THE BASICS OF STATE REGISTRATION AND DISCLOSURE
AFTER THE NEW FTC RULE

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I. INTRODUCTION AND STATUS

On December 21, 1978, the Federal Trade Commission (“FTC” or the “Commission”) promulgated the trade regulation rule entitled “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures”¹ (the “FTC Rule” or the “Rule”), creating a national franchise pre-sale disclosure rule.

In April 1995, as part of its continuing review of FTC trade regulation rules, the FTC published in the Federal Register² a Rule Review Notice seeking comment on issues such as the costs and benefits of the Rule, what changes in the Rule would increase the Rule’s benefits to consumers, how would those changes affect compliance costs, and what changes in the marketplace and new technologies may affect the Rule.

The FTC then sought additional comments on possible amendments to the Rule and in February 1997 published an Advance Notice of Proposed Rulemaking,³ seeking comments on various issues relating to the FTC Rule. On October 15, 1999, a Notice of Proposed Rulemaking⁴ (“NPR”) was announced requesting public comments on proposed revisions to the FTC Rule. The NPR, among other details, outlined the history of the FTC Rule, summarized the changes proposed by the FTC with its analysis supporting the changes, and then attached the proposed new FTC Rule itself. On August 25, 2004, the FTC staff issued a revised version of the proposed rule (the “Proposed Rule” or the “New FTC Rule”).⁵ Additional public comments were then sought with a public comment cut-off deadline of November 12, 2004. As of the press date for this paper August 2005, no further developments had been announced. The FTC staff has an unspecified time frame to review the submitted comments and make its final recommendation to the FTC. Upon receipt of the proposal, the Commission will be allotted unlimited time to consider and adopt the determined changes.

The Proposed Rule disclosure requirements are based on the 1993 UFOC Guidelines developed by the North American Securities Administrators Association (“NASAA”),⁶ which we will refer to as the “UFOC Guidelines.” The Proposed Rule, however, differs from the existing UFOC Guidelines in several respects. The FTC has reorganized, edited and streamlined the UFOC disclosures for clarity, and in a number of instances, has made substantive changes. In addition, the FTC proposes to change the title of the New FTC Rule to “Disclosure Requirements and Prohibitions Concerning Franchising” because it also proposes to eliminate business opportunity ventures from the New FTC Rule by establishing a separate trade regulation rule solely for business opportunities.

A primary focus of this paper will be the process by which the New FTC Rule, assuming it is ultimately adopted by the FTC, will be implemented by the various states regulating the offer and sale of franchises. Each state has its own existing registration and disclosure requirements

⁵ Notice of Proposed Rulemaking ¶ 1 (1999); BUS. FRAN. GUIDE ¶ 11,713, at 32330-32356.
⁶ The UFOC Guidelines were adopted by NASAA on April 25, 1993, BUS. FRAN. GUIDE ¶¶ 5900-5932.
which must be reconciled with the FTC’s final form of disclosure. We will concentrate our discussion on the process anticipated in the states in which the authors reside.

This paper will also describe some of the key differences between the existing UFOC Guidelines and the modified UFOC proposed by the FTC, and referred to as the “UFOC Plus”. The reader must realize however, that as this paper is being written, the FTC continues its evaluation of the final public comments and potential additional changes before it submits the Proposed Rule to the Commission. The FTC is charged with the preparation of a Statement of Basis of Purpose and Compliance Guides, so this paper will not be the definitive or last word on this subject. Because other papers at this forum will elaborate on the proposed changes to the existing UFOC Guidelines, we will describe those changes in abbreviated fashion.

The FTC’s proposed changes to the pre-sale disclosure process, the requirements for updating and amending the UFOC and negotiated changes will be explored. We will also address state law differences and the perspectives of the state regulators on the panel who have co-authored this paper.\(^7\) One of the by-products of the New FTC Rule is that the existing FTC Rule is contemplated to be modified so that it will remain in effect, but will apply only to business opportunity ventures.

Assuming the Commission adopts the Proposed Rule, with or without additional changes, there is expected to be a phase-in period to provide time for registration states to coordinate state laws and regulations and for franchisors to implement the new disclosures.

II. PROCESS FOR STATE ADOPTION OF NEW FTC RULE

A common question raised by franchisors and franchise law practitioners is how long will it take for the Proposed Rule to become law, particularly in each of the so-called “registration states” which now require pre-sale registration and disclosure of franchises. These states have essentially adopted the existing UFOC Guidelines, as they were last amended by NASAA in 1993 (with modifications in some instances). The steps needed to be taken by the states will vary depending on state law and how the current version of the UFOC had been adopted by the particular state. In some cases, adoption will be automatic upon adoption by the FTC, or by NASAA, because the state’s existing statutes or regulations incorporate the FTC Rule or the NASAA UFOC Guidelines “as amended” from time to time. In other cases, where the existing disclosure format was adopted by regulation, it can be modified by the state regulator charged with overseeing the franchise laws, the time and process for which will also vary by state. In yet other instances, the current form of disclosure format is dictated by statute, in which case the franchise statute itself must be amended by the state legislature and timing may turn, in part, on whether the state legislature is in session at the time that the Commission adopts the New FTC Rule. Before we examine the state-specific processes that we anticipate will apply in each of the registration/disclosure states, it is instructive to note that the states have been actively involved throughout the FTC’s development of the Proposed Rule under the auspices of the North American Securities Administrators Association, Inc. (“NASAA”).

\(^7\) The views and opinions expressed herein by the authors are not necessarily the views of the Illinois, Maryland or New York Office of the Attorney General, which is also known as the New York State Department of Law. Further, the authors individually contributed information and comments for the completion of this publication, and, as such, that information and comments may not necessarily be the views or opinions of the other authors.
A. **What Will Be NASAA’s Role?**

NASAA is a voluntary association of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. NASAA proposes model acts, regulations, statements of policies, and other initiatives to assist its member jurisdictions in their role to administer and enforce securities and franchise laws at the state and provincial levels. In 1974, NASAA’s predecessor, the Midwest Securities Administrators Association, proposed for implementation at the state level the original uniform franchise offering circular guidelines. NASAA adopted successive versions of the guidelines (“the UFOC”), most recently in 1993.\(^8\) The 1993 UFOC Guidelines have been the required format for franchise disclosure document in the 15 franchise jurisdictions since 1994. In addition, since 1995, the FTC has permitted franchisors to use the UFOC format as an alternative to the FTC’s own disclosure requirements.\(^9\)

NASAA has no direct authority over franchising in the United States or over the 15 state agencies that register franchise offerings, but as an association comprised of representatives of the state securities administrators who administer franchise laws, NASAA’s recommendations and policy initiatives have traditionally been given great weight by the states that regulate franchises.\(^10\)

For many years, NASAA has designated a standing committee, the Franchise and Business Opportunity Project Group (hereafter the “Franchise Project Group” or “NASAA”) to coordinate tasks and initiatives at the state level. The Franchise Project Group is generally comprised of four - five representatives from state franchise agencies with experience in franchise matters. The Franchise Project Group also receives advice and guidance from members of an Industry Advisory Committee, comprised of attorneys, advocates, and other individuals with a particular expertise or viewpoint on franchise issues.

The Franchise Project Group coordinates efforts among the states on many franchise matters. For example, in 1998, the Franchise Project Group initiated a program for coordinated franchise review, in which all franchise registration states now participate. NASAA has issued several Commentaries on the UFOC Guidelines, which are generally accepted interpretations of the meaning of specified disclosure requirements. NASAA has also issued other statements of policy, both formal and informal, dealing with such franchise issues as Internet Offers, Internet Advertising, “Y2K” disclosure, and Electronic Disclosure.

It is evident from the Staff Report of the Bureau of Consumer Protection to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (August 2004) (“the FTC Staff Report”) that the Federal Trade Commission has consulted and coordinated with NASAA. Throughout the FTC’s Rulemaking process, the FTC Staff sought NASAA’s input into the project. NASAA filed comment letters during each phase of the FTC’s Rulemaking process, starting with the Advanced Notice of Proposed Rulemaking (“ANPR”) issued in 1997.\(^11\)

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\(^8\) BUS. FRAN. GUIDE ¶ 5700, at 8405.


\(^10\) 14 of the 15 states that require registration of franchise offerings are NASAA members through their state securities administrators. In Illinois, the Illinois Attorney General’s Office, which administers the Illinois Franchise Act, is not a NASAA member because there is only one membership per state, and the NASAA member for Illinois is with the Office of the Secretary of State, which administers the Illinois Securities Act.

Although the FTC did not adopt all of NASAA’s recommendations,\textsuperscript{12} the FTC Staff Report clearly reflects an intention on the part of the FTC Staff to coordinate issues of franchise disclosure between the FTC and the states. First, the FTC Staff Report specifically states that it “adopts many of the UFOC Guidelines without changes or with minor edits.”\textsuperscript{13} The FTC also recognizes NASAA’s role in interpreting the UFOC Guidelines since their enactment in 1993.\textsuperscript{14} It is clear from the FTC Staff Report, that the FTC Staff acknowledges the role that NASAA and NASAA members have played and continue to play in the development of franchise disclosure generally.

One example of the FTC Staff’s attempt to coordinate with NASAA is found in the discussion regarding one of the most important disclosures in the UFOC, Item 20 (“Outlets and Franchisee Information”). NASAA and others noted that Item 20 of the UFOC Guidelines was flawed. NASAA proposed an entirely new and revamped Item 20, with new charts and more precise definitions, including a separate chart for franchise transfers. After reviewing a number of alternatives, the FTC Staff Report decided to incorporate the NASAA recommendation to revamp UFOC Item 20.\textsuperscript{15}

Informally, the FTC Staff has had numerous discussion with members of the Franchise Project Group, and with state franchise administrators and examiners, about the FTC Staff Report and continuing issues with the UFOC Guidelines. In that context, the FTC Staff appears to recognize that NASAA and the states have a particularly relevant perspective on disclosure issues based on their experience with reviewing franchise offerings, and with investigating and bringing actions based on allegations of franchise fraud.

In the future, assuming the FTC enacts a franchise disclosure format based on the current FTC Staff Report, it is likely that the FTC will continue to seek input from NASAA and state franchise administrators. To the extent that franchise registration states affirmatively adopt a new state franchise disclosure format based on the FTC Staff Report, those states and the FTC would be wise to coordinate their public pronouncements regarding the requirements, in the form of FTC Staff Advisory Opinions, Compliance Guides, NASAA Commentaries, and similar pronouncements, in order to avoid the possibility that the FTC and the states would reach different interpretations of identical or nearly identical requirements. At present, there is every likelihood that this coordination will continue to occur.

To better insure as much uniformity as possible, NASAA may submit a recommended, new set of UFOC Guidelines that adopt the revised FTC Rule disclosure provisions, together with any additional examples, instructions or comments that the regulatory states believe are necessary. This is also important for the states that implemented the existing UFOC Guidelines through a regulation that accepts the UFOC Guidelines “as adopted and amended by NASAA.”

\textsuperscript{12} FTC Staff Report at 51 (rejecting NASAA’s comment to define the term franchisor to include shareholders of privately held entities); \textit{id.} at 151 (rejecting NASAA’s suggestion to expand UFOC Item 15 to specifically disclose operating hours).

\textsuperscript{13} \textit{id.} at 15.

\textsuperscript{14} \textit{id.} at 20, 76 (citing to NASAA’s 1993 Commentary to the UFOC Guidelines).

