Regulatory Update:
Recent Changes and Hot Issues
Panel

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Overview

- Regulatory Framework - FTC, NASAA, Regulatory States
- State Cover Pages
- Risk Factors
- Financial Performance Representations (FPRs)
- Multi-Unit FDDs
- Financial Statements & Assurances
- Misc. Registration Issues
- Misc. Disclosure Issues
Regulatory Framework – FTC, NASAA, Regulatory States
Regulatory States

- **Red**: Franchise disclosure and registration law
- **Pink**: Franchise or business opportunity disclosure and notice law
- **Blue**: Business opportunity disclosure and registration or notice law
- **Green**: Franchise or business opportunity disclosure law
State Cover Pages

- **NASAA Project Group proposal** – request for comments on proposed change to 2008 Guidelines made June 2018; 9 comments submitted July 2018; comments being reviewed

- Additional request for comments may be made

- Change may be implemented in 2019
State Cover Pages

- Proposal – from current 1-2 pages, to 4 pages with following headings:

1. How to Use This Franchise Disclosure Document
2. What You Need to Know About Franchising *Generally* and Some States Require Registration
3. Special Risks to Consider About *This* Franchise*
   *Other risks may be required to be in state addenda
4. State Effective Dates
1st State Cover Page – How to Use This Franchise Disclosure Document

- How much will I earn?
- How much will I need to invest?
- Does the franchisor have the financial ability to support my business?
- Is the franchise system stable and growing or shrinking?
- Will my business be the only [XYZ] business in my market?
- Does the franchise have a troubled legal history?
- What’s it like to be [an XYZ] franchisee?
- What else should I know?
2nd State Cover Page – What You Need to Know About Franchising *Generally*

1. Payment of fees even if losing money
2. Additional investment if franchisor implements changes
3. Operation of similar business during and after may be prohibited
4. Renewal may not be permitted, or may be on different terms
5. Purchases/leases from franchisor/suppliers may be required

- Some states require registration
About This Franchise

- Old risk factor on out-of-state dispute resolution kept - if applicable
- Old risk factor on governing law eliminated
- Other uniform risk factors required by examiners – no ALL CAPS; underlined and bold initial summary; caps and lower case
- Non-uniform and state-specific risk factors required by examiners – not on this page; in state addendum
Special Notice Pages

- Special notice pages required by states with franchise laws may follow 3 state cover pages (before Table of Contents) (e.g., HI, MI)

- Special notice pages required by states with business opportunity laws must be moved to state addenda (e.g., GA, NC)
4th State Page – State Effective Dates

- Immediately before FDD receipts

- Only states with franchise registration or notice laws may be referenced

- No other states or territories may be referenced, including states with business opportunity laws
Risk Factors

- FTC does not require risk factors
- NASAA 2008 Guidelines and examiners require risk factors
- NASAA Project Group – has recommended uniform risk factors to examiners; non-public “living document”
Risk Factors

- All risk factors must be required by examiners, other than 3 mandatory risk factors on dispute resolution, governing law and other risks (if applicable)

- Lawyers cannot add or water down risk factors

- Examiner may require franchisor to identify source of a risk factor by examiner name and date
Risk Factors

- Examiners requiring uniform risk factors – factual statement, followed by explanation of risk

- Example:

  “The franchisor’s financial condition, as reflected in its financial statements (see Item 21), calls into question the franchisor’s financial ability to provide services and support to you.”
Risk Factors

- Another example:

“You must make minimum royalty or advertising fund payments, regardless of your sales levels. Your inability to make the payments may result in termination of your franchise and loss of your investment.”
Risk Factors

- Risk factors required by 1 state or a few states, or risk factors with non-uniform wording – NASAA encourages placement in state addenda:
  - No exclusive territory (CA)
  - Franchisee’s investment vs. franchisor’s equity (NY, VA)
Risk Factors

- **Lawyer-volunteered risk factors** – prohibited; generally disclaimers

- **Sample (lawyer-generated):**

  “This disclosure document is provided for your own protection and contains a summary only of certain material provisions of the franchise agreement.”
Risk Factors

- Another sample (lawyer-generated):

  “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 ..., 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.”
Financial Performance Reps. (FPRs)

• **NASAA FPR Commentary** – adopted May 2017; for most franchisors, effective April 2018; Q&As 19.1-19.23

• More FDDs with FPRs – about 60%

• Most FPRs substantially or fully compliant with FPR Commentary, but some deficiencies and trends
FPRs – Most Frequent Deficiencies

1. 19.3, 19.21 & 19.22 – admonition required

- **wording structure**: “Some outlets have earned this amount. Your individual results may differ. There is no assurance that you’ll earn as much.” – that’s it

