REGULATORY UPDATE: RECENT CHANGES AND HOT ISSUES

Peggy D. Shanks, Senior Franchise Examiner
Maryland Office of Attorney General
Securities Division
Baltimore, Maryland

Timothy O’Brien, Chief Examiner
Virginia Division of Securities & Retail Franchising
Richmond, Virginia

Michelle Webster, Financial Legal Examiner
Washington Department of Financial Institutions
Securities Division
Tumwater, Washington

Warren Lee Lewis, Partner
Akerman LLP
Washington, DC

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I. INTRODUCTION

In the United States, the regulatory framework for disclosure and registration in franchising begins, at the top, with the Disclosure Requirements and Prohibitions Concerning Franchising issued by the Federal Trade Commission ("FTC"), known as "the FTC Rule." Other FTC authorities clarify and interpret the FTC Rule, including: the FTC Statement of Basis and Purpose (2007); the FTC Compliance Guide (2008); FAQs published on the FTC's website ("FTC Rule FAQs"); informal FTC Staff Advisory Opinions issued under the FTC Rule; the original 1978 FTC Statement of Basis and Purpose; and informal FTC Staff Advisory Opinions issued under the original 1978 FTC Rule.

The regulatory framework then encompasses guidelines and commentaries issued by the North American Securities Administrators Association, Inc. ("NASAA"), and state laws,
regulations and state franchise examiner ("examiner") enforcement.

The NASAA guidelines and commentaries include: the NASAA Franchise Guidelines (2008);11 the NASAA Franchise Commentary on the NASAA Franchise Guidelines ("NASAA Franchise Commentary") (2009);12 the NASAA Multi-Unit Commentary (2014);13 the NASAA Financial Performance Representation Commentary ("NASAA FPR Commentary") (2017);14 and proposed state cover page changes released by NASAA for public comment on June 12, 2018.15

States with laws and regulations on disclosure and registration in franchising include: 10 states with franchise disclosure and registration laws;16 1 state with a franchise disclosure law;17 9 states with franchise or business opportunity disclosure and notice laws that apply to all franchisors;18 and 6 states with business opportunity disclosure and registration, notice or filing laws that apply to franchisors without registered trademarks.19 Examiner enforcement is greatest

notice states, generally require compliance with NASAA guidelines and commentaries. Some states formally adopt the NASAA guidelines and commentaries, and some do not.

12 CCH Business Franchise Guide ¶ 5706.
17 Oregon Franchise Transactions Law, OR. REV. STAT., TIT. 50 §650.005 et seq.
18 Florida Sale of Business Opportunities Act, Fla. Stat. § 559.80 et seq.; Indiana Franchises Law, IND. CODE, TIT. 23 ART. 2, CHAP. 2.5 § 0.5 et seq.; Kentucky Sale of Business Opportunities Law, KY. REV. STAT. ANN. § 367.801 et seq.; Michigan Franchise Investment Law, MICH. COMP. LAWS § 445.1501 et seq.; Nebraska Seller-Assisted Marketing Plan Act, NEB. REV. STAT. § 59-1701 et seq.; South Dakota Franchise Investment Law, S.D. CODIFIED LAWS § 37-B5-1 et seq.; Texas Business Opportunity Act, TEX. CODE ANN. § 51.001 et seq.; Utah Business Opportunity Disclosure Act, UTAH CODE ANN. § 13-15-1 et seq.; and Wisconsin Franchise Investment Law, WIS. STAT. § 553.01 et seq. A notice law may require a franchisor to submit just a notice to the state, or a notice and a copy of the franchisor’s FDD to the state. However, except in South Dakota, the state normally does not review or approve the franchisor’s FDD.
in the 10 states with the franchise registration laws, but there is some examiner enforcement in the states with other laws.

This paper focuses on recent changes and hot issues in the regulatory framework. In particular, it summarizes: NASAA’s recently proposed state cover page changes; current examiner enforcement of the NASAA FPR Commentary, NASAA Multi-Unit Commentary, risk factors and financial statement requirements; the increasing impact of technology on disclosure and registration; and current hot disclosure and registration issues.

II. NASAA PROPOSED STATE COVER PAGE CHANGES

A. FTC, NASAA and Registration State Cover Page Requirements

The FTC Rule specifies the format and content of a franchisor’s Franchise Disclosure Document (“FDD”), but does not preclude the issuance of guidelines and commentaries by NASAA, and does not preempt state disclosure and registration requirements that are equally or more protective of prospective franchisees than the FTC Rule.

The FTC Rule requires a franchisor’s FDD to begin with an FTC cover page. Under the FTC Rule and 2008 Compliance Guide, the FTC cover page must contain, in the following order:

- “FRANCHISE DISCLOSURE DOCUMENT” at the top
- the franchisor’s principal trademark and contact information
- brief description of the franchised business
- total investment amount, and total amount that must be paid to the franchisor and its affiliates

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20 The FTC Rule, supra note 3, §§ 436.3-436.5, 436.7.

21 The 2007 Statement of Basis and Purpose specifically acknowledges that the FTC Rule does “not preclude consideration of any new or revised UFOC Guidelines promulgated by the states.” 72 FR 15448 n.46, 15537 n.949.

22 The FTC Rule, supra note 3, 436.10(b). The 2007 Statement of Basis and Purpose explicitly recognizes the states’ rights to require additional disclosures. For example, footnote 295 states: “As discussed below, the final amended Rule does not preempt state laws that afford greater or equal protection to prospective franchisees. Indeed, states enjoy great latitude in fashioning franchise disclosure laws, including how and when state specific information is to be included in FDDs. Therefore, franchisors must be permitted to add to an FTC disclosure document in order to comply with non-preempted state law.” 72 FR 15473 n.295. Similarly, footnote 949 states: “Examples of state and local laws not preempted by the original or amended Rule include registration of franchisors and franchise salespersons, escrow or bonding requirements, substantive regulation of the franchisor-franchisee relationship (e.g., termination practices, contract provisions, and financing arrangements), and disclosure laws requiring more extensive disclosures than those provided by the amended Rule.” 72 FR 15537 n.949.

23 The FTC Rule, supra note 3, § 436.3.
• this disclosure: “The total investment necessary to begin operation of a [franchise name] franchised business is [total in Item 7]. This includes [total in Item 5] that must be paid to franchisor [or, and] its affiliate[s].”

• this disclosure: “This disclosure document summarizes certain provisions of your franchise agreement and other information in plain English. Read this disclosure document and all accompanying agreements carefully. You must receive this disclosure document at least 14 calendar days before you sign a binding agreement with, or make any payment to, franchisor or an affiliate in connection with the proposed franchise sale. **Note, however, that no government agency has verified the information contained in this document.”

• this disclosure, if applicable: “You may wish to receive your disclosure document in another format that is more convenient for you. To discuss the availability of disclosures in different formats, contact [name or office] at [email address, business address, or both] and [telephone number].”

• these disclosures: “The terms of your contract will govern your franchise relationship. Don’t rely on the disclosure document alone to understand your contract. Read all of your contract carefully. Show your contract and this disclosure document to an advisor, like a lawyer or an accountant.”

“Buying a franchise is a complex investment. The information in this disclosure document can help you make up your mind. More information on franchising, such as “A Consumer’s Guide to Buying a Franchise,” which can help you understand how to use this disclosure document, is available from the Federal Trade Commission. You can contact the FTC at 1-877-FTC-HELP or by writing to the FTC at 600 Pennsylvania Avenue, NW, Washington, DC 20580. You can also visit the FTC’s home page at www.ftc.gov for additional information. Call your state agency or visit your public library for other sources of information on franchising.”

“There may also be laws on franchising in your state. Ask your state agencies about them.”

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24 The FTC Rule, supra note 3, 436.3. Under the NASAA Franchise Commentary, the amounts on the FTC cover page must conform to the total amounts in Items 5 and 7 (Commentary 0.2), and clarifying information may not be added (Commentary 0.1), but a franchisor may make separate disclosures for different concepts offered in the FDD (Id.). CCH Business Franchise Guide ¶ 5706.


- the issuance date of the FDD

For any FDD filed with a registration state, the NASAA Franchise Guidelines require a state cover page to be included immediately after the FTC cover page. The state cover page must contain, in the following order:

- “STATE COVER PAGE” at the top

- these disclosures: “Your state may have a franchise law that requires a franchisor to register or file with a state franchise administrator before offering or selling in your state. REGISTRATION OF A FRANCHISE BY A STATE DOES NOT MEAN THAT THE STATE RECOMMENDS THE FRANCHISE OR HAS VERIFIED THE INFORMATION IN THIS DISCLOSURE DOCUMENT.”

“Call the state franchise administrator listed in Exhibit ___ for information about the franchisor, or about franchising in your state.”

- (renewal) a capitalized disclosure that the franchise agreement may not allow the franchisee to renew unconditionally after the initial term expires, and may require the franchisee to sign a new agreement with different terms and conditions

- (out-of-state dispute resolution proceedings) a capitalized risk factor if the franchise agreement requires out-of-state mediation, arbitration or litigation

- (governing law) a capitalized risk factor if the franchise agreement specifies that the law of another state applies (typically the law of the franchisor’s state)

- (other risks) if 1 or both of the other risk factors apply, a capitalized risk factor stating that there may be other risks concerning the franchise

- this disclosure, if applicable: “We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise.”

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27 Under the 2008 Compliance Guide, a franchisor obtaining an effective date for a FDD from a registration state may use the term “effective date” on the FTC cover page, even in non-registration states. www.ftc.gov/tips-advice/business-center/guidance/franchise-rule-compliance-guide, p. 26; CCH Business Franchise Guide ¶ 6086. As a practical matter, most franchisors use “issuance date” on the FTC cover page and, later in their FDDs, disclose the multiple “effective dates” obtained from registration states.


29 Examiners may require, and often do require, additional risk factors. Any risk factor required by an examiner may be included in, but is not required to be included in, a FDD used by a franchisor in other states. CCH Business Franchise Guide ¶ 5706 (Commentary 0.3).
B. **Proposed State Cover Page Changes**

There has been a perception among examiners – and there is at least anecdotal evidence – that many prospective franchisees do not know how to use a FDD or understand the risks involved in investing in a franchise. The currently-required state cover page does not help in this regard, but rather focuses on legal issues (renewal, dispute resolution, governing law), instead of business issues. This can be argued to be a weakness of the state cover page.

Accordingly, on June 12, 2018, the Franchise and Business Opportunity Project Group of NASAA (“NASAA’s Project Group”) sought public comment on a proposal to change the state cover page and any immediately following state effective dates page, to three state cover pages and a state effective dates page near the end of the FDD, with the headings:

- **How to Use This Franchise Disclosure Document** on the first state cover page
- **What You Need to Know About Franchising Generally and Some States Require Registration** on the second state cover page
- **Special Risks to Consider About This Franchise** on the third cover page
- **State Effective Dates** on a page immediately before the FDD receipt pages

The proposal would effectuate these changes by replacing the State Cover Page instructions and Form G in the NASAA Franchise Guidelines.

Comments on the proposal were required to be submitted to NASAA’s Project Group by July 13, 2018.

Under the proposal, the page with the **How to Use This Franchise Disclosure Document** heading would contain the following business-focused questions and short instructions on how to find information in the FDD relevant to each question:

- **How much will I earn?**
- **How much will I need to invest?**
- **Does the franchisor have the financial ability to support my business?**

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30 The effective date must be approved by a registration state. As a practical matter, since most franchisors register in multiple states and obtain multiple effective dates, most franchisors list the multiple effective dates on a separate page immediately following the state cover page, rather than trying to include them on the state cover page. Either approach is permitted. http://www.nasaa.org/wp-content/uploads/2011/07/2-2008UFOC.pdf, Section III.B.7; CCH Business Franchise Guide ¶ 5705.

• Is the franchise system stable and growing or shrinking?

• Will my business be the only [XYZ] business in my market?

• Does the franchisor have a troubled legal history?

• What's it like to be [an XYZ] franchisee?

• What else should I know?

NASAA’s Project Group believes that these are “top-of-mind” questions for a typical prospective franchisee, and that giving guidance on where to find information in the FDD relevant to the questions will be helpful.

Under the proposal, the page with the What You Need to Know About Franchising Generally and Some States Require Registration headings would highlight the following five “facts” about franchising generally:

• The franchisee may have to pay royalties and other fees even if the franchised business is losing money.

• The franchisee may be required to make additional investments if the franchisor changes its manuals and business model.

• The franchisee may be prohibited from operating a similar business during and after the term of the franchise.

• The franchisee may not be able to renew, or may have to renew on different terms and conditions.

• The franchisee may be required to buy or lease items from the franchisor or suppliers designated by the franchisor.

The page then would state that the franchisee’s state may have a franchise law requiring the franchisor to register, or laws that require special disclosures or special amendments to the franchise agreement. NASAA’s Project Group believes that the five “facts” referenced above apply to nearly all franchises, and should be highlighted for a prospective franchisee.

Under the proposal, the page with the Special Risks to Consider About This Franchise heading would contain a risk factor about out-of-state dispute resolution (if applicable), and any other standard general risk factors required by examiners. The page also would include a reference (if applicable) to later state specific addenda pages in the FDD that might contain additional risk factors that are state-specific, that are required by only one state, or that are differently worded from standard general risk factors. All risk factors would be required to be preceded by bold and underlined summaries (e.g., Out-of-State Dispute Resolution), and would be in regular text, rather than ALL CAPS text, to make them easier to understand and read.

The proposal would permit state specific pages required by states with franchise laws, such as Hawaii and Michigan, to be included between the three cover pages specified above and Item 1 of an FDD, but would not permit state specific pages required by states with business
opportunity laws, such as Ohio, to be included there. State specific pages required by states with business opportunity laws would be required to be included with other state addenda later in an FDD.

Finally, under the proposal, the page with the State Effective Dates heading would be moved to the back of the FDD, immediately before the FDD receipt pages. While many franchisors currently reference effective dates from registration states and all notice states, and specify states and territories where their FDDs may and may not be used, on their state effective dates pages, the proposal would permit the disclosure of effective dates for registration and notice states with franchise laws, but would not permit the disclosure of effective dates for notice states with business opportunity laws, or the names of non-registration states or territories. The NASAA Project Group is not expected to change this aspect of the proposal, which will require many franchisors to abbreviate their state effective dates pages.

In July, only 9 formal comments were submitted to NASAA’s Project Group on the proposal. The comments were generally favorable, and for the most part focused on suggested word improvements. After NASAA’s Project Group has finished reviewing the comments, further public comment may be sought on the proposal. After any additional comment and review period, assuming the proposal is finalized, which looks likely, it will be presented to NASAA’s Board of Directors for approval before being implemented, perhaps, in 2019.

III. NASAA FPR COMMENTARY

A. FTC, NASAA and Registration State Requirements

The FTC Rule defines a financial performance representation (“FPR”) as:

[A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.\(^{32}\)

With two exceptions,\(^{33}\) the FTC Rule prohibits a franchisor from providing an FPR to a prospective franchisee unless the FPR is included in Item 19 of the franchisor’s FDD.\(^{34}\) The FTC Rule, supra note 3, § 436.9(c).