\textsuperscript{15} \textit{id.} at 180.
Following is a state-by-state review of the alternative approaches expected to be followed in the states which regulate pre-sale disclosure. Except for the states of Indiana, Michigan, Rhode Island and Wisconsin where it appears that acceptance of the New FTC Rule’s "UFOC Plus" disclosure format will occur automatically upon adoption by the FTC and/or NASAA, the laws or rules of the other states requiring pre-sale disclosure enable the New FTC Rule to be implemented by rule, without the need for state legislation and the states with whom we have discussed timing, have uniformly expressed confidence that implementation can be effected during the FTC’s phase-in period, anticipated to be at least six to 12 months.

1. **California**

The California Commissioner of Department of Corporations is charged with overseeing the Franchise Investment Law ("CFIL"), and with adopting regulations necessary to implement the CFIL, including establishing the disclosure format. California law does not contemplate automatic adoption of any amendments which NASAA may make to the UFOC Guidelines and disclosure format.

In a release describing the manner of presenting certain information in the UFOC, the Commissioner states that the California state regulations require strict compliance with UFOC as amended by April 25, 1993 NASAA Guidelines, stating that, "Applicants are cautioned to ensure compliance with the amended [UFOC] when filing an application for registration. A franchise offering that does not comply with the 1993 version of the [UFOC] Guidelines will be declared deficient, in toto, and could result in the termination of the review of the registration application." Accordingly, it will be necessary for the Commissioner to amend the existing regulations to adopt the Proposed Rule. CFIL Section 31503 requires that, "All rules of the commissioner, other than those relating solely to the internal administration of the Department of Corporations, shall be made, amended or rescinded in accordance with the provisions of Chapter 4.5 (commencing with Section 11371) of Part 1 of Division 3 of Title 2 of the Government Code."

2. **Hawaii**

There is no language in the statute that refers to NASAA, the UFOC or the process by which Hawaii’s franchise law and regulations are to be amended. The statute only details the appointment of an administrator by the Director of Commerce and Consumer Affairs "to carry out the provisions of this chapter." Accordingly, in Hawaii, the New FTC Rule disclosure requirements will need to be adopted through regulations issued by the Director of Commerce and Consumer Affairs.

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17 *Bus. Fran. Guide ¶ 5050.46; Cal. Code Regs. tit. 10, § 310.114.1 explicitly adopts the 1993 version of the UFOC, but with slight variations, stating: "Each offering circular shall contain the information required by the Uniform Registration Application, as defined in section 310.111(b), and as modified by this section." Section 310.111(b), in turn, provides in pertinent part that "On or after January 1, 1995, the term "Uniform Franchise Registration Application" means information required from the applicant in accordance with the Uniform Franchise Offering Circular ("UFOC") Guidelines, as amended by the North American Securities Administrators Association, Inc. on April 25, 1993.*

18 *Bus. Fran. Guide ¶ 3050.80.*

Existing Hawaii regulations do not mention the words “Uniform Franchise Offering Circular”, “UFOC” or “NASAA”. Nor is there language in the regulations that refers to any kind of amendments issued by NASAA with respect to the UFOC. Moreover, Rule 16-37.4, which lists all the requirements for filing an Offering Circular and contains exactly 23 items, just as in the UFOC, the 23 items in the Hawaii regulations do not match the 23 items in the UFOC as adopted by NASAA in 1993. Some of the requirements are the same such as use of public figures, financial statements, limitations on goods and services that the franchisee may offer to his customers, among other items, but the section numbers under which these requirements are listed are not the same section numbers listed in the UFOC. Furthermore, Hawaii imposes additional requirements on an applicant that are not found in the UFOC.

3. Illinois


During the transition period following adoption by the FTC, Illinois will look at the final rule, its overall effects, the position taken by NASAA, and the Illinois Franchise Disclosure Act and Regulations to determine the best avenue to proceed. The Act enables the Attorney General’s Office to pursue a rule amendment via Sections 705/9 and 705/32 with Section 705/32 citing conformance with “The Illinois Administrative Procedure Act, approved September 22, 1975, as amended [5ILCS 100/1-1 et seq.]”

If the Attorney General’s Office opts for rulemaking, new Illinois rules will be drafted for submission to the statutory, legislative committee known as the Joint Committee on Administrative Rules (JCAR) comprised of Illinois House and Senate members and supported by a staff responsible for procedural and content compliance. The proposed Illinois rules will be published in the Illinois Register (via the Secretary of State’s Office) with a 45 day public comment period. Upon completion of the rulemaking process, the amended rules and regulations would be resubmitted to the Secretary of State’s Office for certification and enactment.

Alternately, Section 705/16 of the Act provides that the disclosure statement is to be prepared in accordance with the NASAA UFOC Guidelines. In conjunction with Section 705/9, a corresponding Order would be published, followed by a reprint of the Act, Rules and new Guidelines.

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20 BUS. FRAN. GUIDE ¶ 5110.04
21 815 ILL. COMP. STAT. 705/16 (2005).
23 815 ILL. COMP. STAT. 705/9, 705/32.
24 Id. 705/16.
Adoption of the New NASAA approved Guidelines will occur during the FTC transition period, however, a specific time period for adoption is not feasible due to the variables which must be considered.

4. Indiana

The only language in the Indiana franchise law that relates to its implementation is in Section 47 which provides that: “It is the intent and purpose of this chapter to delegate and grant to and vest in the secretary of state, the securities division and the commissioner full and complete power to carry into effect and accomplish the purpose of this chapter and to charge them with full and complete responsibility for the effective administration thereof.” There is no language in the statute that refers to NASAA, the UFOC or amending Indiana’s franchise law.

The Indiana Securities Commissioner, pursuant to state regulations, issued an Order which explicitly adopted the UFOC Guidelines, stating, “All disclosure statements filed with the Uniform Franchise Registration Application Form shall comply with the [UFOC] Guidelines established by [NASAA] and the FTC Franchise Rule...” However, the Indiana regulations do not say which version of the UFOC is to be followed and it is unclear whether this implies an intent to incorporate UFOC in the most current version in effect from time to time, or whether Indiana intended to adopt the current version (the 1993 version) and no other version, past or future.

5. Maryland

Section 14-216 of the Maryland Franchise Law includes a listing of disclosures that are required to be included in a franchise disclosure document (or “prospectus”) under the Franchise subtitle. The disclosures correspond generally with the disclosures listed in the UFOC Guidelines. Under Section 14-215 (a) of the Maryland Franchise Registration and Disclosure Law (the “Maryland Franchise Law”), the Maryland Securities Commissioner may accept a form of franchise disclosure document similar to the prospectus required under that law that are (i) required by a unit of the federal government...; or (ii) approved by an association of administrators of state franchise laws. Section 14-216 of the Maryland Franchise Law sets forth requirements for a franchise prospectus that correspond, generally, with the requirements of the UFOC Guidelines.

In 1994, the Maryland Securities Commissioner promulgated a regulation that adopted and incorporated by reference the “Uniform Franchise Offering Circular Guidelines adopted by the North American Securities Administrators Association, Inc. on April 25, 1993...,” with certain modifications set forth.

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26 BUS. FRAN. GUIDE ¶ 5140.012.
28 Id. §14-215.
29 MD. REGS. CODE 2, §02.02.08.04A (2005).
The Maryland Securities Commissioner is free, therefore, to adopt a new franchise disclosure format, if the format is prescribed by the FTC or NASAA, so long as she finds the requirements to be “similar” to the UFOC Guidelines. She may adopt a substitute format by regulation pursuant to the requirements of the Maryland Administrative Procedures Act. The procedure for adopting regulations under the Maryland Administrative Procedure Act generally require publication of proposed regulations, with notice and the opportunity for comments. The timing for adoption can vary but generally may be completed in six months or less, for non-controversial proposals.

6. **Michigan**

Since 1984, Michigan law has required pre-sale disclosure, but not state registration. In addition to filing a notice with the Michigan Consumer Protection Division prior to offering franchises in that state, the franchisor must deliver a disclosure statement in the form required by a federal or state government agency, or a disclosure statement approved by an association of state regulatory agencies (e.g. such as NASAA), which the department determines by rule or order to encompass disclosure requirements similar to those in this subsection, or may be a disclosure statement that shall contain all of the items set forth in Section 45.1508 of the Franchise Investment Law.

Although no new regulations have been adopted, the Attorney General's office issued a brochure entitled “Guidelines for Prospective Franchisees,” as well as an explanatory letter for franchisors, which explains that although Michigan's Franchise Act did away with registration and exemption filings and review, the Act does provide for disclosure statements or offering circulars to be provided to prospective franchisees meeting one of the following five forms: (1) A disclosure statement meeting the requirements of the Trade Commission Rule 16 CFR Section 436.1, et seq.; (2) A disclosure statement approved for use by another state under its Franchise Law; (3) A disclosure statement approved by an association of state regulatory agencies which has requirements similar to those of section 8(2) (a) through (t) of the Michigan Act; (4) A disclosure statement that meets the requirements of section 8(2)(a) through (t) of Section 45.1508 of the Franchise Investment Law; or (5) Such disclosure statements as the Department of Attorney General may by rule or order provide in the future.

It is unclear whether the incorporation of the Trade Commission Rule 16 CFR §436.1, et seq. will automatically include any subsequent changes made upon the FTC's adoption of the Proposed Rule. Section 45.1508 of the Michigan Franchise Investment Law may require the department to determine by rule or order that the New FTC Rule encompasses disclosure requirements similar to those in Section 45.1508(b).

7. **Minnesota**

The contents of the “public offering statement” required to comply with the Minnesota franchise statute is set forth in Section 80C.04 of the franchise statute and consists of 22 items generally similar to the requirements of the UFOC Guidelines established by

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31 BUS. FRAN. GUIDE ¶ 3220.08; MICH. COMP. LAWS § 45.1508 (2005).

32 *Id.* ¶ 5220.01.
In addition, Section 80C.18 provides, “The commissioner [of commerce] may promulgate rules to carry out the provisions of sections 80C.01 to 80C.22 (i.e., concerning sales and offers to sell made in, or when the franchise is to be located in, Minnesota), including rules and forms governing public offering statements, applications, financial statements and annual reports, and defining any terms, whether or not used in sections 80C.01 to 80C.22, insofar as the definitions are not inconsistent with sections 80C.01 to 80C.22. . . .”

Pursuant to this authority, Minnesota has adopted regulations augmenting the state disclosure requirements. These regulations adopt many of the types of information within the 23 items enumerated in the current form of UFOC. In addition, the regulations permit the commissioner to accept the Uniform Franchise Registration Application adopted by the NASAA. However, the commissioner retains the right to require alterations to the UFOC as necessary. Thus, it will be necessary for the Minnesota Commissioner of Commerce to promulgate amended rules adopting the disclosure format contemplated by the New FTC Rule.

8. New York

In New York, adoption is not automatic if NASAA adopts the New FTC Rule. Depending on the circumstances, the legislature may amend the New York Franchise Act or the Department of Law may adopt changes in the New York Franchise Act’s corresponding franchise regulations.

With regard to changes to the New York Franchise Act, NY G.B.L. Section 683, entitled “Disclosure Requirements,” provides as follows:

“It shall be unlawful and prohibited for any person to offer to sell or sell in this state any franchise unless and until there shall have been registered with the department of law, prior to such offer or sale, a written statement to be known as an “offering prospectus” concerning the contemplated offer or sale, which shall contain the information and representations set forth in and required by this section. Any uniform disclosure document approved for use by any agency of the federal government or sister state may be utilized and sought to be registered, provided that said uniform disclosure documents comply with the provisions of this article.”