- **format**: separate paragraph; bold; upper and lower case; same font as other text; not underlined, italicized, ALL CAPS or larger font

- **placement**: just before last paragraph starting “Other than the preceding financial performance representation, ...”
FPRs – Most Frequent Deficiencies

2. 19.23 – disclaimers prohibited, such as:

- “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.”
FPRS – Other Frequent Deficiencies

- **19.13** – best performing outlets – must disclose corresponding results of lowest performing outlets

- **19.16** – average sales – must disclose median sales, and highest and lowest sales in range

- **19.18** – outlets that closed during period – must disclose; may exclude from average and median
FPRs – Trends

• **19.12** - subsets of more mature franchisees – open at least 2, 3 or 5 years, rather than at least 1 year; may be “misleading”

• **19.16** – averaging franchisee results, mixing the results of franchisees with single territories and multiple territories, or of small territories and large territories

• **19.19 & 19.20** – projections using software tools
Multi-Unit FDDs

- **NASAA Multi-Unit Commentary** – adopted 2014; effective 2015; should be followed in all states

- **3 multi-unit arrangements addressed:**
  - Area development
  - Subfranchise
  - Area representation
Multi-Unit FDDs – Area Development

- Unit and area development rights may be offered in single FDD

- Sample issues:
  - Item 1 – franchise agreements for future outlets may be different
  - Item 20 - footnote indicating area developers; disclosure of no area developers at FYE
Multi-Unit FDDs - Subfranchise

- Franchisor must have FDD separate from unit FDD
- Subfranchisor must have its own unit FDD

Sample issues in franchisor’s subfranchise FDD:
  - Item 1 – reference to franchisor’s separate unit FDD
  - Item 20 – no listing of unit franchisees or franchised outlets
  - Item 22 – inclusion of franchisor’s then-current franchise agreement
Multi-Unit FDDs - Subfranchise

- Sample issues in subfranchisor’s unit FDD:
  - Items 2, 3, 4 and 20 – subfranchisor’s information first
  - Item 13 – disclosure of limitations on subfranchisor’s rights regarding franchisor’s trademarks
  - Item 21 – inclusion of subfranchisor’s and franchisor’s financial statements
Multi-Unit FDDs – Area Representation

- Franchisor must have separate unit and area rep FDDs

- Area representatives must be disclosed in franchisor’s unit FDD

- Sample issues:
  - Item 20 – no disclosure of unit franchisees or franchised outlets in area rep FDD
  - Item 22 – no franchise agreement or area development agreement in area rep FDD
Financial Statements & Assurances

- Audited comparative statements for 3 years

- Interim unaudited statements – some states require if filings made 90 or 120 days after FYE (MD, WA)

- Phase-in of audited statements – permitted by FTC and some states (not MN, NY, VA)
Financial Statements & Assurances

- Common issues:
  - not GAAP-compliant
  - not comparative
  - less than 11-point font
  - missing unaudited statement
Financial Statements & Assurances

- “Weak” financial statements:
  - examiner discretion – current assets vs. current liabilities; low or negative net worth; affiliate notes or loans; losses or profits, etc.
  - NY requires risk factor; other states require financial assurances
  - VA requires financial assurance if liabilities exceed assets (statutory)
  - no “bright line” net worth minimum that triggers financial assurance requirement
Financial Statements & Assurances

• Financial assurances:
  • fee deferrals
  • escrows (impounds)
  • surety bonds
  • guarantee by parent or affiliate

• New FASB rules
Misc. Registration Issues

- E-filings and e-responses to examiner comments
- Dates on auditor’s letters earlier than dates on FDD
- Effectiveness of filings
- Advertising submissions and claims
Misc. Disclosure Issues

- **Plain English** – still required in Items 1-23

- **Franchisor disclaimers** – can appear anywhere in FDD

- **Franchisee acknowledgments** – can appear anywhere in FDD, not just in franchise compliance questionnaire
Misc. Disclosure Issues

- **Gratuitous marketing information** – particularly in Items 1 & 2
- **SBA financing** – Item 10; SBA addendum as exhibit
- **Technology and FDD content**
Presentation Disclaimers

- This presentation is for use in beginning to analyze some of the issues involved under the FTC Franchise Rule and state laws. It is not legal advice. You should review all relevant laws, regulations and sources of authority, and should confer with legal counsel, before coming to any conclusions about your legal obligations.

- The views expressed in this presentation are those of the authors, and do not necessarily reflect the views of the North American Securities Administrators Association, Maryland Office of Attorney General, Virginia State Corporation Commission, Washington Department of Financial Institutions, or Akerman LLP.
Questions

Thank You