\(^{32}\) The FTC Rule, supra note 3, § 436.1(e). The NASAA Franchise Guidelines, supra note 11, at 29, contain the same definition. Under the FTC Rule, a franchisor may provide “cost information alone” to a prospective franchisee, even if that information is not in Item 19 of the franchisor’s FDD or supported by information in the FDD. This is because the definition of an FPR in the FTC Rule does not cover a representation giving only a specific level or range of actual or potential costs. FTC Statement of Basis and Purpose, 72 Fed. Reg. 15,444 at 15,457. The “cost information alone” may not be stated as a percentage of revenues or income (such as “cost of goods equals 25% of gross revenues”) unless that information is in Item 19 as part of an FPR. Instead, only “raw” cost information may be given.

\(^{33}\) If a franchisor seeks to provide an FPR limited solely to the actual operating results of an outlet being offered for sale, the FPR is not required to be incorporated into Item 19 of the franchisor’s FDD, if the FPR is provided only to a potential purchaser of the outlet. Or, if a franchisor has already included an FPR in Item 19 of its FDD, the franchisor may provide a “supplemental” FPR to a prospective franchisee a “supplemental” FPR directed to a particular location or circumstance. The “supplemental” FPR must be in writing, must explain the departure from the FPR in the FDD, and must be left with the prospective franchisee. The FTC Rule, supra note 3, § 436.5(s)(5).

\(^{34}\) The FTC Rule, supra note 3, § 436.9(c).
Rule requires an FPR to have a “reasonable basis”\textsuperscript{35} at the time it is made. Any Item 19 containing an FPR must: describe the factual basis of the FPR, and any material assumptions, other than matters of common knowledge, underlying the FPR; state whether the FPR is based on the actual experience of outlets and, if so, the percentage of outlets in operation for the period covered by the FPR that have attained or surpassed the stated results; contain a statement that substantiation of the data used in preparing the FPR will be made available to a prospective franchisee on reasonable request; and contain a conspicuous admonition that a new franchisee’s financial results are likely to differ from the results stated in the FPR.\textsuperscript{36}

On May 7, 2017, NASAA adopted the NASAA FPR Commentary, which became effective, for a franchisor, the later of 180 days after adoption or 120 days after the franchisor’s next fiscal year end, if it had an effective FDD when the NASAA FPR Commentary was adopted.\textsuperscript{37}

The NASAA FPR Commentary addresses disclosure issues relating to FPRs in Item 19 of a franchisor’s FDD. It gives definitions for terms such as “average,” “company-owned outlet,” “gross profit,” “median,” and “net profit.” It re-publishes three commentary items in the NASAA Franchise Guidelines. And it contains 20 new commentary items, with four items focusing on FPRs generally, four items focusing on the use of data from company-owned outlets, four items focusing on the use of subsets, three items focusing on the use of averages and medians, two items focusing on the use of forecasts, and three items focusing on the use of disclaimers.

For most franchisors – those with December 31 fiscal year ends that had effective FDDs on May 7, 2017 – the NASAA FPR Commentary became effective on April 30, 2018. Therefore, examiners were required to review numerous revised FPRs this year, in order to determine if they complied with the NASAA FPR Commentary. Those reviews focused on certain key issues discussed below, namely the use of: improper language and disclaimers; data from franchised, company-owned and affiliate-owned outlets; data from subsets or outlets; averages, medians, highs and lows; projections; disclosures about outlets that closed, or that both opened and closed, within the FPR reporting period.

B. Registration State Implementation of NASAA FPR Commentary

1. Improper Language and Disclaimers

Under the FTC Rule, an Item 19 with an FPR must begin with the following paragraph, with no language or punctuation changes:

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19

\textsuperscript{35} The franchisor has the burden of proving the “reasonable basis” for any FPR. Neither the FTC Rule nor the NASAA Franchise Guidelines defines “reasonable basis.” The FTC Rule, supra note 3, § 436.1(e); NASAA Franchise Guidelines, supra note 11, at 29.

\textsuperscript{36} The FTC Rule, supra note 3, § 436.5(s).

\textsuperscript{37} NASAA FPR Commentary, supra note 14.
may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.  

The FTC Rule permits the following paragraph to be included at the end of an Item 19 with an FPR, with no language or punctuation changes:

Other than the preceding financial performance representation, [name of franchisor] does not make any financial performance representations. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor’s management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

The language in these paragraphs may not be limited, and no additional disclaimer-type statements may be made by a franchisor in Item 19. In reviewing FPRs this year, examiners found modifications and re-punctuations of these paragraphs that they required franchisors to correct.

The FTC Rule states that an Item 19 with an FPR must include “a conspicuous admonition that a new franchisee’s individual financial results may differ from the result stated in the financial performance representation.” The NASAA Franchise Commentary addresses the question of what constitutes an appropriate clear and conspicuous admonition. For an historical representation, the admonition should be, in bold:

Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.

For a projection, the admonition should be, in bold:

These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.

38 The FTC Rule, supra note 3, § 436.5(s)(i); FTC Rule FAQs, supra note 6, FAQ 27. Since the amendment of the FTC Rule in [2007] requiring this introductory paragraph, the percentage of FDDs containing FPRs filed with registration states has steadily increased. In 2018, most FDDs filed with Maryland contained FPRs.

39 FTC Rule FAQs, supra note 6, FAQ 27.

40 FTC Compliance Guide, supra note 5, at 86.

41 The FTC Rule, supra note 3, § 436.5(s)(3)(iv).

42 NASAA Franchise Commentary, supra note 12, § 19.3.

43 Id.
The NASAA Franchise Commentary provides, further, that: “In either case, franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented.”

In reviewing FPRs this year, examiners sometimes found the above-referenced admonition to be missing, or to be fully or partially mis-worded. For example, the following mis-wordings were required to be corrected:

Importantly, you should not consider the Annual Gross Sales presented above to be the actual potential sales or gross profit that you will realize. We do not represent that you can or will attain these sales or gross profits, or any particular level of sales. We do not represent that you will generate income that exceeds the initial payment of, or investment in, the franchise.

You should not use this information as an indication of how well your franchise will do. A number of factors will affect the success of your franchise. These factors include the current market conditions, the type of market in your franchise area, the location of your franchise area, the competition and your ability to operate the franchise.

The information presented in this Item 19 is not a reliable basis for estimating or projecting actual, probable or possible financial results for any store to be operated by you.

If you rely on our figures, you must accept the significant risk of not doing as well.

You are likely to achieve results that are different, possibly significantly and adversely, from the results shown above.

The correct placement of the admonition, according to most examiners, is after the body of the FPR and before the last paragraph permitted by the FTC Rule.

2. **Franchised and Company-Owned Outlets**

The FTC Rule expressly allows a franchisor to make an FPR based on data for franchised and company-owned outlets within the same franchise system.

The NASAA FPR Commentary is very specific about how data for franchised and company-owned outlets in the same franchise system may be used in an FPR. For example:

- if a franchisor has franchised outlets, an FPR may not be based on company-owned outlet gross sales data alone

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44 Id.

45 The FTC Rule, *supra* note 3, § 436.5(s)(1). Company-owned outlets generally are understood to include outlets owned both directly by the franchisor and indirectly by the franchisor’s affiliates.

• if a franchisor has no franchised outlets, an FPR may be based on company-owned outlet sales data, so long as the franchisor discloses the financial and operational characteristics of the company-owned outlets that are reasonably anticipated to differ from the characteristics of franchised outlets.\textsuperscript{47}

• whether or not a franchisor has franchised outlets, an FPR may disclose company-owned outlet gross or net profit data, so long as the franchisor discloses franchised outlet gross sales data (if any), company-owned outlet actual costs, and actual and reasonably expected financial and operational differences between company-owned outlets and franchised outlets.\textsuperscript{48}

• an FPR may not merge the data for company-owned and franchised outlets, unless the data has already been disclosed separately in the FPR, or unless the franchisor has a small number of franchised outlets.\textsuperscript{49}

Examiners reviewing FPRs this year found that most complied with the NASAA FPR Commentary requirements on these issues, although some FPRs were non-compliant.

3. **Outlets Operating Under Different Brand**

Beyond the issue of the use of data for franchised and company-owned outlets in the same franchise system in an FPR, there is the issue of whether data for affiliate-owned outlets operating under a different brand may be used in an FPR.

The FTC Rule itself does not expressly permit a franchisor to include data for outlets operating under a different brand in an FPR. However, the FTC staff has indicated that the FTC Rule does allow a franchisor to use such data in limited circumstances - specifically, when the franchisor lacks adequate performance data for outlets in its own franchise system.\textsuperscript{50}

Addressing the use of data for outlets operating under a different brand, the FTC Staff, in FTC FAQ 8, citing the old NASAA UFOC Guidelines (1993), stated:

All financial performance representations must have a “reasonable basis.” When a franchisor has adequate performance data of its own upon which to base a performance representation, basing a financial performance representation on affiliate information likely would not be “reasonable.” Nevertheless, in limited circumstances, a franchisor may base a financial performance claim upon the results of operations of the substantially similar business of an affiliate.

The NASAA FPR Commentary, on the other hand, does not expressly or impliedly permit

\textsuperscript{47} Id. § 19.9.

\textsuperscript{48} Id. § 19.10.

\textsuperscript{49} Id. § 19.11.

\textsuperscript{50} FTC Compliance Guide, supra note 5, at 87-88; FTC Rule FAQs, supra note 6, FAQ 8.
a franchisor to base an FPR on data for outlets operating under a different brand.\textsuperscript{51}

In 2018, nevertheless, some franchisors continued to try to use such data in their FPRs.

For example, in one FDD, Item 12 stated: “A typical Basic or Optimal franchise territory consists of approximately 55,000 to 100,000 persons. A typical Metro Franchise territory consists of approximately 200,000 to 300,000 persons.” But in Item 19, the FPR was based on the historical performance of an affiliate’s outlet that operated in a territory with a population of about 2,225,000 people. The examiner asked the franchisor to explain why there was a reasonable basis for making a FPR based on the revenue of an affiliate’s outlet with a territory that was more than 7 times larger than the largest territory assigned to any franchisee.

In another FDD, a franchisor stated: “The financial performance representation discloses historical gross sales, cost information for calendar 2017 for four Centers consisting of two affiliate-owned and two licensee-owned Centers, each of which had been open and in operation for 12 full calendar months as of December 31, 2017.” Based on the examiner’s review of Item 1, it appeared that the two licensee-owned outlets were licensees of an affiliate of the franchisor. In the absence of a detailed description of the terms of the license agreement and a comparison with the terms of the franchise agreement, the examiner determined that the franchisor had not demonstrated a reasonable basis for the financial performance representation.

4. \textit{Subsets of Outlets; No Cherry Picking}

The FTC Rule permits a franchisor to provide historical information about a subset or subsets of outlets within a franchise system.\textsuperscript{52} The franchisor is then required to disclose the number and percentage of outlets that attained or surpassed the results, based on the number of outlets in the subset or subsets. The franchisor also must disclose how the subset or subsets were determined, to allow prospective franchisees to evaluate the sample size, the number of franchisees responding, the weight of the results, and the differences between the outlets being offered and the outlets within the subset or subsets.\textsuperscript{53}

On these issues, the NASAA FPR Commentary specifies that: an FPR based on a subset must have a reasonable basis, be accurate and not be misleading;\textsuperscript{54} an FPR showing the results of a subset of best performing outlets also must show the results of a corresponding subset of lowest performing outlets;\textsuperscript{55} a franchisor with fewer than 10 franchised and company-owned outlets is presumed to have too few outlets to base an FPR on a subset;\textsuperscript{56} and an FPR may be

\textsuperscript{51} NASAA FPR Commentary, \textit{supra} note 14, Definitions, § 19.20. Under the Definitions, a “company-owned outlet” must be “a substantially similar business [which operates] under the same brand as the business the franchisor offers to franchisees.” Under § 19.20, a projection “must be based on a reasonable sample of the historic results of the brand offered to the prospective franchisee.”

\textsuperscript{52} The FTC Rule, \textit{supra} note 3, § 436.5(s)(3)(i)-(ii).

\textsuperscript{53} \textit{Id}.

\textsuperscript{54} NASAA FPR Commentary, \textit{supra} note 14, § 19.12.

\textsuperscript{55} \textit{Id}., § 19.13.

\textsuperscript{56} \textit{Id}., § 19.14.
based on a geographic subset if the franchisor explains why and how the subset was selected, and if the FPR is not misleading.57

While the FTC Rule and NASAA FPR Commentary permit an FPR based on a subset or subsets, a franchisor is not permitted to create a subset by “cherry picking” only the outlets with the best performance, while purposefully excluding outlets with poor performance. This is because an FPR must have a “reasonable basis.” The accuracy, reliability and relevance of the information in an FPR impact its “reasonable basis.” Whether it is reasonable to assume that a prospective franchisee can duplicate the results shown by the information in an FPR, also impacts whether an FPR has a “reasonable basis.” If the information for a subset in an FPR is too restrictive or “cherry picked,” the FPR arguably does not have a “reasonable basis.”

Examiners reviewing FPRs this year found that most complied with the NASAA FPR Commentary requirements on these issues, with some notable exceptions. For example, one FDD contained the following FPR disclosure, which failed to give information for poor performers:

### Annual Average Unit Volume for 2017 Calendar Year

<table>
<thead>
<tr>
<th></th>
<th>Top 10%</th>
<th>Top 25%</th>
<th>Top 50%</th>
<th>Total (All)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Outlets</td>
<td>11</td>
<td>28</td>
<td>55</td>
<td>109</td>
</tr>
<tr>
<td>Average Unit Volume (AUV)</td>
<td>$544,383</td>
<td>$470,611</td>
<td>$416,233</td>
<td>$335,837</td>
</tr>
<tr>
<td>Number and Percent that Met or Exceeded the AUV</td>
<td>5</td>
<td>11</td>
<td>21</td>
<td>51</td>
</tr>
<tr>
<td></td>
<td>45%</td>
<td>39%</td>
<td>38%</td>
<td>47%</td>
</tr>
</tbody>
</table>

Explanatory Note:

1) Each column identified as “Top 10%”, “Top 25%” and “Top 50%” refers to the respective percentage of outlets ranked by their Gross Sales in descending order.

Examiners reviewing FPRs this year saw a trend toward the use of subsets of “mature outlets” open at least 18 months, or open at least two, three or four years, rather than the more traditional approach of using subsets of outlets open at least one year. This approach was permitted by most examiners, but raises the issue of whether the franchisors may be providing misleading FPRs by excluding the results of presumably lower-earning outlets open at least one year.

Washington examiners have objected to FPRs based solely on “mature outlets.” For example, in one FDD, the franchisor presented, in part, the following table:

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57 *Id.*, § 19.15.
The examiner questioned the reasonableness for presenting a subset of outlets that had been open for at least two full calendar years. Although the examiner was sympathetic to the argument as to why a franchisor reasonably may exclude information for outlets that had been open for less than a year, the examiner questioned the reasonableness of presenting information only for a more “mature” subset, on the basis that beyond a year of operations, the more mature an outlet is, the less relevant and meaningful the data is to a prospective franchisee, who wants to know what can be earned a reasonable startup period, rather than after several years.

In response to arguments from franchisors that they have included only “mature outlets” in Item 19 because of the time it takes to build customer bases or ongoing businesses, Washington examiners have pointed out that if it takes two or more years to build customer bases, then the franchisors have a duty to disclose this fact. By only presenting figures achieved by franchisees in their third, fourth, or even fifth year of operation, but not disclosing that it takes that much time to build customer bases or ongoing businesses, the franchisors are omitting material facts necessary in order to make the statements made not misleading, according to Washington examiners.