For statutory amendments, a proposed bill must be submitted to the State Senate and Assembly. The Legislature is in session from January through mid-June. For a bill to become law, it has to be passed by both houses and signed by the Governor.

33 BUS. FRAN. GUIDE ¶ 3230.04; MINN. STAT. § 80C.04 (2005).
34 BUS. FRAN. GUIDE ¶3230.18; MINN. STAT. § 80C.18.
35 BUS. FRAN. GUIDE ¶ 5230.24; MINN. STAT. §§ 2860-3600.
36 BUS. FRAN. GUIDE ¶ 5230.24; MINN. STAT. 2860-3800.
37 N.Y. GEN. BUS. LAW § 680 et seq. (2005). Gen. Bus. Law 694, subsection 2, states: “The department may from time to time make, amend, and rescind such rules, forms and regulations as are necessary to carry out the provisions of this article, including rules and forms governing applications and reports, and defining any terms, whether or not used in this article, insofar as the definitions are not inconsistent with the provisions of this article.”
39 N.Y. GEN. BUS. LAW § 683.
Adopting changes in the corresponding franchise regulations is a much less involved process. The Department of Law can adopt the changes in the franchise regulations through a rulemaking process, as long as such changes are consistent with state law. Pursuant to GBL Section 694(2) “Administration,” the department may from time to time make, amend, and rescind such rules, forms and regulations as are necessary to carry out the provisions of this article, including rules and forms governing applications and reports, and defining any terms, whether or not used in this article, insofar as the definitions are not inconsistent with the provisions of this article.40

The regulatory process in the State of New York is governed primarily by Article 2 of the State Administrative Procedure Act (“SAPA”). To initiate a regulatory proposal, SAPA requires submission of a Notice of Proposed Rulemaking to the Secretary of State for publication in the New York State Register. If no public hearing is required, the notice must precede adoption by at least 45 days. Publication by the Secretary of State affords the public an opportunity to submit comments on the proposed rule.41

It is important to note that the FTC Staff Report states that “it is clear that the proposed revised Rule, if adopted, would create a new disclosure floor with which all franchisors must comply. It is our hope that NASAA and the states would adopt the revised Rule, further reducing inconsistencies between federal and state law. However, the Commission lacks the legal basis to preempt the field of pre-sale disclosure.”42 The FTC Staff Report further states that,

“The Federal Trade Commission Act does not include any clause directly preempting state law. Furthermore, the legislative history of the Act and of the 1975 amendments to the Act establishing the Commission’s rulemaking authority indicate that Congress did not intend the Act to occupy the field of consumer protection regulation. Any preemptive effect of the [FTC] Rule, therefore, is limited to instances where state law conflicts with the FTC requirements, such that a ‘repugnancy’ is created between the state laws and the Commission regulations. Preemption would occur where there is an “actual conflict between the two schemes of regulation [such] that both cannot stand in the same area.” Accordingly, the Commission generally has declared the preemptive effect of Commission rules to be limited to the extent of an inconsistency only and in some instances (such as with the UFOC Guidelines) has provided a mechanism by which a state or local government may petition the Commission to permit enforcement of any part of a state or local law that would provide for greater consumer protections than an FTC rule’s requirements. Therefore, absent federal legislation evidencing a clear intent from Congress to occupy the field of pre-sale franchise disclosure, the revised [FTC] Rule would not affect state laws providing greater consumer protection.” (emphasis added).43

9. **North Dakota**

Section 51-19-06 of the North Dakota Franchise Investment Law sets forth the information required to be submitted with the franchisor’s application for registration44

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40 Id. § 694(2).
42 See FTC Staff Report, at 269.
43 Id. at 270.
44 BUS. FRAN. GUIDE ¶ 3340.06; N.D. CENT. CODE § 51-19-06 (2005).
and Section 51-19-08(1) provides that the proposed prospectus must contain the material information set forth in the application for registration, as specified by rule of the commissioner, and such additional disclosures as the commissioner may require.” Subsection (5) of the same provides that, “The commissioner may accept, in lieu of the prospectus meeting the requirements set forth in this chapter, a prospectus which complies with the requirements of any federal law or administrative rule or with the law of any other state requiring substantially the same disclosure of information as is required under this chapter.”

Accordingly, once the New FTC Rule is adopted by the FTC, it could be incorporated in North Dakota by a legislative amendment to Section 51-19-06, or by action of the securities commissioner. The state has informally advised that it has not yet evaluated what changes it may make upon FTC adoption of the New FTC Rule or how those changes will be effectuated, but it is confident that through informal or administrative action by the Securities Commissioner, the New FTC Rule could be implemented within three to six months. Action by the legislature could take much longer depending upon when the FTC issues the rule as the North Dakota legislature is in session only during odd numbered years and then only for 3 months, with its next session scheduled in January 2007.

10. Oregon

The Oregon franchise law, in Section 650.050, labeled as “Rulemaking Authority” authorizes the Director of the Department of Consumer and Business Services from time to time make, amend and rescind such rules as are necessary to carry out the provisions of ORS 650.005 to 650.085, in accordance with that section and ORS 183.310 to 183.550. Pursuant to that authority Oregon adopted regulation Section 441-325-020 permitting the use of the disclosure statement in the format prescribed by the FTC Rule “set forth in 16 C.F.R. 436, effective December 21, 1978” or the 1993 version of the UFOC. Accordingly, the Department of Consumer and Business Services will have to adopt amended regulations to adopt the New FTC Rule disclosure format, even if adopted by NASAA.

11. Rhode Island

In Section 19-28.1-3(f) of the Rhode Island franchise law, the statute specifically defines the words “disclosure document” to mean the UFOC as adopted and amended by NASAA. Also, in subsection (r) of the same section, Rhode Island defines the “registration application” to mean an initial franchise application on the Uniform Franchise

45 BUS. FRAN. GUIDE ¶ 3240.08; N.D. CENT. CODE § 51-19-08(1).

46 Id.

47 BUS. FRAN. GUIDE ¶ 3340.17; N.D. CENT. CODE § 51-19-17, Item 3. a. and b. provide, “3.a. The [securities] commissioner may from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this chapter, including rules and forms governing applications and reports and defining any terms, whether or not used in this chapter, insofar as the definitions are not inconsistent with the provisions of this chapter.” Section 3.b. states that “All rules of the commissioner, other than those relating solely to the internal administration of his office, must be made, amended, or rescinded in accordance with chapter 28-32.”

48 Telephone interview with Matthew Bahrenburg with the North Dakota Securities Department dated August 8, 2005.

49 BUS. FRAN. GUIDE ¶ 3370.05; OR. REV. STAT. § 650.050 (2005).

50 BUS. FRAN. GUIDE ¶ 5370.02; OR. ADMIN. R. 441-325-020 (2005).

51 BUS. FRAN. GUIDE ¶ 3390.03; R. I. GEN. LAWS § 19-28.1-3(f) (2005).
Registration Application as adopted and amended by NASAA and the amendment or renewal of the application. So Rhode Island, by statute, arguably automatically incorporates any amendment to the UFOC in its definition of what is a disclosure document. The Rhode Island Securities Division has confirmed that upon adoption by NASAA of the New FTC Rule disclosure format the Rhode Island statute will automatically incorporate the amended UFOC Guidelines as the most current version of the UFOC. In addition, Section 19-28.1-27 also grants the Rhode Island director of business regulation the power to promulgate rules, forms, and orders necessary to administer the act.

12. South Dakota

Section 37-5A-16 of the South Dakota franchise law requires a registration application to include a proposed public offering statement containing the information required by Sections 37-5A-17 to 37-5A-28 of the statute. In addition, at Section 37-5A-31, the South Dakota franchise law grants the director of the division of securities to issue a rule or order finding a public offering statement which is compliant with federal law or administrative rule or with the law of any other state requiring substantially the same disclosures to be in full or partial compliance.

South Dakota has issued a policy statement finding that an offering circular that complies with the UFOC Guidelines as adopted by NASAA on April 25, 1993, will be considered to be in compliance with the requirements of SDCL 37-5A-17 to 37-5A-28. Thus it will be necessary for the director of the division of securities to issue a rule or order to amend the state regulations to adopt the New FTC Rule disclosure format. Although it will be possible to adopt the New FTC Rule by issuance of a rule or order, in a telephone interview with the State Director of the Division of Securities, he advised that South Dakota will likely entirely revise its statute when the FTC acts, to allow use of a disclosure document that either complies with NASAA guidelines or the new FTC rule. The South Dakota legislature meets annually beginning in January and assuming that the legislature passes a new statute in January, the new legislation would be effective July 1.

13. Virginia

The Virginia Retail Franchising Act does not specifically set forth the form of disclosure document required to comply with the Act, but at Section 13.1-572 provides that, “The [State Corporate] Commission shall have authority from time to time to make, amend and rescind such rules and forms as may be necessary to carry out the provisions of this chapter.

52 Id.
53 Telephone interview with Steve Kagan with the Rhode Island Securities Division, Franchise Section, on August 5, 2005
54 BUS. FRAN. GUIDE ¶ 3390.27; R. I. GEN. LAWS § 19-28.1-27.
56 BUS. FRAN. GUIDE ¶ 3410.30; S.D. CODIFIED LAWS § 37-5A-31.
58 Id. ¶ 5410.01.
59 Telephone interview with Gail Sheppick, Director of the Division of Securities, on August 5, 2005.

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including but not limited to rules and forms governing disclosure documents, applications and reports, and defining accounting, technical and trade terms used in this chapter not inconsistent with the provisions of this chapter. The Commission shall have the authority, for the purpose of this chapter to prescribe the content and form of financial statements and to direct whether they should be certified by independent public or certified accountants. For the purpose of rules and forms, the Commission may classify franchises, persons and matters within its jurisdiction and prescribe different requirements for different classes.”

Pursuant to that authority, the State Corporate Commission adopted the 1993 version of the UFOC verbatim, without identifying it as such. Accordingly, it will be necessary for the State Corporate Commission to amend the existing rules once the FTC adopts the New FTC Rule disclosure format, which would normally be anticipated to take 6 months to accomplish.

14. Washington

Under Section 19.100.040 of the Washington Franchise Investment Protection Act, a franchisor’s offering circular must be prepared in compliance with guidelines adopted by rule of the director of financial institutions, who “shall be guided in adopting such rule by the guidelines for the preparation of the Uniform Franchise Offering Circular adopted by the [NASAA], or its successor, as such guidelines may be revised from time to time” (emphasis added). Accordingly, it will be necessary for the director of financial institutions to issue a rule or order to amend the state regulations to adopt the New FTC Rule disclosure format. We were advised informally by telephone that Washington will adopt by rulemaking the revised disclosure format matching, or at least meeting, whatever minimum FTC disclosure standard is adopted, though a rulemaking process which typically takes from four to eight months; if necessary, the state has the authority to waive its rule and accept any FTC disclosure format even prior to formal adoption of a rule.

