another. Obviously, the time and investment necessary to achieve equivalent brand recognition similar to that of the partner may make any alternative other than dual branding unattractive.

At the same time, dual branding is no panacea. The choice of one or more strategic partners, as well as the actual implementation of the dual branded concept, including designing the appropriate mix of products, operating systems and personnel (including specialized training) are vital to realizing the benefits that can flow from dual branding. [Note that, from a legal standpoint, nothing prevents a company from undertaking dual branding with more than one partner.]

This type of analysis (a full review of each of the supposed business bases for the proposed dual branding operation) needs to be applied on three levels: First of all, internally, so that your company is clear about precisely what it wants to achieve. Second, in negotiations with the proposed strategic partner, to discover what they want to achieve and to determine if that's consistent with your goals. Third, during the test period, to evaluate if the original aims are being achieved or if unintended (and perhaps unacknowledged) "mission shift" has occurred, leading to non-achievement of the original goals that justified the project.

STRUCTURAL ALTERNATIVES

Assuming that business considerations justify dual branding, what alternative structures and venues exist?

Three main approaches to the structure of a dual branding operation are available:

1. Master Franchising,

2. Direct Franchising of Host Company-Owned Units and Host Franchisees and

3. Existing or New Tenant Franchisees Placed in of Host Company-Owned or Franchised Units.

MASTER FRANCHISING

In this model, the Tenant grants a master franchise to the Host, who (in turn) issues subfranchises to its Host Franchisees (on a selected basis.) The Host acts, in effect, as the franchisor for each of these subfranchised units, identifying potential franchisees, selling franchises, supplying services to the franchisees and collecting initial franchise fees and royalties. A portion of fees collected are remitted to the Tenant franchise system.

Three major downsides are present with this approach:

First, the Host presumably knows less about the Tenant business than the Tenant, yet it is the one selecting franchisees and locations, delivering services, maintaining system standards, dealing with suppliers, administering assignments and terminations, etc. Clearly, this violates the basic management principle of linking responsibility with demonstrated competence.

Second, the Host (acting as a subfranchisor) will need to be compensated for its services and typically will demand a significant portion of the revenue stream generated by the Tenant operation. This simply may leave too little on the table for the Tenant franchisor to justify doing the deal.

Third, the Tenant franchise system will have lost control of a portion of its operating units, those involved in the dual branding operation. For Franchisors that value system standards and the goodwill associated with their trademark, this alone may make the subfranchising approach unacceptable.

[For example, will the Host Franchisor be willing to terminate a franchisee who is failing to uphold Tenant system standards but is generating significant royalty and product purchase income in the Host's main business lines? Creating a relationship with such inherent potential conflicts of interest seems unwise.]

DIRECT FRANCHISING OF HOST COMPANY-OWNED UNITS AND HOST FRANCHISEES

This approach is perhaps the simplest, at least from a structural and legal standpoint. The Tenant Franchisor awards one or both of the following: (1) franchises to the Host Franchisor to operate Tenant units at Host company-owned locations and/or (2) franchises to Host Franchisees to operate Tenant units at Host Franchisee-owned locations.

Control is maximized in this model and the operation of the Tenant-franchised units is supervised by the Tenant, the organization with the most knowledge and experience in the business. Training and system standard enforcement are enhanced and the Tenant maintains control over Franchisee selection, development of units, supply of product, assistance to Franchisees, marketing and advertising, relocations and renewals.

Tenant system revenue is enhanced, as there is no fee splitting (or, at worst, a reduced level of fee splitting) with the Host system. In addition, as a direct supplier to the Tenant Franchisees, enhanced revenue opportunities exist for the Tenant/Franchisor.

EXISTING OR NEW TENANT FRANCHISEES PLACED IN HOST COMPANY-OWNED OR FRANCHISED UNITS

Here, the Host system allows the Tenant to franchise units in Host facilities to persons other than Host Franchisees. For example, Dunkin' Donuts Franchisees (existing or new) would be placed in Subway or other units and such Franchisees would not have any franchise relationship with Subway, but a sublease relationship may be present. The Tenant Franchisee would normally be placed in a Host company-owned unit, although placement in a Host franchised unit is conceivable.

A primary factor driving this approach is a judgment that current Host managers or Franchisees are not the appropriate persons to be operating Tenant units, even with training or other support.

This approach is usually less appealing to the Host system, since it introduces a third party to the relationship and generates fears of loss of control on the part of the Host system. In addition, since the Host typically derives no direct revenue in this arrangement (other than possible sublease revenues including percentage rent), the Host would have to be strongly convinced of the likelihood of a significant halo effect on its sales to enter into the relationship with a third party.

Additionally, a series of issues would have to be resolved in this type of system. For example, who controls Franchisee selection, who determines supply relationships, is the Host involved in system standard compliance, will the Tenant system indemnify the Host regarding the errors of the Tenant Franchisee, how will common advertising be funded, who controls renewals, etc.? Although some of these issues also exist in direct franchising of Host Franchisees by the Tenant, the fact that the Tenant Franchisee is also a Host Franchisee makes their negotiation and resolution much easier than where the Tenant Franchisee has no other relationship with the Host.[3]

Real legal problems can exist where the proposed Host unit is franchised, since the Host Franchisee probably has no legal obligation to take on a Tenant operation and is unlikely to consent without a clear view of how it will improve his/her bottom line. Any suggestion by the Host Franchisor may be met by skepticism (if not suspicion) and 100% system acceptance is unlikely, with follow-on problems for marketing programs, etc.