5. **Averages, Medians, Highs, and Lows**

The FTC Rule permits “representations” about the “results” of outlets in FPRs, and requires the disclosure of the number and percent of outlets “that actually attained or surpassed the stated results,” but does not explicitly permit or require the disclosure of average, median, high or low sales or profits.\(^58\)

The NASAA FPR Commentary specifies that: whenever an FPR discloses an “average” of a range of numbers, it must disclose the median of those numbers, and the highest and lowest numbers in the range;\(^59\) and similarly, whenever an FPR discloses a “median” of a range of numbers, it must disclose the average of those numbers, and the highest and lowest numbers in the range.\(^60\)

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\(^{58}\) The FTC Rule, *supra* note 3, §§ 436.5(s) and 436.5(s)(3)(ii)(E). The FTC Statement of Basis and Purpose, *supra* note 4, and FTC Rule FAQs, *supra* note 6, do not address the issue of the disclosure of average, median, high and low sales and profits. The FTC Compliance Guide, *supra* note 5, at 87 and 131, mentions the use of “average sales” and “average net profits” in passing, but otherwise do not address the issue of the disclosure of average, median, high and low sales and profits.

\(^{59}\) NASAA FPR Commentary, *supra* note 14, § 19.16.

\(^{60}\) Id., § 19.17.
Examiners reviewing FPRs this year found that most complied with the NASAA FPR Commentary requirements on these issues, with some notable exceptions. For example, one FDD contained the following FPR disclosure, which failed to give a median and high or low Gross Sales:

<table>
<thead>
<tr>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Gross Sales for 22 Units</td>
</tr>
<tr>
<td>Average Gross Sales per location</td>
</tr>
<tr>
<td>Number of Units that exceeded the average Gross Sales</td>
</tr>
</tbody>
</table>

Another notable exception is the way in which franchisors have been calculating averages. For example, in one FDD, the franchisor presented the average gross sales achieved by each franchisee, and not by each franchised territory. The franchisor further stated, “The data in the tables… represents Gross Revenue for each reporting franchisee, not for each franchise (or franchise territory). Some franchisees own more than one territory and manage their business and report Gross Revenue and royalty information as a single unit for all territories they own.” The examiner objected to this presentation of averages, stating her concern that the financial results of a franchisee with multiple territories likely were significantly better than the results of franchises operating in only one territory, and that combining the results (i.e., mixing apples and oranges), created averages that were misleading to prospective franchisees. Even if purchasing multiple territories did not guarantee more revenue, there was no way to tell from the way the averages were presented.

6. Projections

The FTC Rule permits a franchisor to provide a projection of perspective franchisees' future financial performance in an FPR.\(^6\) If an FPR is a projection of future financial performance, a franchisor must state the material bases and assumptions on which the projection is based. The material assumptions underlying a projection must include a description of the significant factors on which a franchisee's future results are expected to depend, such as economic or market conditions that are basic to a franchisee's operation, and matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.\(^7\)

The FTC Compliance Guide lists factors that affect whether there is a reasonable basis for a projection:

- A projection should be prepared in good faith;
- A projection should be prepared with appropriate care by qualified personnel;

\(^6\) Id., § 436.5(s)(3)(i).

\(^7\) Id., § 436.5(s)(3)(ii).
A projection should be prepared using appropriate accounting principles – a franchisor making a projection should consult the current standards for projections issued by a professional organization such as the American Institute of Certified Public Accountants;

The process used to develop a projection should provide for seeking out the best information that is reasonably available at the time;

The information used in preparing a projection should be consistent with the plans of the entity;

Key factors should be identified as a basis for the assumptions;

Assumptions used in preparing a projection should be appropriate;

The process used to develop a projection should provide the means to determine the relative effect of variations in the major underlying assumptions;

The process used to develop a projection should provide adequate documentation of both a projection and the process used to develop them;

The process used to develop a projection should include, where appropriate, the regular comparison of the projection with attained results; and

The process used to prepare projections should include adequate review and approval by the responsible party at appropriate levels of authority.  

Regarding projections, the NASAA FPR Commentary requires that: they may not be based on "mere hypothetical situations or expectations;" must be based on historical data "from outlets substantially similar to the type of outlet offered" in the FDD; must be based on "a reasonable sample of the historic results of the brand offered to the prospective franchisee;" and may not be based on "the results of other brands operated or licensed by the franchisor or its affiliates, or on the results of similar or competitive brands operated by others, or on industry reports."

Examiners reviewing FPRs in the past two years have not found more projections than usual (they are still relatively rare), but did find some projections that were suspect and unacceptable.

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63 FTC Compliance Guide, supra note 5, at 135-36.
64 NASAA FPR Commentary, supra note 14, § 19.19.
66 Id., § 19.20.
67 Id., § 19.20.
For example, one FDD contained the following “brick & mortar” projection, which was deemed by the reviewing examiner to be unacceptable because it was based on the results of a predecessor and franchisees that did not have significant experience operating “brick & mortar” businesses:

**Gross Revenue and Gross Profit Projections**

We estimate that on average, new [XYZ] businesses will achieve the following Gross Revenue and Gross Profit results in their first two years of operation:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenues</td>
<td>$837,000</td>
<td>$1,488,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>$208,250</td>
<td>$372,000</td>
</tr>
<tr>
<td>Gross Profit (Gross Revenues minus Cost of Goods Sold)</td>
<td>$628,750</td>
<td>$1,116,000</td>
</tr>
</tbody>
</table>

Our predecessor [ABC] and our existing franchisees do not have significant history using our current “brick and mortar” franchise model. Our only franchisee that has more than 2 months of operations using the local office model is our Dallas, Texas business, which opened in January 2017 and became a franchisee in May 2017. Operating in conjunction with [ABC], the Dallas business acquired 39 new clients in February-April 2017, for an average of 13 new clients per month.

In another situation, the franchisor had an affiliate that was operating a business substantially similar to the franchise offered under the FDD. The affiliate had only been in operation for six months, so the franchisor presented the six months of actual operations, and then projected out what the business would make for the rest of the year, month-over-month. The franchisor ultimately removed the FPR, after an examiner objected to the FPR on the basis that there appeared to be no reasonable basis for projecting the numbers shown.

7. **Outlets that Closed Within Reporting Period**

The FTC Rule does not require a disclosure of the number of company-owned or franchised outlets that closed during the time period covered by an FPR, if data for those outlets is excluded from the FPR, which is generally the case.

The NASAA FPR Commentary requires this new disclosure.68

Examiners reviewing FPRs this year found that many FPRs – probably inadvertently - did not comply with this new requirement.

C. **FPRs in Non-Registration States**

After a franchisor has prepared an FPR, it is fairly common that one or more examiners will require the franchisor to modify the FPR in some manner, or to remove the FPR entirely, even though other examiners have not required modification or removal. The issue then arises as to whether the franchisor must use the modified FPR, or must stop using the FPR, in all states in

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which it offers franchises.

FTC FAQ 38\(^{69}\) addresses this issue. There, the FTC Staff states as follows:

If a franchisor revises its FDD at the request or direction of one registration state, it ordinarily should incorporate the same revisions in the FDDs it uses in other registration and non-registration states to ensure that its disclosures are complete and accurate. In the case of an FPR in Item 19 questioned by one registration state, a failure to make any resulting voluntary or involuntary changes to the FPR in all other states, or abandonment or withdrawal of the registration application without making changes, will raise significant concerns about whether the FPR meets the requirements of the Franchise Rule. In particular, any such failure will call into question whether an FPR meets the requirement that a franchisor have written substantiation demonstrating that its FPR had a reasonable factual basis at the time it was made.\(^{70}\)

A franchisor's failure to use the same FPR in all states, or the franchisor's use of an FPR in other states when one registration state has required the FPR's removal, exposes the franchisor to the risk of heightened scrutiny by federal or state franchise law enforcers,\(^{71}\) and to allegations by franchisees in the other states that the FPR they received did not have a "reasonable factual basis."

A franchisor often finds itself in the position of having its FDD approved by most registration states, but then being required to modify the FPR in its FDD in one or a few registration states. The issue then is whether the franchisor must file post-effective amendments with the states that earlier approved the FDD in order to use the modified FPR in those states. As a practical matter, if the modifications are made in order to slightly adjust the FPR so that it is more complete, understandable and/or compliant with the NASAA FPR Commentary, it is unnecessary to file post-effective amendments in the other states. If the modifications are more substantial, however, the franchisor may want to file post-effective amendments. In either case, it is best practice to re-disclose any pending prospective franchisees with an FDD containing the modified FPR, or at least to provide the pending prospective franchisees with copies of the modified FPR and a redlined document showing the modifications.

IV. NASAA MULTI-UNIT COMMENTARY

A. FTC, NASAA and Registration State Requirements

The FTC Rule does not extensively address disclosure issues specific to area development, subfranchising, or area representation. In that regard, the FTC Rule and FTC Compliance Guide provide only that: the term "franchise seller" includes a franchisor's representative or subfranchisor;\(^{72}\) the term "franchisor" includes a subfranchisor;\(^{73}\) Item 8 must

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\(^{69}\) FTC Rule FAQs, supra note 6, FAQ 38.

\(^{70}\) Id.

\(^{71}\) Id.

\(^{72}\) The FTC Rule, supra note 3, § 436.1(j).

\(^{73}\) Id., § 436.1(k).
disclose how a franchisor issues specifications and standards to subfranchisees;\textsuperscript{74} Item 20 in a subfranchisor’s FDD must include both the subfranchisor’s and the franchisor’s franchised and company-owned outlet data;\textsuperscript{75} Item 21 of a subfranchisor’s FDD must include separate financial statements for the franchisor and any subfranchisor;\textsuperscript{76} and a subfranchisor, in its FDD, must disclose the required information about the franchisor and the same information about the subfranchisor.\textsuperscript{77}

Nor did the NASAA Franchise Guidelines or the NASAA Franchise Commentary extensively address these issues. In that regard, they provide that: if a franchisor (sometimes called a “master franchisor”) is offering subfranchises (sometimes called “master franchises”), references in the NASAA Franchise Guidelines to a “franchisee” include references to a subfranchisor;\textsuperscript{78} the offer of subfranchises usually requires a separate FDD;\textsuperscript{79} the offer of unit franchises and area development rights may be made in the same FDD if not confusing;\textsuperscript{80} the term “franchisor” includes a subfranchisor;\textsuperscript{81} a subfranchisor, in its FDD, must disclose the required information about the franchisor and the same information about the subfranchisor;\textsuperscript{82} the term “franchise seller” includes a franchisor’s representative or subfranchisor;\textsuperscript{83} and Item 21 of a subfranchisor’s FDD must include separate financial statements for the franchisor and any subfranchisor.\textsuperscript{84}

NASAA adopted the NASAA Multi-Unit Commentary on September 16, 2014, and it became effective on April 30, 2015 for most franchisors.\textsuperscript{85}

The NASAA Multi-Unit Commentary defines “area development” and “area developer,” “subfranchise rights” and “subfranchisor,” and “area representation” and “area representative.” It contains thirty-five commentary items, with eight items focusing on area developers, sixteen items focusing on subfranchisors, and eleven items focusing on area representatives. The items specify disclosures that must be in franchisors’ FDDs offering unit/area development rights, and in their separate FDDs offering subfranchise and area representation rights. The items also specify

\begin{itemize}
    \item \textsuperscript{74} Id., § 436.5(h)(5).
    \item \textsuperscript{75} FTC Compliance Guide, supra note 5, at 18.
    \item \textsuperscript{76} The FTC Rule, supra note 3, § 436.5(u)(i)(v).
    \item \textsuperscript{77} Id., § 436.6(f).
    \item \textsuperscript{78} NASAA Franchise Guidelines, supra note 11, Part IV.A.13.
    \item \textsuperscript{79} Id., Part IV.A.14.
    \item \textsuperscript{80} Id.
    \item \textsuperscript{81} Id., Part IV.A.15.
    \item \textsuperscript{82} Id., Part IV.A.16.
    \item \textsuperscript{83} Id., Part VII, Definition (h).
    \item \textsuperscript{84} Id., Part VI, Disclosure Item (u)(1)(v).
    \item \textsuperscript{85} NASAA Multi-Unit Commentary, supra note 13, at 1.
\end{itemize}
disclosures that must be in a subfranchisors’ FDDs offering unit franchises.

The purpose of the NASAA Multi-Unit Commentary is to promote a more uniform approach to disclosing multi-unit franchising arrangements, which hopefully benefits prospective franchisees, franchisors and their attorneys, examiners, and franchising in general.

Before the adoption of the NASAA Multi-Unit Commentary, there were no universally accepted standard terms for the three types of multi-unit franchising arrangements, with terms varying widely in different franchise systems, and in different laws and regulations. Even after the adoption of the NASAA Multi-Unit Commentary, there are no universally accepted standard terms, but the NASAA Multi-Unit Commentary is available as a starting point for understanding terms. In order to facilitate examiners’ review of FDDs, the NASAA Multi-Unit Commentary recommends that franchisors use in their FDDs the terms adopted in the NASAA Multi-Unit Commentary, or at least explain in their cover letters to the examiners how any different terms used in their FDDs correlate to the terms used in the NASAA Multi-Unit Commentary. Examiners have found that franchisors often disregard these recommendations, which can make FDDs harder for examiners to review, and which can make it harder for prospective franchisees to compare offerings by different franchisors. A frequent occurrence is the use of term “area developer” when “area representative” rights are actually being offered.

In this section, we describe the NASAA Multi-Unit Commentary’s disclosure requirements for each of the three types of multi-unit franchising arrangements, and some of the comments that examiners have provided to franchisors regarding their multi-unit franchising disclosures.

B. Franchisors’ Unit, Unit/Area Development, Subfranchise and Area Representation FDDs

1. Franchisors’ Unit and Unit/Area Development FDDs

A unit franchise, granted in a franchise agreement, authorizes the operation of a single franchised business.

Under the NASAA Multi-Unit Commentary, an “area development arrangement” involves “a person that is granted, for consideration paid to the franchisor, the right to open and operate multiple unit franchises, generally within a delineated geographic area.” An “area developer” is the person who is granted those rights. The franchisor and area developer generally are parties to an area development agreement that specifies the number of units to be developed and a development schedule, and the area developer or an affiliate generally is a party to each franchise agreement entered into with the franchisor for each franchised business. The area developer does not have the right to grant or sell unit franchises to third parties.

86 Id.
87 To illustrate this point, attached as Appendix A to this paper is a chart that summarizes the varying, and sometimes contradictory, terms used in the FTC Rule and its interpretations, in various NASAA guidelines, and in state laws relating to the three types of multi-unit franchising arrangements.
88 See supra note 85.
89 NASAA Multi-Unit Commentary, supra note 13, at 2.
90 Id.
Before the NASAA Multi-Unit Commentary, franchisors regularly used FDDs that offered both unit franchises and area development rights. The NASAA Multi-Unit Commentary endorses that approach. Specifically, it affirms the use of a single FDD for the offer of unit franchises and area development rights, since “[a]n area developer essentially is a unit franchisee with the right to operate more than one unit franchise.”  

For this reason, according to the NASAA Multi-Unit Commentary, “[i]t is not confusing to prospects for an area development agreement and related disclosures to be included in the same [FDD] as a unit franchise agreement and related disclosures.”