15. Wisconsin

Section 553.27 of the Wisconsin Franchise Investment Law expressly provides that the offering circular may be in a form that the division of securities requires by rule, or in a form permitted under 16 CFR 436 or in a form permitted by a successor to that regulation. Accordingly, upon adoption of the New FTC Rule by the FTC, the new form of disclosure would appear to automatically be approved for use in Wisconsin by reason of Section 553.27.
III. COVERAGE OF THE PROPOSED FTC RULE

A. Scope of Coverage

The Proposed Rule will change or eliminate other familiar aspects of the existing FTC Rule:

1. **International Franchises.**

   The FTC Rule will only apply to the sale of franchises for locations in the United States, its possessions, or territories. However, the Rule does not restrict any jurisdiction the FTC may have over foreign franchise sales under Section 5 of the FTC Act.66

2. **Business Opportunities and Other Exemptions.**

   The Rule would no longer apply to “business opportunities,” franchises requiring an investment of more than $1.5 million which is not financed by the franchisor; franchises sold to a corporation which is five years or more old and which has a net worth exceeding $5 million, and franchises sold to certain owners and managers of franchisors.67

3. **PMPA and Exclusions.**

   The Proposed Rule retains exemptions from coverage for sales of “fractional franchises,” “leased departments,” franchises governed by the Petroleum Marketing Practices Act (“PMPA”) and “oral franchises,” but deletes the exclusions for general partner relationships, cooperative associations, certification and testing services and single trademark licenses. The FTC Staff states in its FTC Staff Report that these arrangements are not covered by the FTC Rule in the first place, and are therefore being eliminated as redundant.

B. Similarity to State Exemptions.

1. **Illinois**

   The Illinois Franchise Disclosure Act, 815 ILCS 705/1 - 44, provides for an extensive number of exemptions.68 Some are self-executing, while others necessitate an application and notification process. Consistent with the current FTC Rule, Section 3(1) of the Illinois Act excludes leased departments, fractional franchises and a franchise relationship whereby a service business, that is subject to a franchise agreement, offers “the evaluation, testing or certification of goods, commodities or services.”

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66 Nevertheless, unless changes are made to the state franchise laws, there still may be a question whether particular transactions may be subject to the registration and disclosure requirements under certain state franchise laws, notwithstanding the express limitation set forth in the New FTC Rule.

67 Just as the FTC’s exclusion of transactions involving international franchise locations will not eliminate concerns about coverage under state franchise laws, these new transactional exemptions and exclusions under the New FTC Rule do not eliminate the necessity to find applicable exemptions under state law. Several states have adopted exemptions similar to the large transaction, experienced franchisee and insider exemptions which have been added to the New FTC Rule, but none has identical criteria and therefore each transaction and prospective franchisee must be examined on a case-by-case basis, in light of the particular circumstances of the transaction. See discussion of similar state exemptions in Illinois, Maryland and New York at III.B.

Franchise relationships subject to the Petroleum Marketing Practices Act (PMPA), 15 U.S.C. 2801, are exempt under the FTC Rule and states are preempted from imposing other restrictions on retail fuel providers.

However, states can regulate non-petroleum franchises that may be located on the dealers site. Illinois and the FTC diverge regarding oral contracts. Section 705/3(1) of the Illinois Act encomasses “oral” franchise agreements while the FTC Rule exempts them.

As referenced above, Section 705/9 of the Illinois Act and Rule 200.201 authorize the Administrator to issue a discretionary exemption, by order, from the registration and/or disclosure requirements of the Illinois Act. The terms of the exemption (if issued) will be dictated by the actual franchise offering and the Administrator’s determination that the enforcement of the Illinois Act is unnecessary 1) in the public interest, or 2) for the protection of the prospective franchisee(s), or 3) by reason of the investment or 4) because of the limited nature of the offering.

The Rule outlines the exemption process and corresponding requirements with exemptions typically sought by the franchising party for: a) “testing the franchising waters” in Illinois with only one or two sales authorized, b) the sale of multiple franchises to one buyer with the buyer possessing business savvy and access to consultants, accountants and counsel, c) the sale of an entire system or d) a one time sale involving millions of dollars and multiple parties. A typical request is for the limited sale described in a) with successful franchisors subsequently pursuing registration. Pre-sale disclosure is required for the limited sale exemption with disclosure requirements dependant upon the structure of the exemption sought.

The most frequently requested exemptions are the “Large Franchisor” and the “$1 Million Dollar Investment” found at Rules 200.202 and 200.201, respectively. Neither exemption is self-executing, necessitating compliance with filing requirements as well as applicable qualifications along with timely pre-sale disclosure.

The purpose of these exemptions is being questioned as you read this paper. Prerequisites and filing requirements aren’t usually associated with the term

70 815 ILL. COMP. STAT. 705/(3)(1).
71 Id.; ILL. ADMIN. CODE 14, §200.201.
72 The “Large Franchisor” exemption is available to the franchisor with both considerable net worth and experience. Net worth requirements can be satisfied by any of the following three options: 1) the franchisor has a consolidated net worth of $5 Million per its audited financials, 2) the franchisor has $1 Million in net worth, bolstered by its parent’s $5 Million in net worth as evidenced by separate, audited financials for each entity or 3) the franchisor’s unaudited financials reflect $1 Million in net worth, further supported by the parent’s net worth of $5 Million according to audited financials plus the documented performance guarantee compelling the parent to assume franchisor obligations under the franchise agreement should the franchisor be unable to fulfill its duties.

The experience component is addressed by the existence of 25 operational franchises in the franchise system for the preceding 5 year period. The franchisor or its parent, predecessor or an entity owning 80% of the franchisor may, individually or jointly, satisfy this requirement. An alternative for 3 of the 5 years is for the franchisor to prove that it conducted a substantially similar business during that time frame.

“exemption.” However, the true nature of these popular exemptions lends itself to the advantages as well, i.e., the reduced review given these applications due to the sophistication and financial wherewithall of the buyer and/or seller.

The “$1 Million Investment” (known as the “Large Franchisee Exemption”) exemption is similar to the FTC’s proposed, $1.5 Million Large Investment Exemption. Illinois requires a minimum initial investment of $1 Million for the purchase of such a franchise with Item 7 of the Offering Circular confirming investment costs.

Both exemptions necessitate an ongoing conformance with the qualifications plus the annual submission of an Offering Circular compliant with the UFOC Guidelines, application documents and a cover letter outlining the franchisor’s eligibility for the requested exemption. The franchisor must also provide timely pre-sale disclosure to franchise prospects.

2. **Maryland**

Maryland’s Franchise Regulations, found at Title 2, Subtitle 2, Section 10 of the Code of Maryland Regulations (“COMAR”), contain several exemptions from the registration and disclosure requirements of the Maryland Franchise Law. Although these exemptions are being revised by the Maryland Securities Division in 2005, two Maryland exemptions are similar to exemptions proposed under the FTC Staff Report, and one other Maryland exemption is worth noting for its flexible application. In these cases, unlike the FTC Rule, a franchisor who seeks to qualify for one of the Maryland exemptions must file a Notice of Exemption with the Division, among other documents, and pay a $250 filing fee.

   a. **The Maryland “Sophisticated Franchisee Exemption.”**

The FTC Staff Report proposes a “Large Investment Exemption” where the investment totals at least $1 Million, exclusive of real estate costs. Maryland’s Franchise Regulations currently provide for a similar “Sophisticated Franchisee Exemption” where the franchisor requires an initial investment by the franchisee of more than $750,000. The Maryland Securities Division is proposing to amend the Sophisticated Franchisee Exemption in 2005, consistent with the proposed Staff Report, to increase the amount of initial investment required to qualify to $1 Million, exclusive of real estate costs.

   b. **The Maryland “Seasoned Franchisor Exemption.”**

The FTC Staff Report proposes a “Large Franchisee Exemption” that would exempt from the Rule franchise sales to entities who have been in business for at

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74 An Interpretive Opinion of the Maryland Securities Commissioner concludes that a franchisor that is exempt from registration under the Maryland Franchise Law is also exempt from the specific disclosure obligations set forth in §14-223 of the Maryland Franchise Law but not the antifraud provisions of that law. Advisory Opinion No. 98-1 (April 14, 1998), BUS. FRAN. GUIDE ¶5200.21, at 7992.

75 Md. Regs. Code tit. 2, § 02.02.08.10.

76 Id. § 02.02.08.10 D-G.

77 See FTC Staff Report, at 235.

78 Md. Regs. Code tit. 2, § 02.02.08.10E.
least five years and have a net worth of at least $5 Million. Maryland has no comparable exemption. Maryland does, however, have a “Seasoned Franchisor Exemption” that exempts franchise offerings where the franchisor has a specific net equity of more than $10 Million and has had at least 25 franchisees conducting the same franchised business at all times during the 5-year period immediately preceding the offer or sale.

c. The Maryland Discretionary “Exemption by Order.”

Maryland’s Franchise Regulations provide for the Maryland Securities Commissioner to issue an exemption by order whenever she finds that a “transaction or class of franchises is not one within the purpose of the Maryland Franchise Law, and registration is not necessary or appropriate in the public interest or for the protection of franchisees.” The Maryland Securities Commissioner has issued exemptions by order in a variety of cases, including sales to franchisees with a large net worth and level of sophistication in an industry related to the franchise (e.g., franchise sales to Host Marriott Corporation, Giant Supermarkets, Sodexho), or when a franchise offering qualifies as a “fractional franchise” exemption under the FTC Rule. If a franchisor has a compelling reason why a franchise sale should be exempted from registration under the Maryland Franchise Law, and the sale does not otherwise qualify for a specific exemption under the Maryland Franchise Regulations, the franchisor may consider contacting the Maryland Securities Division to discuss whether the facts justify the issuance of an exemption by order.

3. New York

Despite the new exclusion under the New FTC Rule for international locations, franchisors based in New York need to be aware that the New York franchise law has been held to apply extraterritorially and may extend to franchises located in foreign countries. In Mon-Shore Management, Inc., et al. v. Family Media Inc., the court upheld the extraterritorial powers included in the New York Franchise Act. In a case involving the sale by a New York franchisor to purchasers in New Jersey, Pennsylvania, and California, the court found that New York had a legitimate state interest in protecting its investors, enhancing its commercial reputation and protecting franchisees both in and outside New York and that, since legitimate state objectives were being served and the burdens imposed on interstate commerce were not excessive, the New York Franchise Act was constitutional.

This decision was based on New York GBL Section 681(12) which states, in relevant part, “(a) An offer or sale of a franchise is made in this state when an offer to sell is made in this state, or an offer to buy is accepted in this state, or, if the franchisee is domiciled in this state, the franchised business is or will be operated in this state; [and] (b) An offer to sell is made in this state when the offer either originated from this state or is directed by the offeror to this state and received at the place to which it is directed. An offer to sell is accepted in this state when acceptance is communicated to the offeror from this state.” Most state franchise

79 If a franchisor sells its franchise operations to a new entity, the franchisor may no longer qualify for a Seasoned Franchisor Exemption under the Maryland Franchise Regulations, as the new entity would no longer have 25 franchisees operating a franchised business for at least five years. See Md. Regs. Code 12, § 02.02.08.10 D.