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[3] Note that many of these problems may be less severe where the Host facilities are simply serving as a **branded product outlet** for the Tenant, with the relationship terminable by either party on 30 days notice and no significant investments have been made. On the other hand, since there is no long-term marriage, the possibility of losing units, particularly Host franchised units, as distribution points is materially higher.

TEST PROGRAMS

As noted above, it would be a bold Franchisor who would not thoroughly test a proposed dual brand or combination franchising operation before introducing it on a system-wise basis. In fact, this may be the point where operational execution is, if not everything, certainly the primary determinant of later success for the concept.

During the test, not only will operational and marketing issues be worked out, but questions of "corporate culture" and how to establish a productive working relationship between all levels of management of the two systems must be faced and resolved. In fact, **the greatest threat to the possibility of successful dual branding is probably the failure to establish the right type of relationship between the two systems**.

The primary purpose of the test program is to clearly determine whether increased sales and/or reduced costs are, in fact, generated by the combined operations. A secondary purpose is to decide if equipment, labor, accounting systems, etc. are compatible and, if they are not, to determine where appropriate adjustments should be made. The parties will need to develop and refine operating procedures, operations manuals and training programs specific to the combined operation. Where possible, test programs should probably be conducted at company-owned units to maximize control, confidentiality and the flexibility to implement "mid-course corrections."

Issues which will need to be negotiated in connection with the test agreement include, at a minimum, the following:

1. Duration of the test. Can the test be terminated early by either party in its sole discretion or only if certain standards aren't achieved? Who bears what costs (equipment removal, recovery of capitalized costs, etc.) in the case of termination?

2. Number and location of test units. A variety of markets and locations should probably be tested, both for comparison purposes and to prevent "surprises" on later system-wide roll-out.

3. Allocation of costs, including equipment, construction, fixtures, signage, operating materials and supplies, operating personnel, insurance, advertising, etc. Most of these costs are normally absorbed by the owner of the Host unit if it is the operator of the Tenant facility, as is usually .

4. Development of Tenant facilities in the Host unit (similar to above), including management control and supervisory responsibility or joint control/approval.

5. The Tenant "menu" in the Host facility. Space or equipment limitations and possible conflicts with the Host menu must be resolved.

6. Operating personnel. Who operates the Tenant portion of the unit? Can

one manager handle both business effectively? One possible way of organizing the test is for the Host manager to have responsibility for management of the Tenant part of the business, but during the test for a Tenant employee to be in-store to assist in training, resolution of problems and observe results. At the same time, it's probably wise to ultimately have "one captain for the ship."

7. Exclusivity during the test period. Will either the Host or the Tenant agree to not enter into similar relationships with others, competitive or otherwise, during the test period? Will each agree to not sell any products on the other's "menu" during the test period?

8. Confidentiality, possibly on a "need-to-know" basis.

9. Insurance and indemnities.

10. Public relations, marketing and advertising. Joint press releases will probably be required and the parties will have to determine if they have the legal right to use ad fund monies to finance marketing for joint units.

11. Monitoring and inspection by the Tenant and Host. Can the Tenant require changes in the operation of the Tenant unit without clearance by the Host?

12. Termination before expiration of the test period. While termination on notice should be allowed, will early termination trigger a payment to the party who made the investment in the Tenant facility?

13. Commitment to roll-out. Normally there will be no binding commitment by either party, leaving this decision to their final, subjective analysis.

14. Obligations after termination/expiration. The Tenant will usually have the option (or obligation) to remove its items and purchase them (if the Host paid for them) at a reduced, depreciated value, possibly financed over a period of time. Continued confidentiality should also be provided for. A time- and area-limited non-compete (or agreement not to deal with a competitor) may also be agreed to.

15. Dispute resolution procedures, both informal (discussions and mediation) and formal (arbitration).

NEGOTIATING CONSIDERATIONS

Given the length this memo has already reached, I'll save for a later time any discussion of the negotiating points related to an actual operating agreement between the Host and Tenant systems. However, a few key items should be focused on at this time.

There is a danger, in some combined operations, of the Host offering the Tenant's products at a reduced (or even loss-leader) price level. If the Host views the Tenant's product line as a less significant contributor to the bottom line and only as “bait” to get customers into his/her Host store and is the Tenant Franchisee, low pricing may be used by the Host to generate traffic **while materially reducing the royalties to be paid to the Tenant system.** This should be addressed (since even an informal price-fixing agreement is illegal) by a minimum royalty provision, possibly combining a weekly (or monthly) minimum overall royalty with a minimum per unit (*e.g.* dozen donuts) royalty.

Clear decisions need to be made up-front regarding structural/operational issues, such as who provides support, services and supplies, who enforces system standards, how is advertising funded, how are expiration, transfer and renewal of two franchises handled (assuming the Tenant Franchisee is also a Franchisee of the Host), who can terminate the Franchisee and on what grounds, etc.? Similarly, appropriate changes to each franchise system’s Franchise Agreements and UFOC will need to be made, with possible addenda for existing Franchisees.

Finally, an exist strategy needs to be formulated (as partly discussed above), since, by definition, not every test is successfully passed!