Since the NASAA Multi-Unit Commentary did not change the practice of most franchisors, examiners have not encountered significant difficulties with franchisors’ unit/area development FDDs, although they have had to remind some franchisors of the specific disclosures about area development rights that are required to appear in those FDDs. For example: in Item 1, franchisors often forget to disclose that future unit franchise agreements may have different terms from the form franchise agreement in the FDD; in Item 17, franchisors sometimes forgot to disclose the existence of cross-default provisions permitting the franchisor to terminate an area development agreement if a franchise agreement is terminated, and vice versa; and in Item 20, franchisors sometimes list area developers separately from franchisees, forget to include footnotes or symbols to indicate franchisees who are area developers, or forget to state that they have no area developers if that is the case.

If a franchisor is offering subfranchise or area representation rights, the NASAA Multi-Unit Commentary requires and prohibits certain disclosures in the franchisor’s unit FDD or unit/area development FDD. For example, in Item 1, the franchisor must refer to its separate FDD offering subfranchise rights or area representation rights. In Items 2, 3 and 4, the franchisor must disclose information about its area representative. In Item 8, the franchisor must disclose rebates received by it and its affiliates, and also rebates it knows its area representatives and their affiliates are receiving. In Item 11, a franchisor must disclose the experience of training instructors provided by area representatives to the extent they are responsible for providing training to unit franchisees. In Item 20, a franchisor must include information about current and former unit franchisees, but may not include information about current or former subfranchisors.

91 Id., AD 0.1.
92 Id.
93 Id., AD 1.0.
94 Id., AD 20.0.
95 Id., AD 20.2 and AD 20.3.
96 Id., SF 1.0 and AR 1.0.
97 Id., AR 2.0, AR 3.0 and AR 4.0.
98 Id., AR 8.0.
99 Id., AR 11.1.
or area representatives. On the Receipts pages, the franchisor must disclose as “franchise sellers” any individuals who participate in franchise sales on behalf of area representatives, including employees and officers of area representatives.

Examiners have had to remind some franchisors of the specific disclosures about subfranchise and area representative rights that are required to appear in the franchisors’ unit FDDs or unit/area development FDDs.

2. Franchisors’ Subfranchise FDDs

Under the NASAA Multi-Unit Commentary, a “subfranchise arrangement” involves “a person that is granted, for consideration paid to the franchisor, rights related to granting unit franchises to third parties, generally within a delineated geographic area.” The “franchisor” grants those rights, and the “subfranchisor” is the person to whom those rights are granted. The franchisor and subfranchisor generally are parties to a subfranchisor agreement, under which the subfranchisor is granted a specified territory within which it must grant third parties the right to open, and/or must open itself, a minimum number of franchised outlets. The subfranchisor is a party to subfranchisee agreements with third-party “subfranchisees,” under which the subfranchisor grants the subfranchisees the right to operate franchised businesses, and under which the subfranchisor typically is obligated to provide support services. The franchisor and the subfranchisor typically split the initial and continuing fees paid by subfranchisees.

Before the NASAA Multi-Unit Commentary, franchisors sometimes used FDDs that offered both unit franchises and subfranchise rights. The NASAA Franchise Guidelines disfavored that practice, but the NASAA Multi-Unit Commentary prohibits the practice. It explains that, unlike area development rights, subfranchise rights cannot be offered by a franchisor in the same FDD in which it offers unit franchises. This is because, although some disclosure items may be identical in a franchisor’s unit FDD and subfranchise FDD (e.g., Items 1-4), the relationships and agreements for these offers are very different, and combining disclosures for both in the same FDD is potentially confusing.

In a franchisor’s subfranchise FDD, the NASAA Multi-Unit Commentary requires specific disclosures in Items 1, 20 and 22. In Item 1, the franchisor must disclose the availability in a

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100 This is because Item 20 requires the disclosure of “outlets,” defined as outlets of a type substantially similar to those offered to prospective franchisees, and subfranchise and area representative rights are not substantially similar to unit franchise rights. However, if a subfranchisor or an area representative owns a unit franchise, information about the ownership and/or statistics related to that unit franchise must be disclosed in Item 20.

101 NASAA Multi-Unit Commentary, supra note 13, AR 23.0.

102 Id., at 2.

103 Id., at 2-3.

104 See supra note 79.

105 NASAA Multi-Unit Commentary, supra note 13, SF 0.1.

106 Id.
separate FDD of unit franchise rights. In Item 20, the FDD may identify only current and former subfranchisors, and may not identify current or former unit franchisees or franchised outlets. If the franchisor requires its subfranchisors to use the franchisor’s form of franchise agreement in the sale of unit franchises, Item 22 of the FDD must include the franchisor’s then-current form of franchise agreement.

Washington examiners often have had to remind franchisors that subfranchisors must separately seek registration for their offer and sale of unit franchises, and that this must be disclosed in Item 1 of the franchisors’ subfranchise FDDs.

3. **Franchisors’ Area Representation FDDs**

Under the NASAA Multi-Unit Commentary, an “area representation arrangement” involves “a person that is granted, for consideration paid to the franchisor, the right to solicit or recruit third parties to enter into unit franchise agreements with the franchisor, and/or to provide support services to third parties entering into unit franchise agreements with the franchisor.” The “area representative” is the person to whom those rights are granted. The franchisor and the area representative generally are parties to an area representative agreement, and “unit franchisees” are the third parties signing the unit franchise agreements with the franchisor. The franchisor and area representative typically split the initial and continuing fees paid by unit franchisees, usually depending on the services to be provided by each.

Before the NASAA Multi-Unit Commentary, franchisors sometimes used FDDs that offered both unit franchises and area representation rights. The NASAA Multi-Unit Commentary prohibits that practice. A franchisor cannot offer area representation rights in the same FDD in which it offers unit franchises. This is because, although some disclosure items may be identical in a franchisor’s unit franchise FDD and area representation FDD (e.g., Items 1-4), the relationships and agreements for these offers are very different, and combining disclosures for both in a single FDD is potentially confusing.

In a franchisor’s area representation FDD, the NASAA Multi-Unit Commentary requires

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107 Id., SF 1.0.
108 Id., SF 20.0.
109 Id., SF 22.0. This requirement stems from the FTC Rule’s requirement that franchisors attach in Item 22 all proposed “agreements” regarding the franchise offering, and the FTC Compliance Guide’s confirmation that this requirement includes all proposed agreements “that the franchisor provides.” The FTC Rule, supra note 3, § 436.5(v); FTC Compliance Guide, supra note 5, at 116. If, on the other hand, a franchisor requires its subfranchisors to use the franchisor’s form of FDD in the sale of unit franchises, the NASAA Multi-Unit Commentary confirms that the franchisor is under no obligation to include a form FDD in Item 22 since an FDD is not an “agreement.” “Including a form [FDD] within another [FDD] would be both impractical and potentially confusing.” Id., SF 22.1.
110 NASAA Multi-Unit Commentary, supra note 13, at 3.
111 Id., at 3-4.
112 Id., AR 0.1.
113 Id.
specific disclosures in Items 1, 2, 3, 4, 8, 11 and 20, and on the FDD Receipts. Item 1 must disclose that unit franchises are offered under a separate FDD.\textsuperscript{114} Item 2 must disclose the business experience of area representatives that have management responsibility relating to the sale or operation of franchises, and Items 3 and 4 must include the litigation and bankruptcy history of those area representatives.\textsuperscript{115} If the franchisor does not grant its area representatives any management responsibility, that fact must be disclosed in Item 1 of the FDD, but no disclosures are necessary in Item 2, 3 or 4.\textsuperscript{116} Although the NASAA Multi-Unit Commentary contains no requirement with respect to what a franchisor must disclose in Item 8 of its area representation FDD about revenue from required purchases and rebates, it seems appropriate to include a disclosure in Item 8 similar to that required in Item 8 of a franchisor’s unit franchise FDD.\textsuperscript{117} Item 8 must disclose the experience of area representatives’ training instructors.\textsuperscript{118} In Item 20, a franchisor must include information about current and former area representatives, but may not disclose information about current or former unit franchisees, or about franchised outlets.\textsuperscript{119} The FDD Receipts must disclose franchise sellers associated with area representatives.\textsuperscript{120}

Some examiners have had to remind franchisors that their area representation FDDs may not include “sample” franchise agreements or area development agreements, which rather should be included in the franchisors’ unit/area development FDDs.

In New York and Washington, area representatives typically fall under the definition of “franchise brokers,” as they are granted the right to solicit or recruit third-party franchisees. If a franchisor is offering an area representative opportunity in Washington, Washington examiners often require the franchisor to disclose in Item 1 of the area representation FDD that the area representative must register as a franchise broker in Washington.

C. Subfranchisors’ Unit FDDs

Under a subfranchise arrangement, the subfranchisor must prepare its own FDD in order to offer unit franchises to subfranchisees.

\textsuperscript{114} Id., AR 1.0.

\textsuperscript{115} Id., AR 2.0, AR 3.0 and AR 4.0.

\textsuperscript{116} Id.

\textsuperscript{117} Id., AR 8.0. The following is sample language that seems appropriate to include in Item 8 of a franchisor’s area representation FDD:

\begin{quote}
As of December 31, 2017, we had 3 area representatives. In 2017, we had no revenue from required purchases or leases by area representatives or by franchisees within their regions, and no approved suppliers paid us rebates for purchases or leases by area representatives or by franchisees within their regions. In 2018 and future years, we may receive revenue from required purchases or leases by area representatives or by franchisees within their regions, and will receive rebates from approved suppliers.
\end{quote}

\textsuperscript{118} Id., AR 11.1.

\textsuperscript{119} Id., AR 20.0.

\textsuperscript{120} Id., AR 23.0.
The NASAA Multi-Unit Commentary specifies disclosures that must or may be in Items 2, 3, 4, 6, 8, 13, 20 and 21 of the subfranchisor’s unit FDD. Items 2, 3 and 4 must include employment, litigation and bankruptcy information for the subfranchisor and the franchisor, in that order. Item 6 may disclose that fees paid by subfranchisees will be shared by the franchisor and subfranchisor. Item 8 must disclose rebates received by the subfranchisor, franchisor or their affiliates on required purchases or leases made by subfranchisees. Item 13 must disclose limitations on the subfranchisor’s right to use or license the use of the franchisor’s marks to subfranchisees. In Item 20, a subfranchisor must include information for outlets in its territory and also outlets in the entire franchise system. The first set of Item 20 Tables 1-5 must include information for the subfranchisor, and a second set of Item 20 Tables 1-5 must include information for the entire franchise system. Finally, Item 20 must include two separate Item 20 lists of unit franchisees with their addresses and telephone numbers. Item 21 must include the separate financial statements of the subfranchisor and the franchisor.

In terms of FDD updates, the NASAA Multi-Unit Commentary clarifies that a subfranchisor must prepare an annual update of its unit FDD within 120 days after the end of its fiscal year, rather than the fiscal year end of the franchisor (to the extent the two are different). The annual update, however, must include any required information from the franchisor’s quarterly updates or amendments, if any, reflecting material changes since the franchisor’s last annual update. The subfranchisor also must amend its unit FDD to reflect material changes in the franchisor’s financial arrangements.

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121 The NASAA Multi-Unit Commentary clarifies that a subfranchisor is not required to include any disclosures in its FDD explaining the financial arrangement between it and the franchisor. Id., SF 0.2. A subfranchisor may, however, disclose in Item 6 that fees paid by subfranchisees will be shared by the subfranchisor and the franchisor. Id.

122 Id., SF 3.0 and SF 4.0.

123 Id., SF 0.2.

124 Id., SF 8.0.

125 Id., SF 13.0. In particular, Item 13 must include disclosures on the circumstances under which a subfranchisor’s rights may be canceled, and the effect, if any, that cancellation may have on a subfranchisee’s rights to continue to use the franchisor’s marks. Also, Item 13 must state whether subfranchisees can continue to use the franchisor’s marks if the subfranchisor agreement with the franchisor expires or is terminated, canceled or not renewed.

126 Id., AR 20.2.

127 Id.

128 Id., AR 20.3. The lists must be organized as follows: (i) a list of the subfranchisor’s own current unit franchisees; and (ii) a list of the current unit franchisees of the franchisor and its other subfranchisors operating under the same brand. As provided in the FTC Rule and affirmed by the NASAA Multi-Unit Commentary, a subfranchisor has the right to choose between providing the lists of current franchisees for either every state in the United States or for only the state in which the subfranchisor offers unit franchises. If a subfranchisor opts for the latter, and if its list of unit franchisees in its state includes fewer than 100 unit franchisees, it must expand its list to include its own unit franchisees in contiguous states, and then the next closest states, until its list includes at least 100 of its own unit franchisees or there are no more of its own unit franchisees to list. If the total is still less than 100, the subfranchisor must separately list unit franchisees of the franchisor and the franchisor’s other subfranchisors in the same manner, until the subfranchisor has listed at least 100 unit franchisees or there are no more unit franchisees to list. Id.

129 Id., SF 21.0.
information. This includes amending the FDD within 120 days after the franchisor’s fiscal year end to include previous-year information and audited financial statement.

Some deficiencies found by examiners in subfranchisors’ unit FDDs have been: in Item 20, the failure to include Tables 1-5 for the entire franchise system, in addition to Tables 1-5 for the subfranchisor’s outlets, and the failure to include separate lists for current and former franchisees of the franchisor, in addition to current and former subfranchisees of the subfranchisor.

Examiners also have found deficiencies in Item 13 of subfranchisors’ unit FDDs. In accordance with Section SF 13.0 of the NASAA Multi-Unit Commentary, a subfranchisor must disclose any currently effective agreements that limit the subfranchisor’s rights to use or license the use of the marks. Thus, Item 13 of a subfranchisor’s unit FDD must include a discussion of the circumstances under which its subfranchise rights may be canceled, and the effect if any, that cancellation may have on the subfranchisee’s rights to continue to use the franchisor’s marks. A subfranchisor also must disclose in Item 13 whether or not the subfranchisee can continue to use the marks if the subfranchisor agreement with the franchisor expires or is terminated, canceled, or not renewed. Examiners have noticed that subfranchise FDDs often have not met all of the requirements set forth in Section SF 13.0 of the NASAA Multi-Unit Commentary.

D. Multi-Unit FDDs in Notice and Non-Registration States

Although FDDs are not reviewed in certain notice states or registration states where FDDs are declared effective upon receipt, or in non-registration states, compliance with the NASAA Multi-Unit Commentary is arguably, although perhaps not technically, required in those states. This is because a representative of the FTC sits ex officio as a member of NASAA’s Project Group, is deeply involved in its deliberations, and routinely works collaboratively with NASAA’s Project Group. Although that participation does not make the approach specified in the NASAA Multi-Unit Commentary technically applicable in notice and non-registration states, it indicates that the FTC in some respect endorses the approach. From an administrative and cost perspective, even if not legally required to do so, a franchisor or subfranchisor that offers franchises in notice and non-registration states benefits from complying with the NASAA Multi-Unit Commentary, to the extent the franchisor or subfranchisor also offers franchises in any of the registration states or more activist notice states, or plans to do so in the future.