80 Id. § 02.02.08.10G(1).


laws use the same or similar language in establishing which transactions will be subject to the statute, though some, but not all, expressly exempt transactions with franchisees located in foreign states or countries.\textsuperscript{83}

Although the New York Franchise Act does not have an exemption comparable to the FTC’s proposed “large investment exemption,” which is based on the theory that a franchisee who has the wherewithal to invest $1 million dollars is sophisticated, GBL Section 684(3)(b) sets forth an exemption for offers or sales made to “a bank, savings institution, trust company, insurance company, investment company, or other financial institution, association, or institutional buyer, or to a broker-dealer, where the purchaser is acting for itself or in some fiduciary capacity.”\textsuperscript{84} With regard to the FTC’s proposed “large franchisee exemption,” New York does not have a comparable exemption, but a franchisor with a net worth of at least fifteen million dollars may qualify for a self-executing exemption\textsuperscript{85}, and a franchisor with a net worth of at least five million and less than fifteen million may apply to the New York State Department of Law for exemption.\textsuperscript{86} Further, GBL Section 684(1) authorizes and empowers the Department of Law “to exempt by any rule or regulation and person, franchise, or transaction . . . or from any rule or regulation thereunder if the department finds that such action is not inconsistent with the public interest or the protection of prospective franchisees.”\textsuperscript{87} Thus, even if a franchisor can not meet the requirements of a specific New York exemption but can demonstrate to the Department of Law that its franchise offering “is not inconsistent with the public interest or the protection of prospective franchisees” it may contact the Department of Law to discuss an exemption pursuant to GBL Section 684(1).

\textsuperscript{83} See, for example, Cal. Corp. Code § 31105 (2005), which provides: “Any offer, sale, or other transfer of a franchise, or any interest in a franchise, to a resident of another state or any territory or foreign country, shall be exempted from the provisions of Chapter 2 (commencing with § 31110) of this part [the registration and disclosure requirements], if all locations from which sales, leases or other transactions between the franchised business and its customers are made, or goods or services are distributed, are physically located outside this state;” BUS. FRAN. GUIDE ¶ 3050.281.

\textsuperscript{84} N.Y. GEN. BUS. LAW § 684 (3)(b).

\textsuperscript{85} Id. § 684 (3)(a)(i) states, “There shall be exempted from the registration provisions of section six hundred eighty-three of this article the offer and sale of a franchise if: (a)(i) The franchisor has a net worth on a consolidated basis, according to its most recent audited financial statement, of not less than fifteen million dollars; or the franchisor has a net worth, according to its most recent audited financial statement, of not less than three million dollars and is at least eighty percent owned by a corporation which has a net worth on a consolidated basis, according to its most recent audited financial statement, of not less than fifteen million dollars.”

\textsuperscript{86} Id. § 684(2) states that, “The department of law may, upon application and within its discretion, exempt from the registration requirements of section six hundred eighty-three of this article the offer and sale of a franchise if: (a) The franchisor has a net worth on a consolidated basis, according to its most recently audited financial statement, of not less than five million dollars; or the franchisor has a net worth, according to its most recently audited financial statement, of not less than one million dollars and is at least eighty percent owned by a corporation which has a net worth on a consolidated basis, according to its most recently audited financial statement, of not less than five million dollars; and (b) The franchisor files with the department of law an application for exemption, on forms and in the manner prescribed by the department, and a consent to service of process on the form required by the department . . . .”

\textsuperscript{87} Id. § 684(1).
IV. UFOC DELIVERY ISSUES

A. Timing of Delivery

Under the current FTC Rule, a franchisor must deliver the UFOC complete with all exhibits at the earlier of the “first personal meeting” or the “time for making the disclosures.” Each of these terms has a specific meaning under the Rule.

1. First Personal Meeting

The term “personal meeting” means a face-to-face meeting between a franchisor or franchise broker or any agent, representative or employee thereof and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise. The term “prospective franchisee” also has a special meaning under the Rule. The term is defined as “any person (including any representative, agent or employee of that person) who approaches or is approached by a franchisor or franchise broker or any representative, agent or employee thereof for the purpose of discussing the establishment or possible establishment of a franchise relationship involving such person.” The first personal meeting may occur substantially before the execution of the final agreements.

The Proposed Rule would eliminate this requirement altogether. The FTC Staff Report proposes to abandon the current requirement that a franchisor must give a franchisee a copy of a franchise disclosure document at the first personal meeting. In the FTC Staff Report, the FTC suggests that a first personal meeting requirement has become obsolete in the current communication age because franchisors communicate with franchisees through a wide array of media.

The FTC Staff Report is clear that the Federal Trade Commission Act does not include any clause directly preempting state law. The FTC Staff notes further that “absent federal legislation evidencing a clear intent from Congress to occupy the field of pre-sale franchise disclosure, the revised [FTC] Rule would not affect state laws providing greater consumer protection.”

The New FTC Rule does not preempt state franchise laws to the extent they provide greater consumer protection. Accordingly, franchisors will still be required to comply with any first personal meeting disclosure trigger under applicable state law, such as in Maryland, New York, and Rhode Island even after enactment of a New FTC Rule. In any

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88 See FTC Staff Report at 75, citing 16 C.F.R. §§ 436.1 (a), 436.2(g) and 436.2(o) (1979).
89 Id. at 270-71.
90 MD. CODE ANN., BUS. REG. §14-223 requires that a franchisor may not sell a franchise in Maryland without first giving a prospective franchisee a copy of the [UFOC] at the earlier of: (1) the first personal meeting of the franchisor and the prospective franchisee to discuss the possible sale of the franchise; or (2) 10 business days before the execution of a contract or payment of consideration that relates to the franchise relationship.
91 N.Y. GEN. BUS. LAW § 683(8) states, “A franchise which is subject to registration under this article shall not be sold without first providing to the prospective franchisee, a copy of the offering prospectus, together with a copy of all proposed agreements relating to the sale of the franchise at the earlier of (a) the first personal meeting between the franchisor or its agent and the prospective franchisee, (b) at least ten business days prior to the execution of a binding franchise or other agreement, or (c) at least ten days prior to the receipt of any consideration in connection with the sale or proposed sale of a franchise. For the purposes of this chapter, the words: (i) “first personal meeting” shall mean the first face to face meeting between a franchisor or franchisor’s agent or any representative or
event, at this time, no determination has been made as to whether Maryland or New York will seek a statutory amendment to change the “first personal meeting” or “10 business day” requirements.

2. Ten Business Day Rule

Under the current FTC Rule, the term “time for making of disclosures” currently means ten (10) business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement or any other agreement imposing a binding legal obligation on such prospective franchisee (of which the franchisor or any agent, representative or employee thereof knows or should know) in connection with the sale or proposed sale of a franchise or (2) the payment by a prospective franchisee (about which the franchisor or any agent, representative or employee thereof knows or should know) of any consideration in connection with the sale or proposed sale of a franchise.

The FTC suggests that the 10 business day requirement is unnecessarily confusing, and notes that 14 calendar days will, in most instances amount to 14 calendar days. The Proposed Rule replaces the so-called “10 business-day rule” with a simpler “14 day rule.” That is, franchisors must furnish prospective franchisees with disclosure documents 14 days before the franchisee signs a binding agreement or pays any fee in connection with the franchise sale. Business days no longer need to be considered. It should be noted, however, that this new timing requirement will not preempt state laws and therefore rather than simplifying franchise compliance practices it may complicate them if individual states do not reconcile their statutes to this new requirement. For example, while Illinois has already adopted the 14 day approach, and some states (like Minnesota) require only seven days, most states follow the existing FTC Rule requirement of 10 business days which may be longer than 14 calendar days in some instances.

In addition to the 14 calendar day disclosure trigger, the FTC proposes to adopt a new prohibition against a franchisor refusing to honor a prospective franchisee’s reasonable request for the franchisor’s disclosure document “during the sale process.” As discussed in Section 4 below, how one counts business days or calendar days is subject to some debate. The FTC states that future compliance guides will clarify how franchisors should count calendar days to comply with the new 14 day trigger.

92 R. I. GEN. LAWS § 19-28.1-8 states that disclosure must be made “at the earlier of (1) the prospective franchisee’s first personal business meeting with the franchisor which is held for the purpose of discussing the sale or possible sale of a franchise; (ii) "other agreement" shall mean an agreement imposing a binding legal obligation on such prospective franchisee, about which the franchisor, franchise sales agent, or any agent, representative or employee thereof, knows or should know, in connection with the sale or proposed sale of a franchise; and, (iii) "receipt of any consideration" shall mean the payment by a prospective franchisee, about which the franchisor, franchise sales agent, or any agent, representative or employee thereof, knows or should know, of any consideration in connection with the sale or proposed sale of a franchise.”

93 Id. In some cases, however, 10 business days is longer than 14 calendar days and therefore affords a prospective franchisee a longer review period. For example, if a franchisor gives a prospective franchisee a copy of its UFOC on November 23, 2005, 14 calendar days from that delivery date would be December 7, 2005. In contrast, under Maryland law, 10 business days from that same date would be December 9, 2005, to account for two midweek Maryland-recognized holidays (Thanksgiving and the Friday after Thanksgiving) and two weekends.
3. Five Business Day Rule

Under the current FTC Rule, franchisors must furnish the prospective franchisee with a copy of the franchise agreement and all other related agreements intended to be executed by the parties at least five business days before any agreements are to be executed. All blank spaces in these copies of the documents to be signed must be completely filled in, and all exhibits attached, prior to the time they are furnished to the prospective franchisee, so that five business days later all that will remain to be done is to sign and date the agreements and collect any fees.

Under the Proposed Rule, franchisors must deliver execution-ready copies of the UFOC and all other related agreements 7 calendar days, rather than 5 business days, before they are executed. However, this waiting period applies only if the franchisor unilaterally (i.e. not in response to franchisee-initiated negotiations) makes material changes to the terms of the basic franchise agreement attached to the UFOC. 94

4. How to Count Days

Counting the currently required 10 and five business day waiting periods continues to initiate both confusion and debate within the franchise community which will carry over to the new 14 and 7 calendar day counting process, if not clarified by the FTC. 95 The FTC’s Staff report states that the 14 days commence the day after delivery of the disclosure document and that the signing of any agreement or receipt of payment can take place 15 days later, essentially guaranteeing prospective franchisees at least a full 14 days in which to review the disclosures. 96 This proposed approach counts neither the delivery date nor the execution date.

This approach is inconsistent with the method of computing time set forth in Rule 6 of the Federal Rules of Civil Procedure (“FRCP”), which essentially provides that when counting days you do not count the first day of the designated period, but do count the last day. Most of the registration states appear to favor the FRCP approach. Illinois, via Section 705/5(2) has already adopted the FTC’s proposed 14 calendar day approach over the 10 business day requirement cited by the existing UFOC Guidelines and followed by the other registration states. 97 The policy in Illinois, when counting the 14 calendar days, is not to count the first day, but to count every day thereafter, including the day the Franchise Agreement is executed and/or money is paid.

Likewise, under Maryland law, when computing any period of time required by rule, order of court or statute, the day of the act or event after which the designated

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94 See FTC Rule § 436.2(b) making it an unlawful practice “to alter unilaterally and materially the terms and conditions of the basic franchise agreement attached to the disclosure document without furnishing the prospective franchisee with a copy of the revised franchise agreement, and any related agreements, at least seven days before the prospective franchisee signs the revised franchise agreement. Changes to a franchise agreement that result solely from negotiations initiated by the prospective franchisee do not trigger this seven-day period.”

95 For example, in a recent posting on the ABA Forum on Franchising listserv dated December 16, 2004, the poster presented three possibilities: (1) only the days falling between UFOC and agreement execution are counted, (2) every day counts (i.e., the day of receipt and day of signing may both be counted, or (3) the day of receipt is not counted, but the day of signing is counted.

96 See FTC Staff Report at 78.

97 815 ILL. COMP. STAT. 705/5(2).
period of time begins to run is not included, but the last day of the period to be computed is counted. Similarly, under New York law, the day the UFOC is offered is not included, but the last day of the period is to be computed or counted unless it is a Saturday, Sunday or public holiday.

The other significant issue that presently exists is what constitutes a “business day,” since most of the registration states follow a business day approach, rather than a calendar day approach and proposed by the FTC. Many states would have to amend their current franchise laws in order to correspond to the FTC’s calendar day approach; and such revisions would require action by state legislatures.

At present, the FTC Rule lists the dates which will not count as “business days.” Many registration states often define the term differently from the FTC, potentially leading to a violation of state law, despite compliance with the FTC Rule.

For example, although “business day” is not defined under the Maryland Rules or the Business Regulation Article of the Maryland Annotated Code, the term “holiday” is defined under Maryland Rule 1-202 as an “employee holiday.” For purposes of complying with the 10 business day trigger under Maryland’s Franchise Law, therefore, franchisors should not count the “employee holidays” set forth in the State Personnel Code.

B. Electronic Delivery of UFOC

The Proposed Rule brings franchise disclosure into the 21st Century by providing that the disclosure documents may be delivered by paper or electronically via the Internet, Email, computer discs and compact discs, among other possibilities and by eliminating the requirement for traditional hand written signatures. It contains many details on what is required if a franchisor elects to comply with the Rule electronically. It suffices to note for our purposes that after the FTC issued the Proposed Rule, Congress enacted “E-SIGN” or the Electronic Signatures in National and Global Commerce Act which has forced the FTC to revamp certain aspects of the Proposed Rule as it pertains to electronic compliance, and significant changes to the Proposed Rule therefore will be forthcoming before it is finalized.

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98 See MD Rule 1-203 (a).
99 See N. Y. GEN. CONSTR. LAW § 20 (2005). In New York “Public holiday” is defined in Section 24 of the General Construction Law as follows: “The term public holiday includes the following days in each year: the first day of January, known as New Year’s day; the third Monday of January, known as Dr. Martin Luther King, Jr. day; the twelfth day of February, known as Lincoln’s birthday; the third Monday in February, known as Washington’s birthday, the last Monday in May, known as Memorial day; the second Sunday in June, known as Flag day; the fourth day of July, known as Independence day; the first Monday in September, known as Labor day; the second Monday in October, known as Columbus day; the eleventh day of November, known as Veterans’ day; the fourth Thursday in November, known as Thanksgiving day; and the twenty-fifth day of December, known as Christmas day, and if any of such days except Flag day is Sunday, the next day thereafter; each general election day, and each day appointed by the president of the United States or by the governor of this state as a day of general thanksgiving, general fasting and prayer, or other general religious observances. The term half-holiday includes the period from noon to midnight of each Saturday which is not a public holiday.”

100 The term “business day” is defined by the current FTC Rule as every day other than Saturday, Sunday or the following national holidays: New Year’s Day, Washington’s Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veteran’s Day, Thanksgiving and Christmas.

Under the FTC Staff Report, franchisors would be able to furnish a franchise disclosure document in a variety of formats, including electronic. The proposal stated in the FTC Staff Report differs significantly from an earlier proposal the FTC discussed in its 1999 Notice of Proposed Rulemaking, which would have required a franchisor who provides disclosure electronically to distribute a separate paper summary document that contained a cover page, table of contents, and acknowledgment of receipt.

Under the proposal discussed in the Staff Report, franchisors would be able to make disclosure electronically so long as the disclosure is contained in a single document, and the format “permits each prospective franchisee to store, download, print, or otherwise maintain the document for future reference.” FTC Staff Report at p. 62. The franchisor may not include any extraneous information not required or permitted by the FTC Rule, or by state law that is not otherwise preempted. The franchisor may include scroll bars, internal links and search features, but it may not include other features such as multimedia tools, animation, or pop up screens. Id.

The proposal in the FTC Staff Report regarding electronic disclosure is very similar to a statement of policy that NASAA adopted more than a year before the date of the report. NASAA’s own version of Electronic Disclosure was adopted on September 14, 2003. The NASAA proposal would allow franchisors to make disclosure electronically, including over the Internet. Similar to the FTC Staff Report, the NASAA proposal requires that the disclosure document be a single, integrated, document or file. The NASAA proposal prohibits an electronic disclosure to include extraneous content beyond what is required or permitted by law and by the UFOC Guidelines. Like the FTC Staff Report, the NASAA proposal would allow customary devices for manipulating electronic documents in machine readable form and tools or access to tools that may be necessary or convenient to enable the recipient to receive and view the disclosure document. The NASAA proposal requires the electronic disclosure to be delivered in a form that intrinsically enables the recipient to store, retrieve, and print the disclosure document.

One difference between the NASAA proposal on electronic disclosure and the FTC Staff Report is that the latter proposal would require a franchisor to “advise the prospective franchisee of the formats in which the disclosure document is made available, any prerequisites for obtaining the disclosure document in a particular format, and any conditions necessary for reviewing the disclosure document in a particular format.” There is no comparable requirement for such notification in the NASAA proposal.

1. **Illinois**

The internet has become such an integral facet of our lives today, we can barely function without “being connected.” Notebooks, blackberries, cell phones, all enable us to interact with the rest of the world irrespective of our location. Companies, regardless of size and locale, are online. In fact, companies must maintain a presence in cyberspace just to survive. Consequently, franchisors who have committed substantial resources to franchisee e-commerce allow the public to connect with franchisees on an electronic basis. Franchisees report sales, place orders, make payments, perform advertising responsibilities, undergo training and engage in other activities online.

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102 See FTC Staff Report, at 62.
104 See FTC Staff Report, at 62-63.
With the internet so integral to franchisee/franchisor business operations, isn’t it likely that the franchise sales process becomes another function of e-commerce? Consequently Illinois is in agreement with the FTC and NASAA regarding electronic disclosure guidelines. Illinois already provides in Rule §200.306 an exemption for internet offers to sell, if an unregistered franchisor limits actions to the maintenance of a prospect list until registration is completed, at which time the franchisor could disclose electronically, in person or by mail.

2. Maryland

The Maryland Securities Division has filed a notice that it intends to promulgate a regulation specifically allowing for electronic disclosure. The regulation will likely follow the NASAA Statement of Policy on Electronic Disclosure.

V. UPDATING AND NEGOTIATED CHANGES

A. Annual Updates

Under the Proposed Rule, annual updates must be made within 120 (rather than 90) days after the franchisor’s fiscal year end.  

1. Illinois

Sections 705/10 and 705/12 of the Illinois Act provide for the continuity of registration if the franchisor timely files its annual report/renewal.  

Section 705/10 states that “Annually, but not later than one business day before the anniversary date of the registration, the franchisor shall file the disclosure document updated as of a date within 120 days of the anniversary date of the registration.” As indicated, this form of update is tied to the registration period in Illinois, Maryland and various other registration states, not the franchisor’s fiscal year end as will be required by the FTC.

2. Maryland

Under the Maryland Franchise Law, a franchise renewal registration is not tied to the franchisor’s fiscal year end; rather, it is tied to one year anniversary of the effectiveness of any previous registration granted by the Maryland Securities Division. Specifically, a renewal registration must be filed within 15 business days before the end of one year from the effective date of a previous registration. If, during any period of registration, there is a “material change” in the information that a franchisor has previously filed with the Maryland Securities Division as part of a registration application, the franchisor must “promptly file” an amendment to its registration.

105 See New FTC Rule §436.7(a).

106 815 ILL. COMP. STAT. 705/10, 705/12.

107 Id. 705/10.

108 MD. CODE ANN., BUS. REG. §14-219; MD. REGS. CODE tit. 2, §02.02.08.07.

109 MD. CODE ANN., BUS. REG. §14-220; MD. REGS. CODE tit. 2, §02.02.08.06.
Under the Maryland Franchise Law, all material information about a franchise offering must be disclosed in a UFOC that has been registered with the Maryland Securities Division. Franchisors are not permitted to make material disclosures about a franchise offering by any means other than in a registered UFOC.

Under Section 14-226 of the Maryland Franchise Law, a franchisor may not require a prospective franchisee to agree to a release, novation, waiver or estoppel that would relieve a person from liability under that law. Maryland’s Franchise Regulations clarify that this “anti-waive” provisions applies to releases and similar instruments that may be required as part of the initial sale of a franchise, but also that may be required upon renewal or assignment of the franchise. As a condition of registering a franchise offering in Maryland, if a franchisor requires a prospective franchisee to waive any rights under the law, the Maryland Securities Division will require the franchisor to amend its UFOC and franchise agreement to limit the effect of the waiver consistent with the statute.

3. New York

The FTC updating requirement is consistent with New York’s franchise regulations.

B. Material Changes

Under the current FTC Rule, franchisors are only required to prepare UFOC supplements with information about material changes on a quarterly basis, except that prospective franchisees must be given updated earnings representations on a current basis. Under the Proposed Rule, franchisors will still be required to prepare quarterly UFOC updates for any material changes, but they will also need to notify a prospective franchisee (orally or in writing) of any additional material changes, both at the time the UFOC is delivered, and also at the time the completed franchise agreement is delivered.

1. Illinois

Section 705/11 of the Illinois Act differs considerably from the New FTC Rule. The Illinois Act requires the franchisor to file an amendment “within 90 days of the occurrence of any material change in any facts required to be disclosed.” Not only is the franchisor required to file the amendment but to also “amend its disclosure statement and ... deliver the amended disclosure statement in accordance with the requirements of subsection (2) of Section 5 [14 calendar day disclosure] and Section 16 [UFOC compliant with the Guidelines] of this Act to any prospective franchisee, including prospective franchisees to whom a disclosure statement was previously delivered if the material change relates to or affects the franchisor or the franchise offered to such prospective franchisees.” Franchisor burdens are

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111 Id. § 14-226.
112 Md. Regs. Code tit. 2, §02.02.08.16L(1).
114 815 ILL. COMP. STAT. 705/11.
115 Id.
minimized by use of an addendum to the Circular with the changes subsequently made in the Circular upon the annual report filing.

Section 705/5(4) broadens the scope of Section 705/11 by addressing the unlawfulness of filing an untrue report with the Attorney General’s Office: “It is unlawful for any person to make or cause to be made any untrue statement of a material fact in any application, notice, or report filed with the Administrator, or to omit to state in any application, notice, or report any material fact, or to fail to notify the Administrator of any material change in such application, notice, or report, as required by the Act.” Section 705/16 focuses upon the UFOC while also working in conjunction with the other two provisions cited in this paragraph. Section 705/16 states that “All statements in the disclosure statement shall be free from any false or misleading statement of a material fact, shall not omit to state any material fact required to be stated or necessary to make the statements not misleading, and shall be accurate and complete as of the effective date thereof.”

The Illinois statute will continue to be compatible with the FTC Rule since it provides the franchise prospect with additional data with which to make an informed decision about the contemplated franchise system. Because the revised Franchise Rule would not impact state laws providing greater consumer protection, the Illinois requirement simply extends that added protection benefiting both the franchise prospect and the franchisor with its proof of timely disclosure.

2. Maryland

Under COMAR 02.02.08.06, a franchisor must file an application for amendment of a franchise registration “promptly” if there is a material change in the information that a registration previously filed with the Commissioner.