V. RISK FACTORS

A. FTC, NASAA and Registration State Requirements

The FTC does not require risk factors to be included in an FDD. As a matter of policy, the FTC considers risk factors to be “unnecessarily burdensome, without corresponding benefits to prospective franchisees,” that “might incorrectly signal prospective franchisees that these are the

130 FDDs are not reviewed in the annual notice states of Florida, Michigan and Utah, and are not reviewed in the one-time notice states of Kentucky, Nebraska and Texas. Although FDDs are submitted to the annual notice states of Indiana, South Dakota and Wisconsin, the FDDs are not subject to detailed review and are effective on receipt by the examiners. For franchisors without registered federal or state trademarks, FDDs are not reviewed in the annual notice state of Maine, or in the consent to service of process states of Georgia, Louisiana and South Carolina.

131 See supra note 10.
most important risk factors to consider.”\textsuperscript{132} In addition, in the FTC’s view, risk factors “essentially repeat what franchisors already must disclose.”\textsuperscript{133}

However, the FTC permits states to require risk factors to be included in FDDs if the states choose to do so.\textsuperscript{134}

The NASAA Franchise Guidelines, which are currently effective, and which will only be superseded if the state cover page changes issued for public comment earlier this year are eventually adopted,\textsuperscript{135} recommend that the registration states require the inclusion of three mandatory risk factors, if applicable, on the state cover page in an FDD.\textsuperscript{136} Those mandatory risk factors are:


2. **THE FRANCHISE AGREEMENT STATES THAT [STATE] LAW GOVERNS THE AGREEMENT, AND THIS LAW MAY NOT PROVIDE THE SAME PROTECTIONS AND BENEFITS AS LOCAL LAW. YOU MAY WANT TO COMPAR these laws.

3. **THERE MAY BE OTHER RISKS CONCERNING THIS FRANCHISE.

During the past several years, NASAA’s Project Group has been focusing on providing guidance to examiners on how to: (i) determine whether additional risk factors should be required on the state cover page; (ii) make risk factors more uniform; and (iii) make clearer the potential consequence of each risk described. The guidance has been given in the form of training, and has been supplemented by sample risk factor wording and related commentary that has not been made public.

At the registration state level, examiners have broad authority to require risk factors that are deemed appropriate and to prohibit risk factors.

When an examiner in one registration state requires a risk factor to be added to an FDD, that risk factor generally is included in FDDs provided to prospects in all states. This approach, which is followed by most franchisors, is consistent with the FTC Staff’s view that “[i]f a franchisor revises its FDD at the request or direction of one registration state, it ordinarily should incorporate

\textsuperscript{132} FTC’s Statement of Basis and Purpose, 72 Fed. Reg. 15,444 at 15,448, 15,452, 15,473.

\textsuperscript{133} Id. at 15,473.

\textsuperscript{134} Id. at n.295; FTC Compliance Guide, supra note 5, at 26.

\textsuperscript{135} See Section II in this paper.

\textsuperscript{136} NASAA Franchise Guidelines, supra note 11, at 3-4, § III.B.
the same revisions in the FDDs it uses in other registration and non-registration states to ensure that its disclosures are complete and accurate.\footnote{FTC Rule FAQs, supra note 6, FAQ 38. See also The FTC Rule, supra note 3, § 436.1(d), which requires “all material facts” to be disclosed accurately and clearly.} Also, this approach is necessary if the franchisor, for ease of administration, wants to use a single FDD throughout the United States.\footnote{There are circumstances when it may be appropriate not to add a risk factor required by an examiner in one state to FDDs used in other states. For example, if one examiner requires a risk factor that is state-focused (such as a risk factor relating to a high turnover rate in one state, or to the unenforceability of a contractual provision under one state’s laws), or a risk factor that does not add significant a material fact to an FDD (such as a risk factor stating that the franchisor has a short operating history), it may be appropriate for a franchisor not to add that risk factor to FDDs used in other states.} When a franchisor registers or renews in multiple states, an issue that often arises is that an examiner in one state will require a new risk factor after the franchisor’s FDD without that risk factor has already been approved in other states. When this happens, a franchisor generally includes the new risk factor in its FDDs provided to prospects in all states, without seeking approval from the states that previously approved its FDD without the new risk factor, since the new risk factor does not materially change the information in its FDD. However, when the franchisor makes its next amendment or renewal filings, it may want to explain in its cover letters to the other states, or may be required by the other states, to explain why the new risk factor is in its FDD.

B. Registration State Implementation

All of the registration states have required the three risk factors, if applicable, recommended in the NASAA Franchise Guidelines. As a result, most FDDs used in the United States include those risk factors.

Some registration states regularly require additional risk factors.\footnote{California, Maryland, Virginia and Washington have been particularly active in terms of requiring additional risk factors, and Illinois and New York often also require additional risk factors.} The facts most likely to trigger examiners to require additional risk factors include:

- disclosures in a franchisor’s financial statements indicating a potential inability to fulfill obligations to franchisees;
- a franchisor with a short operating history;
- a high franchisee turnover rate;
- the requirement of a personal guarantee and/or a spousal guarantee;
- a minimum payment or performance requirement;
- a non-exclusive territory;\footnote{Generally, only California.} or

\footnote{FTC Rule FAQs, supra note 6, FAQ 38. See also The FTC Rule, supra note 3, § 436.1(d), which requires “all material facts” to be disclosed accurately and clearly.}
• a principal trademark that is not federally registered.\(^{141}\)

The following circumstances are most likely to trigger risk factors about a franchisor’s financial statements:

• a “going concern” opinion in the auditor’s cover letter or in a footnote;\(^{142}\)

• current liabilities that exceed current assets (i.e., a working capital deficit) on the balance sheet;

• a negative net worth (stockholders equity) on the balance sheet;\(^{143}\)

• a positive net worth on the balance sheet of less than an amount deemed adequate by the examiner,\(^{144}\) or of less than the estimated initial investment required;

• a high proportion of intangible assets in relation to tangible assets on the balance sheet;

• a significant receivable, loan or advance from a parent or affiliate company on the balance sheet; or

• a significant loss on the profit and loss statement, generally if coupled with significant losses in previous fiscal years.

Additional risk factors required by reviewing examiners typically, first, re-state the facts, and second, state the possible consequences of the facts.

NASAA’s Project Group has encouraged examiners to require the use of uniform language in all additional risk factors.

In Washington, examiners most commonly require risk factors about financial condition, limited operating histories, minimum performance requirements and spousal guarantees. These

\(^{141}\) A few examiners require additional risk factors related to contractual provisions, such as the following: waiver of the right to bring a counterclaim or offset in litigation arising out of or related to a financing agreement; the requirement to form a corporation, limited liability company or other legal entity, obtain a business license, and obtain several types of insurance before operating the franchise; controls on inventory, pricing and/or suppliers; and, provisions in the franchise agreement, such as a waiver of jury trial or a limitation on damages, that might not be enforceable in a particular state.

\(^{142}\) South Dakota requires a franchisor to notify the state, in a separate letter, if the franchisor’s auditor has concluded that there is substantial doubt about the franchisor’s ability to continue as a going concern for a reasonable period of time. This must be done when a notice filing is made, or afterwards, within 15 days after the auditor concludes that there is a going concern. S.D. CODIFIED LAWS § 37-5B-5; www.dlr.sd.gov/securities/franchise_registration.aspx.

\(^{143}\) Virginia, for example, requires a risk factor if there is a negative net worth.

\(^{144}\) There is no minimum net worth that is deemed adequate in all registration states. For example, a $100,000 or $200,000 net worth may be necessary to avoid a risk factor in some states, but may be more than adequate or insufficient to avoid a risk factor in other states. New York and Virginia, for example, require a risk factor if the franchisor’s net worth is less than the estimated initial investment of the franchisee stated in Item 7.
track the uniform risk factor language suggested by the NASAA Project Group).

All examiners prohibit franchisors from adding “gratuitous” risk factors to their FDDs, and some reviewing examiners require franchisors to prove that risk factors not required by their states have been required by other states. If a reviewing examiner sees an atypical or non-uniform risk factor on a state cover page, the examiner often asks the franchisor to provide the name of the examiner requiring the risk factor. If the risk factor was required by another examiner, the reviewing examiner may accept the risk factor as is or may require it be re-worded to be more uniform. If, on the other hand, the risk factor was not required by another examiner, the reviewing examiner will require the franchisor to remove it.

Here are some examples of “gratuitous” risk factors added by franchisors and required to be removed by examiners, unless other examiners had required them to be included:

1. YOUR BUSINESS WILL BE AFFECTED BY CHANGES IN CONSUMER TASTES, DEMOGRAPHIC PATTERNS, CHARACTER OF THE AREA WHERE YOUR RESTAURANT IS LOCATED, WEATHER, COMPETITION, INFLATION, FOOD COSTS, COSTS OF MOTOR FUEL, GOVERNMENT REGULATIONS LIKE REQUIRED DISCLOSURE OF NUTRITIONAL INFORMATION, PUBLIC ATTENTION TO INGREDIENTS, HEALTH AND NUTRITION CONCERNS, HEALTH CODES, ZONING, ENVIRONMENT CONCERNS, WAGE AND PRICE CONTROLS, EMPLOYMENT AND WAGE LEVELS, ENERGY USAGE, AND OTHER OPERATING COSTS.

2. THERE ARE CERTAIN FEDERAL, STATE AND LOCAL FOOD AND HEALTH REGULATIONS REGARDING FOOD DISTRIBUTION AND RESTAURANT OPERATIONS THAT YOU MUST FOLLOW.

3. THIS FRANCHISE AGREEMENT PROVIDES THAT THE FRANCHISEE WAIVES CLAIMS, DEMANDS OR DAMAGES RELATED TO LOSS OF MARKS AND SYSTEM AND/OR LOSS OF ASSOCIATION AS A FRANCHISEE SHOULD FRANCHISOR DISPOSE OF ITS INTEREST.

4. THE FRANCHISE AGREEMENT PROVIDES THAT FRANCHISOR MAY SEEK INJUNCTIVE RELIEF WITHOUT THE NECESSITY OF POSTING SECURITY OR BOND, AND THAT FRANCHISEE SHALL BE RESPONSIBLE FOR FRANCHISOR’S REASONABLE ATTORNEY’S FEES FOR PURSUING SUCH INJUNCTIVE RELIEF.

Another issue that arises during examiners reviews of state cover pages is the addition by franchisors of mitigating language to risk factors. For example, one franchisor included the following risk factor on the state cover page:


The examiner required the franchisor to remove the mitigating language relating to its acquisition of the franchise system.

Some examiners require risk factors that are not required by examiners in other
registration states. For example, examiners in some states require risk factors about “non-exclusive territories,” while examiners in other states view such risk factors as duplicative of Item 12 disclosures. Similarly, some examiners in New York and Virginia require the following risk factor:

THE FRANCHISEE WILL BE REQUIRED TO MAKE AN ESTIMATED INITIAL INVESTMENT RANGING FROM [$-] TO [$-]. THIS AMOUNT EXCEEDS THE FRANCHISOR’S STOCKHOLDERS’ EQUITY AS OF [MONTH/DAY/YEAR], WHICH WAS [$-].

With the examiners’ focus on risk factors, there is the danger of requiring too many risk factors on the state cover page, which could have a “numbing” effect on prospective franchisees and reduce the impact of the individual risk factors. Examiners are sensitive to this concern, and so far, are not requiring excessive numbers of risk factors to be added to state cover pages.

VI. FINANCIAL STATEMENTS

A. FTC, NASAA and Registration State Requirements

The FTC Rule requires franchisors to include three years of audited financial statements in their FDDs if they have three or more fiscal years of operating history. In notice and non-registration states, the FTC Rule permits start-up franchisors to use unaudited statements initially, and to phase in the use of fully audited statements over three years.

In the registration states, under the NASAA Franchise Guidelines and consistent with the FTC Rule, franchisors with three or more years of operating history must include three years of audited financial statements in their FDDs. Although the NASAA Franchise Guidelines also permit the phase-in of audited statements by start-up franchisors, the registration states treat start-up franchisors differently: Hawaii, Illinois and Washington permit the phase-in of audited statements; Maryland, North Dakota and Rhode Island permit the phase-in of audited statements, but only if franchisors agree to financial assurances such as fee deferrals or escrows; California

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145 NASAA’s Project Group proposal to change the state cover page (see discussion in Section II) would likely cause this type of risk factor to be moved back to a state specific addendum, rather than being included on the state cover page with the Special Risks to Consider About This Franchise heading.

146 The FTC Rule, supra note 3, § 436.5(u)(1). Audited financial statements must compare at least two fiscal years. Id.

147 Id. § 436.5(u)(2). See FTC Rule FAQs, supra note 6, FAQ 11 (If a start-up franchisor is qualified to phase in the use of audited statements, its unaudited opening balance sheet is not required to be prepared by an accountant, but must be prepared in accordance with U.S. Generally Accepted Accounting Standards (“GAAP”)). Until a franchisor has been in business long enough to provide 3 years of audited statements, it must state in Item 21 of its FDD that: “The franchisor has not been in business for 3 years or more and cannot include all the financial statements required by the [FTC] Rule.” FTC Compliance Guide, supra note 5, at 115. Examiners occasionally require the last part of this statement to be re-worded to state “and thus cannot include all financial statements as required by statute.

148 NASAA Franchise Guidelines, supra note 11, at 66.

149 Id. at 66-67.

150 ILL. ADMIN. CODE § 200.600(c). Illinois’s phase-in requirements in its regulations are different from the FTC’s phase-in requirements in The FTC Rule, supra note 3, § 436.5(u)(2).
does not permit the phase-in of audited statements, and normally requires the immediate use of audited statements, although it permits the use of “review” statements in some circumstances.\(^{151}\) and Minnesota, New York and Virginia require the immediate use of audited statements.\(^{152}\)

In addition, in registration states, a franchisor must include an interim unaudited financial statement in its FDD if the franchisor files a registration or renewal application more than a certain number of days after its fiscal year end. For example, Maryland\(^{153}\) and Virginia\(^{154}\) regulations require a franchisor to include a recent unaudited financial statement if the franchisor files a registration or renewal application more than 120 days after its fiscal year end. Although Washington does not have a specific regulation, depending on the timing of an application, it generally imposes the same requirement, looking to the 120-day-update requirement in the FTC Rule. Similarly, California sometimes exercises its discretion to require, and Illinois generally requires, a franchisor to include a recent unaudited statement if the franchisor makes a filing more than 120 days after its fiscal year end. Hawaii requires a franchisor to include a recent unaudited statement if the franchisor makes a filing more than 90 days after its fiscal year end.

**B. Format Deficiencies, Risk Factors and Financial Assurances**

In registration states, reviewing examiners sometimes scrutinize a franchisor’s financial statements for format deficiencies, and more importantly, regularly scrutinize a franchisor’s financial statements for disclosures that might indicate the potential inability of the franchisor to fulfill obligations to franchisees.

Regarding format deficiencies, some reviewing examiners refuse to permit registration of an FDD if the franchisor’s financial statements are grossly deficient in form, or if the text in a franchisor’s financial statements is extremely difficult to read (for example, is in less than 10 or 11 point type). Other format-related comments on financial statements have included those such as the following:

The financial information submitted was not current within a 120-day time period as required. Please amend the FDD to include the current information.

\(^{151}\) California Guidelines for Franchise Registration, at ii-iii, ¶ 5. A “review” statement may be used only if: the franchisor is making its first registration application in California and has no prior audited statements; the “review” balance sheet is as of a date within 90 days of the application filing date; the “review” statement includes profit and loss statements for the prior 3 years or from the inception of the franchisor’s business, a cash flow statement and appropriate footnotes; and the “review” statement conforms to AICPA standards.