The disclosure provisions of the Maryland Franchise Law must be read in conjunction with Section 14-229 of the act, which requires, among other things, that a franchisor may not make an untrue statement of material fact, or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading. Therefore, when a “material change” occurs in a franchisor’s franchise offering, the franchisor should update its UFOC before distributing it to any prospective franchisees. The franchisor should also promptly file an amendment application with the Maryland Securities Division and disclose the prospective franchisee with the UFOC that has been reviewed and made effective by that agency.

116 Id. 705/5(4).
117 Id. 705/16.
118 MD. REGS. CODE tit. 2, § 02.02.08.06.
119 MD. CODE ANN., BUS. REG. §14-2229.
3. **New York**

With regard to the FTC’s proposed “notice to the franchisee,” GBL Section 683(9) of the New York Franchise Act states, in relevant part, that, “A franchisor shall promptly notify the department in writing, by an application to amend the registered offering prospectus, of any material change in the information contained in the prospectus as originally submitted or amended.” As New York’s law provides greater consumer protection than the proposed FTC rule, it would not affect state law.

C. **Waivers and Negotiated Changes**

The Proposed Rule adds a prohibition against waivers of any representation in the UFOC. To avoid any implication that this would prohibit negotiated changes to the franchise agreement, the Commission has also added an express provision permitting negotiated changes if certain specified procedures are followed.

1. **Illinois**

The FTC Rule prohibits waiver of reliance on disclosure document representations, although the franchisee can waive disclosure representations through negotiation. Section 41 of the Illinois Act provides that “Any condition, stipulation, or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this Act or any other law of this State is void.” Rule 200.609 identifies the waivers as inclusive of but “not limited to, statements involving unregistered earnings claims, timely disclosure, warranty, material misrepresentations or limitation of liability.” However, neither of these provisions prevent the execution of a settlement agreement, general release regarding a potential or actual lawsuit filed under the Act, or arbitration actions under Title 9 of the United States Code. Depending upon the disclosure document, franchisors would insert language into the state addenda addressing the limitations of waivers for compliance with both the Act and the New FTC Rule. Illinois Rule §200.303 also requires that oral or written representations be consistent with information in the UFOC.

Negotiated changes to the Franchise Agreements are permitted by Section 705/11 and Rule 200.14 without necessitating a corresponding amendment filing. However, the noted cites limit “negotiated changes” to the result of negotiations between the franchisor and the franchisee/prospect with such corrections considered permanent changes if the franchisor consistently makes the same changes in additional, consecutive franchise sales.

2. **Maryland**

Section 14-226 of the Maryland Franchise Law provides, “As a condition of the sale of a franchise, a franchisor may not require a prospective franchisee to agree to a release, assignment, novation, waiver, or estoppel that would relieve a person from liability under this subtitle.”

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120 N.Y. GEN. BUS. LAW § 683(9).
121 ILL. ADMIN. CODE § 200.609.
123 MD. BUS. REG. CODE ANN. § 14-226 (hereafter, the “Anti-waiver Provision”).
The Maryland Securities Division consistently has interpreted the Anti-waiver Provision of Section 14-226 to apply not only to the initial sale of a franchise, but also to any later renewal or transfer (assignment) of the franchise by the franchisee. \(^{124}\) Because the franchisee’s obligation to sign a release at renewal or assignment arises from the franchisee’s contractual obligation in the initial franchise agreement, such a release is required as a condition of the sale of the franchise. Therefore, the Anti-waiver Provision prohibits a franchisor from requiring a franchisee to sign any release or waiver of liability under the Maryland Franchise Law, except a release negotiated by the parties pursuant to a settlement agreement that resolves a legal dispute.

This policy and interpretation is reflected in COMAR 02.02.08.16, which states as follows:

L. **Prohibited Releases from Liability and Waivers.** A person authorizing, aiding in, or causing to be made, an offer or sale of a franchise commits a “misrepresentation to, deceit of, or fraud on the buyer” within the meaning of the Maryland Franchise Law, Business Regulation Article, §14-221(2), and engages in an “act, practice, or course of business which operates or would operate as a fraud or deceit on another person” within the meaning of the Maryland Franchise Law, Business Regulation Article, §14-229(a)(3), if that person requires a franchisee to:

1. Provide a release from liability under the provisions of the Maryland Franchise Law as part of a franchise agreement or as a condition of the sale, renewal, or assignment of a franchise;

2. Assent to a period of limitations for causes of action under the Maryland Franchise Law, Business Regulation Article, §14-226, other than the period of limitations set forth in that statute; or

3. Waive the franchisee’s right to file a lawsuit alleging a cause of action arising under the Maryland Franchise Law in any court of competent jurisdiction in this State. \(^{125}\)

Thus, Maryland franchise regulations expressly bar releases of liability that are required upon the initial sale of the franchise, as well as those that are required upon the later renewal or assignment of the franchise. If a franchisee does sign such a release, it is void and unenforceable under the Maryland Franchise Law.

Maryland’s franchise regulations make clear that negotiated changes to a franchise agreement are acceptable and trigger no adverse registration consequences for a franchisor. COMAR 02.02.08.06A(2) expressly states that a change to a franchise agreement does not require that the franchisor file an amendment application, so long as the change is made as a result of negotiations between the franchisee and the franchisor and the franchisor agrees to the change or a similar change only on an individual or isolated basis. \(^{126}\)

\(^{124}\) See, e.g., Williams v. Stone, 109 F.3d 890 (3rd Cir. 1997) (Maryland Attorney General’s Office filed an amicus brief in support of appellants arguing that Anti Waiver provision applies to a general releases executed as a condition of a franchisor’s consent to a transfer of a franchise).

\(^{125}\) MD. REGS. CODE TITLE, §02.02.08.16L.

\(^{126}\) Id. § 02.02.08.06A(2).
3. New York

The New York Franchise Act contains “antiwaiver” provisions. NY GBL Section 687(4) makes “void” “[a]ny condition, stipulation, or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law, or rule promulgated hereunder . . .” Further, NY GBL Section 687(5) makes it “unlawful” “to require a franchisee to assent to a release, assignment, novation, waiver or estoppel which would relieve a person from any duty or liability imposed by this article.”

New York permits negotiated changes so long as the franchisor does not “use the negotiating process to prevail upon a prospective franchisee to accept terms which are less favorable than those set forth in the prospectus.”

VI. CHANGES TO UFOC DISCLOSURE REQUIREMENTS

The following is a brief overview of some of the key substantive changes that the latest version of the Proposed Rule contemplates making to the UFOC Disclosure. Items to which no substantive changes have been proposed are omitted.

A. General Approach.

The FTC uses a consumer protection approach and wants only disclosures specified by Guidelines whereas States generally follow the securities law approach and want all material information made available to franchisees.

B. The Cover Page

The disclosure document will now be entitled “Franchise Disclosure Document” and not “offering circular,” “UFOC” or “Uniform Franchise Offering Circular.”

Risk factors will be included only if required under state law.

Franchisors must include their e-mail addresses and Internet home pages, and must include a statement that the franchisee may wish to receive the UFOC in a different format (e.g. in writing or electronically).

C. Table of Contents

Titles of several disclosure items will change.

D. Item 1 The Franchisor, and any Parent, Predecessors, and Affiliates

The Proposed Rule adds required disclosures about the franchisor’s direct and indirect parent companies.

127 N.Y. GEN. BUS. LAW § 687(4), 687(5).

Franchisors must also disclose competition from any entity in which an officer of the franchisor owns an interest.

**E. Item 2 Business Experience**

The Proposed Rule omits franchise broker disclosure from Item 2, but this will not override any of the registration states with franchise broker regulations. As previously cited, state laws are not impacted when such laws provide greater consumer protection than the FTC Rule. Continued broker disclosure, whether in Item 2, Item 3 or as an exhibit to the Offering Circular, may be maintained by the registration states viewing this information as beneficial to the franchise prospect even if it is just to ease concerns about the parties involved in the sale process.

In addition to disclosure, state broker registration requirements would continue to apply, as they have in the past. Illinois, 815 ILCS 705/5(3) of the Act and Rule 200.900, and Washington have required broker registration for years without any crossover problems between state and federal law. And, if history prevails, the future will likely yield the same harmonious results.

Broker disclosure is also required pursuant to New York’s franchise regulations. As New York’s regulation provides greater consumer protection than the proposed FTC rule, it would not affect state regulations. In any event, at this time, no determination has been made as to whether broker disclosures will be omitted.

**F. Item 3 Litigation**

The Proposed Rule adds required disclosures of litigation involving a parent who guarantees the franchisor’s obligations.

It also adds required disclosure of franchisor-initiated lawsuits against franchisees during the last fiscal year which concern franchise relationship issues.

The Proposed Rule also broadens the types of affiliates about whom the franchisor must disclose government agency litigation.

Some states have broader disclosure requirements, which if not changed will continue to apply. For example, New York does not have a time limit regarding the disclosure of felonies and requires the disclosure of misdemeanor convictions within the 10 year period immediately preceding the application for registration that relate to violations of a franchise, antifraud or securities law, fraud, embezzlement, fraudulent conversion, or misappropriation of property, or unfair or deceptive practices or comparable allegations. As New York’s law and regulation provides greater consumer protection than the proposed FTC rule, it would not affect state law or regulation.

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129 815 ILL. COMP. STAT. 705/5(3); ILL. ADMIN. CODE § 200.900.


131 N.Y. GEN. BUS. LAW § 683(2)(e)(1).

G. **Item 4 Bankruptcy**

The Proposed Rule may expand bankruptcy disclosures by including a franchisor’s affiliates (beyond those who offer franchises under the franchisor’s principal mark), predecessors and parent companies, officers, general partners, and other persons who occupy a similar status or perform similar functions.

H. **Item 5 Initial Franchise Fee**

The title of this item will be changed to “Initial Franchise Fees Paid to the Franchisor,” but without substantive changes to the required disclosures.

I. **Item 6 Other Fees**

The Proposed Rule expands Item 6 to include payments that the franchisee must pay to a third party, and the formula or maximum amount by or to which a fee may increase.

The expansion of Item 6 will enhance the disclosure by itemizing, in a single location, all required franchisee expenditures during the term of the franchise agreement. Such a concise enumeration of expenses will enable a franchisee to quickly determine its weekly, monthly, quarterly or even annual costs at a glance while minimizing franchisor rewrites to the Circular.

The current Item 6 is arguably not an accurate or thorough representation of ongoing expenses as it does not provide for all franchisor prescribed advertising commitments, software purchases, updates and maintenance, internet and website expenditures, annual training attendance, financial statement preparation, etc. The totality of these sums would be material to a franchise prospect, and a franchisee, when preparing a budget or loan proposal, completing an expense proforma or attempting to pay bills.

The argument has even been made that the current Item 6 is omits important information and is misleading especially when a prospect has purchased a franchise based upon the Item 6 and 7 figures, only to realize later that the actual expenses exceed franchisor estimates. These miscalculations can exacerbate the struggle for survival.

J. **Item 7 Initial Investment**

The Proposed Rule changes the title of this Item to “Estimated Initial Investment.”

Although there are no substantive changes, Item 7 estimates must include both pre-opening expenses and those incurred during the “initial period of operations” of at least 3 months following opening or other reasonable period in the industry. The FTC dropped its proposal to require a break-even analysis, which would have deviated from the current UFOC Guidelines.