\(^{152}\) Since 3 of the 10 registration states require the immediate use of audited financial statements, and since 4 of the 10 registration states either may not permit the phase-in of unaudited financial statements or may permit their use only if financial assurances are imposed, it is generally best for a start-up franchisor to retain an accountant to prepare an audited opening balance sheet and full audited financial statements annually thereafter. If the franchisor has the means, it is also best for the audited opening balance sheet to show a positive net worth of $200,000-$300,000, preferably made up primarily of cash in a bank account or tangible assets, and to show at least some fixed assets, such as furniture, equipment, property, etc., to indicate that the franchisor is an operating company with assets it can use to support its franchise system, rather than merely a company with a bank account.

\(^{153}\) The Maryland regulation says 90 days, but in November 2013, the Maryland Securities Commissioner issued a no action position allowing franchisors to file financial statements current within 120 days of an application, instead of 90 days. Mo. CODE § 02.02.08.13.C.2; www.oag.state.md.us/Securities/Franchise%20IO%20120%20days.pdf.

\(^{154}\) VA ADMIN. CODE § 5-110-30-E.
Please submit an accountant’s consent form that is prepared on the accountant’s letterhead and includes the issuance date of the franchise disclosure document.

Please include the required financial statements in a format of columns that compare at least two fiscal years.

Deficiencies often arise in FDDs submitted by startup franchisors. When franchisors are permitted by the FTC Rule to use unaudited financials and phase in the use of audited financials, the unaudited financials sometimes are not GAAP-compliant. For example, there may be no footnote disclosures; liabilities may be presented as negative expenses; and there may be other obvious accounting errors. Examiners usually issue comments saying “these financial statements do not appear to be prepared in accordance with GAAP,” that they need to be GAAP-compliant, and that the franchisor may want to hire an accountant to prepare a compilation, which is GAAP-compliant but less expensive than an audit.

A related issue is that disclosures in financial statement footnotes sometimes do not match disclosures in franchisors’ FDDs. For example, the financial statement footnotes may disclose that there are X number of outlets in the franchise system, but Item 20 may disclose a different number of outlets.

If there are disclosures in a franchisor’s financial statements indicating a potential inability to fulfill obligations to franchisees, reviewing examiners may require risk factors or financial assurances, or other conditions that are more or less restrictive on franchisors. If financial assurances are required, most franchisors elect fee deferrals or surety bonds, although there has been a recent trend toward the election of surety bonds.

Risk factors concerning financial statements are discussed in Section V of this paper. New York requires risk factors if there are financial statements that cause concern, despite the state’s authority to require financial assurances. Other states may require risk factors or financial assurances such as fee deferrals, impounds (also called “escrows”) or surety bonds.

\[155\] In terms of financial assurances, on the more restrictive end of the spectrum, if a franchisor does not have a substantial net worth and cannot provide a guarantee of performance from an affiliate with a substantial net worth, Minnesota may refuse registration. Similarly, Virginia may refuse registration if a franchisor has a negative net worth. On the less restrictive end of the spectrum, a state may permit a franchisor to show a capital infusion into, or sometimes a loan to, the franchisor that will make it possible for the franchisor to meet all of its pre-opening obligations to new franchisees without relying on their initial franchise fees. If a loan to the franchisor is permitted, the franchisor or its accountant may be required, in Item 21, in a letter or in a subsequent event footnote to the franchisor’s financial statement, to verify that the loan note will not require the franchisor to pay interest or principal until all of the franchisor’s pre-opening obligations to its new franchisees have been met. Or, a state may permit a franchisor to obtain a guaranty of performance from a company that has audited financial statements that show an ability to perform. The guaranty of performance must be referenced in Item 21 of the franchisor’s FDD and included as an exhibit in the FDD. A state also may permit a franchisor to submit an undertaking committing that a shareholder holding a significant demand note with the franchisor will not call the note during the franchise registration period. California, for example, permits capital infusions and guaranties of performance.

\[156\] New York Franchise Sales Act, N.Y. GEN. BUS. L. § 685, and N.Y. COMP. CODES R. & REGS. § 200.6 (New York examiners may require escrows or surety bonds).

\[157\] E.g., California Franchise Investment Law, CAL. CORP. CODE § 31113 and CAL. ADM. CODE REG. § 310.113-.115 (examiner may require escrow or surety bond); Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. § 705/15 and ILL. ADMIN. CODE § 200.500-505 (examiner may require escrow, surety bond, fee deferral, guaranty of performance or issuance of Certificate of Deposit); Maryland Franchise Registration and Disclosure Law, Md. CODE ANN. BUS. REG. § 14-217 and Md. CODE § 02.02.08.08 (examiner may require escrow, surety bond or fee deferral); WASH. REV. CODE §
Washington generally requires financial assurances for all new franchisors.\textsuperscript{158}

Despite franchisors technically being given the option to choose between fee deferrals, impounds (escrows) or surety bonds, franchisors are increasingly opting for fee deferrals or surety bonds due to the unwillingness of many banks -- likely due to the administrative burdens and potential liabilities involved -- to serve as impound (escrow) depositories for initial franchise fees. Many banks that focus on serving the franchise industry, and that previously handled impound (escrow) accounts, are no longer willing to do so.\textsuperscript{159} Lately, more franchisors have been choosing the surety bond option. This may be in response, at least in part, to some examiners’ comments on unit/area development FDDs, when financial assurances are required, specifying that if the fee deferral option is chosen, the area development fee may only be released proportionally when each franchised business opens under an area development agreement, rather than being released in full when the first franchised business opens.

C. New FASB Rules

Franchisors’ audited financial statements must be prepared in accordance with GAAP rules.

For public entity franchisors beginning after December 31, 2017, the GAAP rules changed significantly; and for non-public entity franchisors beginning after December 31, 2018, the GAAP rules will change significantly. This is because of new rules issued by the Financial Accounting Standards Board (“FASB”),\textsuperscript{160} which require initial development fees and initial franchise fees to be recognized as revenue ratably over the terms of development and franchise agreements, rather than when first units open under development agreements or when units open under franchise agreements.

The new FASB rules have had, and will have, the effect of depressing the reported net worth and reported revenue of franchisors. This effect will be particularly severe for startup and smaller franchisors that are growing and highly dependent on initial fees.

Another workshop at this Forum will address the new FASB rules in detail,\textsuperscript{161} so we will not address them in detail here.

\footnotesize
19.00.050 and WASH. ADMIN. CODE § 460-80-410-460 (examiner may require escrow, surety bond, fee deferral, parent or affiliate guarantee, “or other arrangements to protect the interests of a franchisee”). Illinois’ sample “Escrow Agreement,” “Franchisor’s Petition for Release of Escrowed Funds” and “Franchisee’s Petition for Release of Escrowed Funds” are available as Illustrations A-C in its regulations, and Illinois’ sample “Surety Bond” is available as Appendix E in its regulations. Washington’s sample “Franchise Impound Agreement” is available at \url{http://dfi.wa.gov/sd/forms.htm} under the “Franchises” heading.

\textsuperscript{158} In the past, these states did not require financial assurances for new franchisors if they had strong balance sheets. More recently, however, these states have gravitated to requiring financial assurances for most or all new franchisors. Washington generally requires the financial assurances to continue until the franchisor demonstrates that it can fulfill pre-opening obligations and afford pre-opening expenses, which can be for more than 1 year.

\textsuperscript{159} In looking for a bank that is willing to handle an impound or escrow account, it is generally best to start with the franchisor’s primary bank or a state community bank, and to contact the bank’s headquarters rather than a branch office.

\textsuperscript{160} FASB ASC 606, \url{https://www.iasplus.com/en-us/standards/fasb/revenue/asc606}.

\textsuperscript{161} W-17: The New FASB Rules.
From the standpoint of examiners, the new FASB rules have resulted in, and will result in, financial statements submitted by franchisors that are radically different from previous financial statements. This has caused, and will cause, examiners to think carefully about whether new risk factors in the franchisors’ FDDs and/or new financial assurances from the franchisors should be required.

VII. MISCELLANEOUS REGISTRATION ISSUES

A. Paper Filings and E-Filings

Most registration and notice states still require applications to be made as paper filings, with delivery being done by mail or courier. Some states, however, are permitting or requiring, or are moving toward permitting or requiring, electronic filings (“e-filings”).

The following states permit or require, fully or to some extent, e-filings:

- California permits registration, renewal, post-effective amendment, material modification, notice of violation and advertising e-filings.\(^{162}\)

- Florida permits renewal notice e-filings,\(^{163}\) but prefers renewal notice paper filings.

- Minnesota permits e-filings for all applications, but its system does not accept credit card payments, which requires franchisors to mail filing fee checks to the state before the applications are considered.\(^{164}\) As a result, some franchisors see no benefit or efficiency in making e-filings, and continue to make paper filings.

- Rhode Island permits initial and renewal registration e-filings, but does not permit amendment registration e-filings.\(^{165}\)

- Utah requires e-filings.\(^{166}\)

- Washington permits e-filings for all applications except pre-effective amendment filings.\(^{167}\) Pre-effective amendments may be emailed directly to examiners. Examiners generally ask that CDs not be submitted, since many of them work on virtual desktops, which means they do not have CD-ROM drives. If CDs are sent, examiners may be required to send the CDs to IT to be scanned, uploaded into a

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\(^{162}\) [https://docqnet.dbo.ca.gov/](https://docqnet.dbo.ca.gov/).

\(^{163}\) [www.FreshFromFlorida.com](http://www.FreshFromFlorida.com).

\(^{164}\) [https://www.cards.commerce.state.mn.us/CARDS/](https://www.cards.commerce.state.mn.us/CARDS/).

\(^{165}\) [https://elicensing.ri.gov](https://elicensing.ri.gov).

\(^{166}\) [https://dcp-egov.commerce.utah.gov/](https://dcp-egov.commerce.utah.gov/).

\(^{167}\) [www.dfi.wa.gov/franchises](http://www.dfi.wa.gov/franchises). In early 2018, Washington published a rulemaking notice, announcing that it is considering engaging in rulemaking to mandate the filing of franchise offerings and franchise brokers, as well as franchise exemption notice filings, through the Securities Division’s electronic franchise filing system.
share drive, and then indexed to the file. In other words, if paper is submitted, it is generally better not to submit a CD; instead, email a PDF to the examiner.

- Wisconsin permits and prefers e-filings for all applications.\textsuperscript{168}

Even when paper filings are made, states often require or permit franchisors to submit CDs containing copies of the paper documents submitted, and require franchisors to state in their paper cover letters that the documents on the CDs are identical to the paper documents. Maryland, for example, requires CDs to be submitted with paper filings. California does not require CDs to be submitted with paper filings, but permits them to be submitted.

Increasingly, examiners are emailing electronic comments (“e-comments”) to franchisors or their lawyers about applications, and are emailing effectiveness orders to franchisors or their lawyers. In their e-comments, the examiners often specify that paper filings must be made in response to the comments, but sometimes permit electronic responses (“e-responses”) to the comments. Maryland, for example, emails comments and effectiveness orders to franchisors, but requires franchisors to submit paper and CD responses to comments. In California, an e-response may be made if the franchisor made an e-filing, or an examiner may expressly request an e-response or a paper response. Washington examiners permit responses to comments to be sent either in paper filings or through e-mail, but generally tell franchisors that e-responses may expedite the registration process. If an examiner’s comment letter or email does not state how a response should be submitted, a franchisor or its lawyers should ask the examiner if an e-response is permitted.

B. Auditors’ Consent Letters

When a franchisor submits an FDD to a registration state with a new audited financial statement, the franchisor must submit an auditor’s consent letter stating that the audited statement may be included in the franchisor’s FDD.

The auditor’s consent letter should be dated, identify the franchisor, refer to the FDD and its issuance date, refer to the date of the audited statement, be on the accountant’s letterhead with an office address, and follow the model language in the NASAA Franchise Guidelines.\textsuperscript{169} A copy of the auditor’s consent letter (rather than an original) may be submitted to the state, unless the state requires otherwise.\textsuperscript{170}

The date on an auditor’s consent letter should be the same as or later than the issuance date of the FDD. While all states do not require this, some states, including Hawaii, are sensitive about this issue and will require a revised auditor’s consent letter to be submitted.

C. Effectiveness of Filings

Unless exemptions apply, all franchisors must file for registration in the 10 registration

\textsuperscript{168} www.wdfi.org/apps/franchiseefiling/.

\textsuperscript{169} NASAA Franchise Guidelines, supra note 11, at 1, 20-21, Form F.

\textsuperscript{170} NASAA Franchise Guidelines, supra note 11, at 21, Form F.
states,\(^{171}\) must file notices in the six annual notice states\(^{172}\) and must file notices in three one-time notice states,\(^{173}\) if they want to offer and sell franchises in those states.\(^{174}\)

Initial, renewal and amendment filings in the registration states generally become effective only when they are approved in state effectiveness orders,\(^{175}\) although there are some exceptions, such as the following:

- California registrations and renewals may become effective at noon PST on the 30\(^{th}\) business day “after the filing of a complete application or the last preeffective [sic] amendment thereto,” if (i) no stop order is in effect, and (ii) the franchisor has not waived automatic effectiveness.\(^{176}\) If the file is incomplete, it is not considered filed. Once any deficiencies are cured and the application is complete, it is deemed filed and the 30-business day automatic clock begins to run. If the reviewing examiner issues a comment letter, the file is deficient and the clock is tolled. Once all the comments are resolved through pre-effective amendment(s), the 30-business-day clock begins again if the response addresses all outstanding comments and no further comment letters are issued. If the reviewing examiner is running up against the deadline, a franchisor may be requested to waive automatic effectiveness. If the franchisor does not waive automatic effectiveness (which the franchisor has the right to do), the examiner must determine whether the Department should issue a stop order to protect the public. If the Department issues a stop order, the franchisor must disclose it in perpetuity in Item 3.\(^{177}\)

\(^{171}\) California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington. See statutory citations, supra note 16.

\(^{172}\) Florida, Indiana, Michigan, South Dakota, Utah and Wisconsin. See statutory citations, supra note 18.

\(^{173}\) Kentucky, Nebraska and Texas. See statutory citations, supra note 18.

\(^{174}\) Franchisors with no registered federal trademarks also must obtain registrations in two additional states (Connecticut and North Carolina), and file notices in one additional annual notice state (Maine), if they want to offer and sell franchises in those additional states. Franchisors with no registered federal or state trademarks also must file consents to service of process in three states (Georgia, Louisiana and South Carolina), if they want to offer and sell franchises in those additional states. See statutory citations, supra note 19.

\(^{175}\) An initial registration application filed with Maryland must be approved in a state effectiveness order, but the state has put itself under 30-business-day deadline to respond to the application. Md. CODE § 02.02.08.05. The response, of course, may be a comment letter. An initial registration, renewal or amendment application filed with New York must be approved in a state effectiveness order, but the state has put itself under a 30-day deadline to respond to an initial registration application, and a 15-day deadline to respond to a renewal or amendment application.

\(^{176}\) California Franchise Investment Law, CAL. CORP. CODE §§ 31116, 31121.