K. **Item 8 Restrictions on Sources of Products and Services**

The Proposed Rule adds disclosure of suppliers in which an officer of the franchisor owns an interest.
L. **Item 11 Franchisor’s Obligations**

The Proposed Rule changes the title of this Item to “Franchisor’s Assistance, Advertising, Computer Systems, and Training.”

It also reduces the level of detail required to be disclosed about computer hardware, software, and POS systems, in favor of general description.

M. **Item 12 Territory**

The Proposed Rule mandates a required statement if no exclusive rights are granted.

The Proposed Rule also expands disclosures relating to alternate channels of distribution, and requires the franchisor to disclose restrictions:

- **On the franchisor** with respect to orders from consumers inside the franchisee’s territory, including: reserved rights to other channels of distribution, e.g. Internet, catalog sales, telemarketing, or other direct marketing sales, using the franchisor’s principal trademarks or different trademarks; and any compensation the franchisor must pay to solicit or accept orders from inside the franchisee’s territory; and

- **On the franchisee** as to orders from consumers outside of the franchisee’s territory, including the right to use other channels of distribution, such as Internet, catalog sales, telemarketing, or other direct marketing.

N. **Item 13 Trademarks**

The Proposed Rule requires franchisors to state the franchisee’s rights if the franchisee is required to modify or discontinue use of a trademark under any circumstances.

O. **Item 14 Patents, Copyrights, and Proprietary Information**

The Proposed Rule requires the franchisor to disclose, in terms of requirements and rights under the franchise agreement, whether the franchisor must take affirmative action when notified of an infringement, and what rights the franchisee has if it must modify or discontinue use of patented or copyrighted matters.

The franchisor must also disclose not only the general nature of proprietary information, but also the terms and conditions under which the franchisee may use it.

P. **Item 15 Obligation to Participate in the Actual Operation of the Franchise Business**

The Proposed Rule reduces UFOC disclosures by limiting disclosures of limitations on whom a franchisee may hire as an on-premises supervisor, and that person’s required successful completion of training, to franchisees who are individuals (i.e., not business entities).
The Proposed Rule requires disclosure only of obligations to participate personally in the direct operation of the business, whereas the NASAA commentaries require disclosure of all agreements that are binding on the franchisee’s owners.

Q. **Item 17 Renewal, Termination, Transfer and Dispute Resolution**

The Proposed Rule requires franchisors to add an explanation of the franchisor’s renewal policies, including any obligation to sign a new franchise agreement on different terms.

R. **Item 19 Earnings Claims**

The title of this Item is proposed to be changed to “Financial Performance Representations.”

Franchisors now must state that they are permitted to provide financial performance information if there is a reasonable basis for the information and if it is included in the UFOC.

One significant development is the FTC’s proposal that cost and expense information will no longer be considered to be an earnings claim. However, note that this position may not be accepted by the states. For example, New York’s franchise regulations incorporate the UFOC Guidelines definition of an “earnings claim,” which includes “costs.” As New York’s regulation provides greater consumer protection than the proposed FTC rule, it would not affect state regulations. In any event, no determination has yet been made as to whether New York’s franchise regulations will be modified.

Franchisors may now provide historical financial information about subsets of the franchise system, if one discloses the number and percentage of outlets that attained or surpassed the stated results, based on the number of outlets in the subset (rather than the number of outlets in the entire franchise system, as the UFOC currently requires).

Item 19 does not cover the providing of actual operating results for a specific outlet being offered for sale to prospective purchasers of that outlet (and the Proposed Rule eliminates the required delivery of the identity of the prior owners of the outlet during the preceding three years).

S. **Item 20 List of Outlets**

The title of this Item has been changed to “Outlets and Franchisee Information.”

The Proposed Rule changes the form and content of the tables used in presenting franchisee- and franchisor-owned outlets statistics, and avoids the current “double counting” problem by counting (or acknowledging) only the last-occurring event if an outlet undergoes multiple relatively concurrent status changes. The Proposed Rule adds required disclosure of “Confidentiality Agreements” signed by franchisees during the franchisor’s last 3 fiscal years that restrict them from discussing their personal experiences with the franchisor.

Included is a new and required disclosure regarding trademark-specific franchisee associations (e.g., those sponsored by or endorsed by the franchisor, and independent, incorporated franchisee associations that timely request to be included in the franchisor’s disclosure document each year).
It prohibits using phony references or "shills."

T. Item 21 Financial Statements

Audited financial statements must be prepared in accordance with generally accepted accounting principles, or as permitted by the Securities and Exchange Commission, and as revised by governmental mandate.

Item 21 need not include separate audited financial statements for a parent company, unless the parent guarantees or commits to perform the franchisor's obligations. An affiliate's audited financial statements may be used in lieu of the franchisor's if the affiliate guarantees the franchisor's performance. Such guarantees must be attached to the UFOC.

Phase-in requirements relating to audited financial statements for startup franchisors are clarified. A startup franchisor that does not have audited financial statements does not need an audit for its first partial or full fiscal year.

Illinois Rule 200.600(c) addresses the "Phase In Of Audit Requirement" for original franchise applicants while Rule 200.603(a)(2) extends the phase in to annual report (renewal) filings and will consequently be consistent with the New FTC Rule. Illinois law has long recognized the need for modified financial requirements relative to the "new to franchising" company.

Pursuant to 13 NYCRR 200.2 (c), Item 21, "Financial Statements," financial statements must be audited. An opening audited balance sheet is required for start-up companies. No determination has been made as to whether this regulation will be modified. As New York's regulation provides greater consumer protection than the Proposed Rule, it would not affect state regulation.

U. Item 23 Receipts

Item 23 has been modified to reflect the revised disclosure timing requirements discussed above.

It also adds the new and potentially unwieldy requirement that the receipt include the name, address, and telephone number of each "franchise seller" offering the franchise. This definition of "seller" includes sub-franchisors and third-party brokers, as well as the franchisor and its employees, representatives, and agents who "are involved in franchise sales activities."

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133 ILL. ADMIN. CODE § 200.600(c), 200.603(a)(2).
On the other hand, these changes to the Receipt Page can be viewed as a positive, record keeping function, benefiting both the franchisor and franchisee because, among other potential advantages, it provides a less onerous alternative to the current disclosures required to be included in Item 2.

VII. CONCLUSION

The New FTC Rule is a positive step in the evolution of franchise pre-sale disclosure that will benefit both franchisors and franchisees by clarifying and augmenting information shared during the courting process, before the parties commit to a long term business relationship, while promoting the continued success and growth of the franchise business model.
Dale E. Cantone

Dale Cantone is an Assistant Attorney General for the State of Maryland and the Deputy Securities Commissioner for the Maryland Securities Division. Since 1996, Dale also has served as Chair of the Franchise and Business Opportunity Committee/Project Group of the North American Securities Administrators Association, Inc. ("NASAA").

In his role with the Maryland Securities Division, Dale oversees the registration function of the Division with regard to franchises and business opportunities. Dale also is primarily responsible for enforcement actions brought by the Maryland Attorney General’s Office in the area of franchising, business opportunities, multi level marketing, and product-based pyramid schemes. In his role as Chair of the NASAA Franchise Project Group, Dale chairs a committee that proposes initiatives, statements of policy, model acts and uniform guidelines related to franchising. In recent years, the NASAA Franchise Project Group has drafted Commentaries on the UFOC Guidelines and Statements of Policy regarding Internet Franchise Offers and Internet Advertising. The Franchise Project Group also implemented an initiative to coordinate multi-state franchise reviews. In 2001, NASAA presented Dale with its Outstanding Service Award for his work in franchising at the state level.

Dale has spoken at programs sponsored by the American Bar Association Forum on Franchising, the International Franchise Association, the American Franchisee Association, the Direct Sellers Association, the Maryland State Bar Association, the Maryland Institute for the Continuing Professional Education of Lawyers, and the Better Business Bureau. In 2002, Dale testified about state franchise issues before the Commerce, Trade and Consumer Protection Subcommittee of the Energy and Commerce Committee of the U. S. House of Representatives. In 2005, the American Association of Franchisees and Dealer awarded Dale its Total Quality Franchising Chairman’s Award for Distinguished Contributions and Service to the Franchising Community.

Dale received his law degree from the University of Baltimore, where he was a member of the law review, and practiced law in Baltimore for several years prior to joining the Maryland Attorney General’s Office.
Kenneth R. Costello

Kenneth R. Costello is a shareholder in the Los Angeles office of Jenkens & Gilchrist, P.C. He is Co-Chair of the firm’s Franchise and Distribution Law practice group and has practiced for more than 27 years in U.S. and international franchise and intellectual property law, including franchise, copyright, trademark and technology law, and represents businesses that use franchising and licensing in the distribution of goods and services.


He serves on the International Franchise Association’s Supplier Forum Advisory Board, and on its Legal Legislative and Membership Committees, on the ABA’s Section of Intellectual Property Law and its Forum Committee on Franchising and previously served as an Articles Editor on the ABA Franchise Law Journal. He serves on the Advisory Boards of Leader’s Franchising Business & Law Alert and Andrews Franchise & Distribution Litigation Reporter.

Mr. Costello is recognized as one of the 22 “Most Highly Regarded” franchise lawyers globally by International Who’s Who of Franchise Lawyer’s (Law Business Research, Ltd., London – 2005 Edition), he has testified on franchise trade regulation issues before the Federal Trade Commission and has been consulted on franchising issues by the Wall Street Journal, New York Times, CBS News, Forbes and Entrepreneur Magazine, among other media.
Shelley Harris Horn

Shelley Harris Horn is the Lead Franchise Examiner in the Franchise Bureau of the Office of the Attorney General for the State of Illinois. As Lead Examiner with 27 years of franchise experience, Shelley is totally immersed in the daily functions of the Franchise Bureau, and focuses on regulatory procedures and enforcement actions. Assisting the Bureau Chief and the other Franchise Examiners in the decision making process and policy analysis and development, Shelley continues to be actively involved in all aspects of bureau operations.

Shelley has participated annually at the NASAA Franchise Examiner training programs and is very active in NASAA’s coordinated review program, which has established Illinois as the “lead state” award recipient in prior years. Shelley has also spoken at prior programs sponsored by the American Bar Association Forum on Franchising and the International Franchise Association.
Joseph J. Punturo

Joseph Punturo is an Assistant Attorney General, Franchise Section chief, in the New York State Attorney General’s Investment Protection Bureau. As Franchise Section Chief, Mr. Punturo commences enforcement proceedings and oversees the franchise section’s functions, including registration and adopting regulations. In 2004, the Office of the Attorney General presented Mr. Punturo with a Louis J. Lefkowitz Memorial Award, an achievement award for Assistant Attorneys General who have demonstrated exceptional service on behalf of the State of New York. Mr. Punturo has been featured in profiles in the New York Law Journal and the Franchise Times Magazine.

Mr. Punturo is a past-Chair and current member of the New York State Bar Association’s (“NYSBA”) Franchise, Distribution and Licensing Law Committee. He is a member of North American Securities Administrators Association Inc.’s (“NASAA”) Franchise and Internet Enforcement Project Groups, and the NYSBA’s Business Law Section’s Executive and Securities Regulations Committees. He has published many articles and has lectured at many forums on franchise law.

Prior to joining the Investment Protection Bureau, Mr. Punturo was a litigator in the private sector. Mr. Punturo holds law degrees from Georgetown University Law Center (LL.M. Securities Regulations – Graduation Commencement Speaker) and Touro Law Center (J.D. Honors).