\(^{177}\) Since automatic effectiveness is conditioned on the filing of a “complete application,” and since registration and renewal applications often generate examiner comments that make the applications “incomplete,” most franchisors do not rely on the automatic effectiveness provision of the California law. Also, for a renewal to qualify for automatic effectiveness on or before the expiration date of the registration being renewed, a complete application must be filed at least 30 business days before the expiration date. This requirement makes it difficult for any renewal to qualify for automatic effectiveness on or before the expiration date of the registration being renewed, since each franchisor’s expiration date is 110 calendar days after its fiscal year end, and 30 business days before the expiration date (taking into account weekend days and state holidays such as Cesar Chavez Day) is less than 10 weeks after its fiscal year end.
Hawaii renewals and amendments become effective seven calendar days after complete updated FDDs are received by the state. It should be noted, however, that Hawaii franchise examiners sometimes send comments much later that need to be addressed by franchisors before they resume offering and selling franchises after they receive the comments.

Illinois initial registrations may become effective “on the 21st day after the filing of the required materials, unless the Administrator has denied registration.” As a practical matter, it is best to wait for a state effectiveness order to be issued, since an Illinois franchise examiner could later take the position that an application did not include all of “the required materials” and was incomplete. Illinois renewals and amendments become effective on receipt by the state, although Illinois franchise examiners sometimes send comments later that need to be addressed by franchisors before they resume offering and selling franchises after they receive the comments.

Subject to the Maryland franchise examiner approving an earlier date, a Maryland renewal may become effective at 12 noon of the expiration date of the prior registration period, if the renewal is filed at least 15 business days before the expiration date, and if no stop order or other order is in effect blocking effectiveness. Also subject to the Maryland examiner approving an earlier date, a Maryland amendment may become effective on the 15th business day after it is filed, if no stop order or other order is in effect blocking effectiveness, and if the Maryland examiner has not requested additional information. As a practical matter, because a Maryland examiner might deem a renewal or amendment to be non-compliant, most franchisors wait to receive state effectiveness orders before they resume offering and selling franchises.

Rhode Island initial registrations and renewals may become effective on the 30th business day after filing, or on the 15th business day after the submission of additional information requested by a Rhode Island franchise examiner, unless the franchisor has waived automatic effectiveness. As a practical matter, this seldom happens because comments are received, additional submissions are made and state effectiveness orders are received before the 30-business-day period runs.

Virginia renewals and amendments may become effective on receipt by the state, or on dates specified by the franchisors, if franchisors file Affidavits of Compliance.

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178 Hawai‘i Franchise Investment Law, HAW. REV. STAT. § 482E-3(c).
180 Id. §§ 705/10, 705/11.
181 Md. CODE § 02.02.08.07.D.
182 Id. § 02.02.08.06.F.
(Form E) with their applications. In the Affidavits of Compliance, franchisors must state that (i) they have not, since their last application filing, been convicted of a crime or held liable in certain types of civil actions, (ii) they are not insolvent or in danger of becoming insolvent, and (iii) their revised FDD complies with Virginia law. Some franchisors choose not to file Affidavits of Compliance, because Virginia examiners sometimes deem revised FDDs to be non-compliant. Therefore, some franchisors consider it safer to wait to receive a state effectiveness order than to rely on the filing of an Affidavit of Compliance.

- Washington initial registrations, renewals and amendments may become effective at 3:00 pm PST on the 15th business day “after filing of the registration statement or the last amendment,” if no stop order is in effect and no proceeding is pending against the franchisor, subject to the Washington examiner approving an earlier date. Washington generally prefers that a waiver of notice to be filed when an initial registration, renewal or post-effective amendment application is filed. This ensures that the examiner will have sufficient time to review a filing before the franchisor would otherwise be allowed to start offering franchises by operation of the statute. To avoid a stop order, it is generally necessary to wait to receive a state effectiveness order.

Many exemption filings in the registration states—such as certain experienced franchisee, fractional franchise, institutional franchisee, isolated sale, large franchisee, large franchisor, large initial investment and related party exemption filings—become effective on receipt by the state. On the other hand, exemption filings in the registration states that require affirmative consent from the states—such as case-by-case exemption filings—become effective only when they are approved in state effectiveness orders.

All initial notice, renewal notice and consent to service of process filings in annual notice, one-time notice and consent to service of process states become effective on receipt by the state, although South Dakota examiners have the authority to send comments later that need to be addressed by franchisors before they resume offering and selling franchises.

D. Advertising Submissions and Claims

Of the 10 states with franchise disclosure and registrations laws, 6 require advertising

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184 VA. ADMIN. CODE § 5-110-60.

185 Washington Franchise Investment Protection Act, WASH. REV. CODE § 19.100.060; WASH. ADMIN. CODE § 460-80-190.

186 E.g., California Franchise Investment Law, CAL. CORP. CODE §§ 31101(d), 31108(f), 31109(e); North Dakota Franchise Investment Law, N.D. CENT. CODE § 51-19-04.1.

187 E.g., Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. § 705/9; Maryland Franchise Registration and Disclosure Law, Md. CODE ANN., BUS. REG. § 14-214(b)(3); Minnesota Franchises Law, MINN. STAT. § 80C.03(g); New York Franchise Sales Act, N.Y. GEN. BUS. L § 684.1-2; North Dakota Franchise Investment Law, N.D. N.D. CENT. CODE § 51-19-04.3.

188 E.g., Indiana Deceptive Franchise Practices Law, IND. CODE § 23-2-2.5; Kentucky Sale of Business Opportunities Law, KY. REV. STAT. ANN. § 367.807(1)(a); Maine Sale of Business Opportunities Law, ME. REV. STAT. ANN. §§ 4696, 4697; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAWS § 37-5B-5.
submissions.\textsuperscript{189}

These submissions give examiners an opportunity to review franchisors’ advertising claims, and to review advertising materials regarding compliance with state specific requirements and prohibitions – such as the Maryland name and address requirements, and FPR prohibition;\textsuperscript{190} the Minnesota name, address trademark and registration number requirements, and FPR prohibition;\textsuperscript{191} and the New York offering statement requirement\textsuperscript{192} – before advertising materials are used in their states.

Even when advertising submissions are made, examiners have limited resources and time for the review of advertising, which means that, within the short 3-business-day to 7-business-day review periods involved, examiners often may not catch inconsistencies between advertising claims and representations in franchisors’ FDDs. That is the responsibility of the franchisors involved.

Increasingly, franchisors are making advertising claims exclusively or primarily on their websites or elsewhere on the Internet. This seems to be causing a decrease in the number of advertising submissions being made to the 6 states that require them. Examiners know the primary home page addresses of franchisors (because that information is required to be on the FTC cover pages of franchisors’ FDDs), but examiners often do not have the resources or time to review advertising claims made by franchisors on their websites or elsewhere on the Internet.

VIII. MISCELLANEOUS DISCLOSURE ISSUES

A. Plain English

Franchisors and their lawyers should not forget that both the FTC Rule\textsuperscript{193} and the NASAA Franchise Guidelines\textsuperscript{194} require a franchisor to use “plain English” when making disclosures in an FDD.\textsuperscript{195}

\begin{footnotes}
\item[189] California Franchise Investment Law, CAL. CORP. CODE, Tit. 4, Div. 5 § 31156 (3 business days before use); Maryland Franchise Registration and Disclosure Law, Md. CODE ANN. § 14-225 (7 business days before use); Minnesota Franchises Law, Minn. STAT. § 80C.09 (5 business days before use); New York Franchise Sales Act, NY COMP. CODES RULES & REGS. § 200.9 (7 days before use); North Dakota Franchise Investment Law, N.D. CENT. CODE § 51-19-10 (5 business days before use); and Washington Franchise Investment Protection Act, WASH. REV. CODE § 19.100.100 (7 days before use). “Advertising” includes form letters, brochures, handouts, advertisements, videos, audios, web pages and other materials used to promote franchises. Advertising materials do not include “consumer-oriented” materials given to prospects.
\item[190] Maryland Franchise Registration and Disclosure Law, MDCR § 02.02.09.09.A(1)(b)-(c) and (2).
\item[191] Minnesota Franchises Law, MINN. REGS. § 2860.4100.
\item[192] New York Franchise Sales Act, NY COMP. CODES RULES & REGS. § 200.9(d).
\item[193] The FTC Rule, supra note 3, §§ 436.1(d), 436.1(o), 436.6(b).
\item[194] NASAA Franchise Guidelines, supra note 11, at 4-5.
\item[195] Although the FTC Rule and NASAA Franchise Guidelines require disclosures to be in “plain English,” they do not require agreements or other exhibits in an FDD to be in “plain English.”
\end{footnotes}
“Plain English” means organizing information and using everyday language so that disclosures are understandable by a person unfamiliar with the franchise industry. It incorporates short sentences; definite and concrete language; active voice; and, the tabular presentation of information, when appropriate. It avoids legal jargon, highly technical business terms, and multiple negatives. The FTC Statement of Basis and Purpose explicitly references the old 1993 NASAA UFOC Guidelines regarding legal antiques and repetitive phrases that should be avoided, and the active voice approach which should be used.

Reviewing examiners do not issue many specific comments about “plain English,” but they appreciate it when FDD disclosures are written in “plain English,” and sometimes require language to be revised if it is confusing, misleading, contradictory of other disclosures, poorly organized, uses run-on sentences, or uses difficult-to-understand legal terms. “Plain English” problems often arise in Item 12, in the paragraphs that describe the territory granted and the franchisor’s reserved territorial rights.

B. Franchisor Disclaimers and Franchisee Acknowledgments

Franchisors sometimes include unrequired and duplicative disclaimers, or prohibited franchisee acknowledgments, in their FDD disclosures, in their franchise and other agreements, and in other exhibits with titles such as “Franchisee Compliance Certifications” and “Franchisee Representations.” Examiners often require these disclaimers and acknowledgments to be removed, even though franchisors try to justify them as “explanations.” In Maryland, in addition, examiners often require agreements and other documents to include the following statement:

“All representations requiring prospective franchisees to assent to a release, estoppel or

196 The FTC Rule, supra note 3, § 436.1(o).


198 “Avoid these legal antiques. Preferred substitutes are in parentheses: aforesaid; arising from (from); as between; as an inducement for; as part of the consideration; as set forth in (in); as the case may be; at a later point in time; binding upon and inure; commence (begin); condition precedent (before); condition subsequent (after); consist of (are); engaged in the business of offering (offers); for and in consideration of the grant of the franchise; for a period of (for); foregoing; forthwith; from time to time; further; hereby; herein; hereinafter; hereto heretofore; if necessary; in the event (if); including but not limited to (including); in any manner whatsoever; including without limitation (including); in conjunction with; in connection with; in no event; in the event of (if); in whole or in part; it will be specifically understood that; manner in which; not later than (within, by); not less than (at least); notwithstanding; offers to an individual, corporation or partnership (offer); on behalf of (for); precedent (before); prescribed (required); prior to (before); provided however (but, unless); provided that (if, unless); purporting to; relating to (under); subsequent (after); such (this); so as to (to); so long as (while); thereafter; therefrom; thereto; thereunder; without limiting the foregoing; whatsoever; with respect to.” NASAA UFOC Guidelines (1993), www.nasaa.org/industry-resources/corporation-finance/franchise-resources/, at General Instruction 150 n.1.

199 “Avoid repetitive phrases. Preferred substitutes are in parentheses: agrees, acknowledges and recognizes; any and all; are and remain; based upon, related to, or growing out of (because); certified as true and correct (certified); consultation, assistance and guidance (guidance); each and every; equipment, furniture, supplies and inventory set forth on the equipment list attached as Exhibit ___ (items on Exhibit ___); necessary and appropriate sample, test and review (test); and twenty-three (23) (write as 23).” id. at n.2.

200 “The preferred phrase is in parentheses: As the franchisor prescribes (you must); being offered (offers); consist of (is); engaged in the business of offering (offer); giving rise to; if it becomes necessary for (if); inure to the benefit of (benefits); is granted the right to (can); is given an opportunity to (can); is required to (must); shall be no less than (a minimum of); shall continue in effect (continues); with the exception of (except).” id. at n.3.
waiver of liability are not intended to nor shall they act as a release, estoppel or waiver of any liability incurred under the Maryland Franchise Registration and Disclosure Law.”

Unrequired disclaimers include, for example: disclaimers in Item 1; disclaimers in Item 7 that the franchisor is making no representation or guarantee of costs; disclaimers in Item 11 that the franchisor’s approval of a site is not a guarantee of the suitability of the site for the franchised business or that standards in the franchisor’s operations manual are subject to change; and, disclaimers in Item 19 that go beyond those already required or permitted under the FTC Rule and the NASAA Franchise Guidelines, such as stating that the FPR should be used for reference purposes only.

Examiners sometimes see blanket disclaimers in Item 1 of the FDD. For example, an examiner required the removal of the following disclaimer in an Item 1:

“The establishment of a new business, including the Franchised Business, involves substantial business risks. Significant investment beyond that outlined in this Disclosure Document may be required to succeed. Additionally, we are inexperienced as a franchisor and our franchised System is unproven and subject to revisions and modifications as the franchise business model evolves. We do not guarantee your success or any level of sales volume, profits (if any) or revenues. Any profit and possible success are primarily dependent on your personal business judgment, your sales ability and your talent as an independent business operator, your financial management and marketing judgment, and other business and personal skills, as well as your proper use of the System.”

Franchisee acknowledgments in franchise agreements also are suspect, and examiners often require them to be removed on the basis that they are unrequired disclaimers.

Examiners have observed a recent increased use of unrequired and duplicative disclaimers by franchisors, and are giving this issue increased scrutiny. Maryland, for example, has issued a paper stating: “Do not add more disclaimer language than is specified under the FTC Rule (and, where applicable, the NASAA Franchise Commentary), or repeat the disclaimer language multiple times.”

C. SBA-Related Disclosures

In the past, some franchisors added the following type of SBA-related disclosure in Item 10 of their FDDs:

You may be eligible for expedited and streamlined SBA loan processing through the SBA Franchise Directory. The approved SBA franchise agreement addendum is included in this disclosure document as Exhibit [X].

Recently, most examiners have required franchisors to delete this type of SBA-related disclosure in Item 10, on the basis that the disclosure is not required or permitted by the FTC Rule or state law.

Some franchisors continue to include the approved SBA addendum in their FDDs,

201 The release can be found at www.oag.state.md.us.
generally as an attachment to their franchise agreement. Although this approach has been
criticized on the basis that the SBA addendum is not a contract of the type required by Item 22 to
be included in FDDs, most registration states (including, for example, California and Maryland)
have permitted the approach.

D. Technology and FDD Content

Technology is turning what was once a world of thick paper FDDs, hand-signed and hand-
dated FDD receipts, and glossy paper marketing materials, into a world of electronic FDDs
transmitted over the Internet, e-signed and e-dated FDD receipts, and electronic marketing
materials. Technology also is also making it possible for franchisors to make more targeted and
malleable FPRs, through the use of software tools.

These changes are subtly changing FDD content, particularly Item 19 FPR content. Some
franchisors’ FPRs, for example, are becoming lengthy explanations of how prospects can use
software tools provided by the franchisor to do multi-year revenue, expense, rebate, profit and
business valuation projections, to do cost of goods comparisons based on actual vendor prices,
and to incorporate industry metrics into projections. Examiners have permitted some of these
changes, but have resisted others, depending on the facts in each situation.

IX. CONCLUSION

In this paper, the authors have focused on recent changes and hot issues affecting the
federal and state regulatory framework that applies to the offer and sale of franchises in the United
States, particularly relating to: NASAA’s recent issuance of proposed state cover pages changes;
state-level implementation of the NASAA FPR Commentary and NASAA Multi-Unit Commentary;
examiners’ increased focus on risk factors, financial statements, disclaimers and franchisee
acknowledgments; and other hot registration and disclosure issues.

This paper is a reference tool for use in beginning to analyze the legal issues involved in
complying with federal and state franchise regulation requirements, and is not legal advice. Actual
current laws, regulations and opinions should be reviewed, and experienced franchise counsel
should be involved, before any decision is made about legal obligations or rights in a particular
situation.
### Appendix A

**MULTI-UNIT FRANCHISING TERMS DEFINED IN FTC RULE AND STATE FRANCHISE LAWS**

<table>
<thead>
<tr>
<th>Multi-Unit Franchising Term</th>
<th>Jurisdiction</th>
<th>Language</th>
</tr>
</thead>
<tbody>
<tr>
<td>Area Franchise</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td>California</td>
<td></td>
<td>“‘Area franchise’ means any franchise between a franchisor and a franchisee whereby the franchisee is granted the right to operate more than one unit within a specified geographic area”</td>
</tr>
<tr>
<td>Hawaii</td>
<td></td>
<td>“‘Area franchise’ means any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.” “‘Subfranchisor’ means a person to whom an area franchise is granted.” (Interpretation based on Sec. 482E-2 definitions of “franchise” and “franchise fee.”) For there to be a “franchise,” subfranchisor must be granted trademark license, have a community of interest with the franchisor, and be required to pay a franchise fee.</td>
</tr>
<tr>
<td>Maryland</td>
<td></td>
<td>“‘Area franchise’ means an agreement between a franchisor and subfranchisor in which, for consideration, the subfranchisor is granted the right to sell or negotiate the sale of franchises in the name of or for the franchisor.”</td>
</tr>
<tr>
<td>Michigan</td>
<td></td>
<td>“‘Area franchise’ means a 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 such right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor; unless specifically stated otherwise, franchise includes area franchise.”</td>
</tr>
<tr>
<td>Minnesota</td>
<td></td>
<td>“‘Area franchise’ means 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 such right, to sell or negotiate the sale of franchises in the name or in behalf of the franchisor. Unless specifically stated otherwise, ‘franchise’ includes ‘area franchise.’”</td>
</tr>
<tr>
<td>New York</td>
<td></td>
<td>“‘Area franchise’ means a 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 such right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor; unless specifically stated otherwise, ‘franchise’ includes ‘area franchise.’”</td>
</tr>
<tr>
<td>North Dakota</td>
<td></td>
<td>“‘Area franchise’ means 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 such right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.”</td>
</tr>
<tr>
<td>Multi-Unit Franchising Term</td>
<td>Jurisdiction</td>
<td>Language</td>
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<tr>
<td>----------------------------</td>
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<tr>
<td></td>
<td>Oregon</td>
<td>“‘Area franchise’ means a contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, for a valuable consideration, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.”</td>
</tr>
<tr>
<td></td>
<td>Wisconsin</td>
<td>“‘Area franchise’ means 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 such right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.”</td>
</tr>
<tr>
<td>Broker or Selling Agent</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td></td>
<td>California</td>
<td>(Interpretation based on Release 18-F) Broker or selling agent is granted the right to sell or negotiate the sale of franchises in the name of or on behalf of the franchisor, but (1) does not give consideration for that right, (2) is not a party to the franchise agreements sold, and (3) may or may not perform post-sale obligations under the franchise agreements.</td>
</tr>
<tr>
<td></td>
<td>Hawaii</td>
<td>“‘Franchise broker or selling agent’ means a person who directly or indirectly engages in the sale of franchises.”</td>
</tr>
<tr>
<td>Development Agent</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td></td>
<td>California</td>
<td>(Interpretation based on Release 18-F) Development agent 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 behalf of the franchisor, but (1) is not a party to the franchise agreements; and (2) may or may not perform post-sale obligations under the franchise agreements.</td>
</tr>
<tr>
<td>Master Franchise</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td></td>
<td>Iowa</td>
<td>(Same as definition for “subfranchise” in the IA law) “‘Master franchise’ means an agreement by which a person pays a franchisor for the right to sell or negotiate the sale of franchises.” “‘Franchise’ [includes] a master franchise.”</td>
</tr>
<tr>
<td></td>
<td>Rhode Island</td>
<td>“‘Master franchise’ means an agreement express or implied, oral or written, by which a person pays a franchisor for the right to sell or negotiate the sale of franchises.” “‘Franchise’ [includes] a master franchise.”</td>
</tr>
<tr>
<td>Subfranchise</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td>Multi-Unit Franchising Term</td>
<td>Jurisdiction</td>
<td>Language</td>
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<tr>
<td>----------------------------</td>
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</tr>
<tr>
<td></td>
<td>California</td>
<td>“‘Subfranchise’ means 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 of or on behalf of the franchisor.” (Clarification based on Release 18-F) Subfranchisor must be granted the right to be a party to the franchise agreements sold, and must perform post-sale obligations under the franchise agreements.</td>
</tr>
<tr>
<td></td>
<td>Illinois</td>
<td>“‘Subfranchise’ means any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, in consideration of the payment of a franchise fee in whole or in part for such right, to sell or negotiate the sale of franchises. When used in this Act, unless specifically stated otherwise, ‘franchise’ includes ‘subfranchise.’”</td>
</tr>
<tr>
<td></td>
<td>Iowa</td>
<td>(Same as definition of “master franchise” in the IA law) “Subfranchise’ means an agreement by which a person pays a franchisor for the right to sell or negotiate the sale of franchises.”</td>
</tr>
<tr>
<td></td>
<td>Washington</td>
<td>“‘Subfranchise’ means an agreement, express or implied, oral or written, by which a person pays or agrees to pay, directly or indirectly, a franchisor or affiliate for the right to grant, sell or negotiate the sale of a franchise.”</td>
</tr>
<tr>
<td>Subfranchisee</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td></td>
<td>Iowa</td>
<td>“‘Subfranchisee’ means a person who is granted a franchise from a subfranchisor.” “‘Franchisee’ [includes] a subfranchisee with regard to its relationship with a subfranchisor.”</td>
</tr>
<tr>
<td></td>
<td>New York</td>
<td>“Subfranchisor’ means a franchisee who has the right to sell or subdivide his franchise to another or others, known as ‘subfranchisees’, while having and retaining all or part of the franchisor’s interest or rights under franchise agreements with such subfranchisee. Under this article and in this situation, the subfranchisee shall be considered the franchisee, and both the principal franchisor and the subfranchisor shall be considered the franchisor.</td>
</tr>
<tr>
<td></td>
<td>Rhode Island</td>
<td>“Subfranchisee’ means a person who is granted a franchise or subfranchise from the subfranchisor.” “‘Franchisee’ [includes] a subfranchisee with regard to its relationship with a subfranchisor.”</td>
</tr>
<tr>
<td>Subfranchisor</td>
<td>FTC</td>
<td>(No definition)</td>
</tr>
<tr>
<td></td>
<td>California</td>
<td>“A ‘subfranchisor’ is a person to whom a subfranchise is granted.”</td>
</tr>
<tr>
<td></td>
<td>Hawaii</td>
<td>“Subfranchisor’ means a person to whom an area franchise is granted.”</td>
</tr>
<tr>
<td></td>
<td>Illinois</td>
<td>“‘Subfranchisor’ means a person to whom the right to sell or negotiate the sale of subfranchises is granted.”</td>
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<tr>
<td>Iowa</td>
<td>“‘Subfranchisor’ means a person who is granted a master franchise.” “‘Franchisee’ [includes] a subfranchisor with regard to its relationship with a franchisor.”</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>“‘Subfranchisor’ means a person to whom an area franchise is granted.”</td>
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<td>Michigan</td>
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<td></td>
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<tr>
<td>Minnesota</td>
<td>“‘Subfranchisor’ means a person to whom an area franchise is granted.”</td>
<td></td>
</tr>
<tr>
<td>New York</td>
<td>“‘Subfranchisor’ means a franchisee who has the right to sell or subdivide his franchise to another or others, known as ‘subfranchisees’, while having and retaining all or part of the franchisor’s interest or rights under franchise agreements with such subfranchisee. Under this article and in this situation, the subfranchisee shall be considered the franchisee, and both the principal franchisor and the subfranchisor shall be considered the franchisor.”</td>
<td></td>
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<tr>
<td>North Dakota</td>
<td>“‘Subfranchisor’ means a person to whom an area franchise is granted.”</td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td>“‘Subfranchisor’ means a person to whom an area franchise is sold by a franchisor.” “‘Franchisee’ [includes] a subfranchisor with regard to its relationship with a franchisor.”</td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td>“‘Subfranchisor’ means a person who is granted a master franchise.”</td>
<td></td>
</tr>
<tr>
<td>Virginia</td>
<td>“‘Subfranchisor’ means a person who is authorized by a franchisor to grant a franchise within a particular geographic region.” “‘Franchisor’ means a person, including a subfranchisor, who grants or sells, or offers to grant or sell, a franchise.”</td>
<td></td>
</tr>
<tr>
<td>Washington</td>
<td>“‘Subfranchisor’ means a person to whom a subfranchise is granted.”</td>
<td></td>
</tr>
<tr>
<td>Wisconsin</td>
<td>“‘Subfranchisor’ means a person to whom an area franchise is granted.”</td>
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</tr>
<tr>
<td>Jurisdiction</td>
<td>Cite</td>
<td>CCH ¶</td>
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<tr>
<td>FTC</td>
<td>Federal Trade Commission Act, 15 USC § 45; Disclosure Requirements and Prohibitions Concerning Franchises, 16 CFR § 436</td>
<td>6016</td>
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<tr>
<td>CA</td>
<td>Franchise Investment Law; CAL. CORP. CODE §§ 31300, 31301, 31302.5, 31303 and 31304; CA Commissioner's Release 18-F</td>
<td>3050.60, .62, .63, .64, .65, 5050.49</td>
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<tr>
<td>HI</td>
<td>Franchise Investment Law, HAW. REV. STAT. §§ 482E-9 (b) and 482E-10.5(b)</td>
<td>3110.09, .11</td>
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<td>IL</td>
<td>Franchise Disclosure Act, ILL. COMP. STAT. §§ 705/26 and 705/27</td>
<td>3130.26, .27</td>
</tr>
<tr>
<td>IN</td>
<td>Franchises Law, IND. CODE §§ 23-2-2.5-28, 30; Deceptive Franchise Practices Law, IND. CODE § 23-2-2.7-7</td>
<td>3140.28, 30; 4140.07</td>
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<tr>
<td>MD</td>
<td>Franchise Registration and Disclosure Law, MD. CODE ANN. § 14-201(c), (i)</td>
<td>3200.27</td>
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<tr>
<td>MI</td>
<td>Franchise Investment Law, MICH. COMP. LAWS §§ 445.1531, 445.1532 and 445.1533</td>
<td>3220.31, .32, .33, .34</td>
</tr>
<tr>
<td>MN</td>
<td>Franchises Law, MINN. STAT. § 80C.17</td>
<td>3230.17</td>
</tr>
<tr>
<td>MO</td>
<td>Franchises Law, MO. REV. STAT. §§ 407.405 and 407.410.</td>
<td>4250.02, .03</td>
</tr>
<tr>
<td>NY</td>
<td>Franchises Law, N.Y. GEN. BUS. LAW §§ 691.1, 691.2 and 691.4</td>
<td>3320.12</td>
</tr>
<tr>
<td>ND</td>
<td>Franchise Investment Law, N.D. CENT. CODE § 19.12.</td>
<td>3340.12</td>
</tr>
<tr>
<td>OR</td>
<td>Franchise Transactions Law, OR. REV. STAT. § 650.020</td>
<td>3370.04</td>
</tr>
<tr>
<td>SD</td>
<td>Franchise Investment Law, S.D. CODIFIED LAWS §§ 37-5B-49, 37-5B-50 and 37-5B-51</td>
<td>3411.49, .50, .51</td>
</tr>
<tr>
<td>VA</td>
<td>Retail Franchising Act, VA. CODE ANN. §§ 13.1-565; 13.1-571</td>
<td>3460.09; .16</td>
</tr>
<tr>
<td>WA</td>
<td>Franchise Investment Protection Act, WASH. REV. CODE §§ 19.100.190 and 19.100.200</td>
<td>3470.19, .20</td>
</tr>
<tr>
<td>WI</td>
<td>Franchise Investment Law, WIS. STAT. § 553.51</td>
<td>3490.15</td>
</tr>
</tbody>
</table>
PEGGY SHANKS

Peggy Shanks is the Senior Franchise Examiner for the Securities Division of the Maryland Office of the Attorney General. She has been an Examiner there for over 28 years. She has spoken at franchise programs sponsored by NASAA, the IFA, the ABA Forum on Franchising, and the Maryland Bar Association. Before becoming an Examiner, she held positions as a Paralegal, a Court Clerk and a Law Clerk, and she was an intern at the Maryland General Assembly. Ms. Shanks received her A.A. Paralegal degree, honors, from Dundalk Community College and her B.A. degree in Jurisprudence, cum laude, from the University of Baltimore.

TIMOTHY O’BRIEN

Tim O’Brien is the Chief Examiner with the Virginia Division of Securities and Retail Franchising. He is responsible for administration of and compliance with the Virginia Retail Franchising Act and the Securities Act. He began his career with the Division over 20 years ago. From 2000 to 2006, he was employed as a Senior Public Finance Analyst with the Virginia Department of the Treasury, and served the Public Building Authority, the College Building Authority and the Debt Capacity Advisory Committee. He returned to the Division in 2006, and was named Chief Examiner in 2008. Mr. O’Brien has served as a member of NASAA’s Franchise and Business Opportunity Project Group since 2011. He received his Bachelor of Business Administration degree from James Madison University in 1987.

MICHELLE WEBSTER

Michelle Webster is a Financial Legal Examiner with the Washington Department of Financial Institutions, Securities Division. She is currently the Chair of the Business Organizations & Accounting Project Group of the North American Securities Administrators Association, and has spoken on various topics related to franchise law at programs sponsored by the American Bar Association Forum on Franchising and the International Franchise Association. She earned her B.A. in Political Science and her J.D. from the University of Washington. During law school, she served as a Judicial Extern to former Justice Richard Sanders of the Washington State Supreme Court and Legal Extern for the Social Security Administration’s Office of the General Counsel.

WARREN LEE LEWIS

Warren Lee Lewis is Chair of the Franchise & Licensing Practice Group of Akerman LLP, a national law firm. International Who’s Who of Franchise Lawyers, Franchise Times, Super Lawyers Magazine and Best Lawyers in America have recognized Mr. Lewis as a leading franchise lawyer. He is the author of books, articles, and studies on franchising; and has been a speaker at ABA and IFA programs, and at FTC hearings. He is a member of the Industry Advisory Committee to the NASAA Franchise & Business Opportunities Project Group. Mr. Lewis has offices in Washington, DC and McLean, Virginia, and represents franchisors nationally. He graduated with highest honors from the University of Maryland (B.S. journalism), and with honors from the George Washington University Law School (J.D.).