BEST PRACTICES FOR ESTABLISHING
A FRANCHISE COMPLIANCE PROGRAM

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I. INTRODUCTION

A. Definition of a Franchise Compliance Program

Franchising as a method of product and service distribution has advantages from the point of view of conserving capital and accelerating the expansion process. It is, however, like beginning an entire new business ancillary to a franchisor's existing operations. Establishing a compliance program is part of setting up this new business. In the initial stages, it is often guided by outside counsel. As the system matures, a franchisor may decide to set up all or a part of this system in-house. The guidelines and observations proposed here should be useful both to in-house counsel and to outside counsel of franchise systems that do not have their own legal departments.

There are a number of components to a franchise compliance program, the first of which is an information-gathering function. In order to properly prepare a Franchise Disclosure Document ("FDD") a franchisor must gather and sort through information about its history, affiliated and parent companies, its management team and their personal histories, the litigation and bankruptcy experience of the franchisor itself and certain affiliated entities and predecessors.

In addition, strategic planning will be involved. For example, a franchisor's management team will need to determine in what geographic regions the franchisor plans to expand over the next 12 months, both on a company-owned basis and a franchised basis. A franchisor must also determine whether or not to make a financial performance representation as part of its FDD. If it decides to do so, analyzing data on historical operations or developing projections will likely involve the accounting staff of the franchisor and possibly its auditors.

Another function in this information-gathering process involves monitoring outside contributors. These include the independent auditors and their audit of the company's financial statements. It may also include outside consultants who are writing operations manuals and designing training and advertising programs.

B. Importance of a Compliance Program

The importance of a comprehensive compliance program cannot be overemphasized. The consequences for violating franchise laws include civil fines and even criminal liability under state and federal law, as well as potential civil actions by franchisees seeking damages and, in some cases, rescission. The franchise laws were enacted as remedial statutes and the definition of a franchise is interpreted broadly. Exemptions are interpreted narrowly and the consequences for failure to comply with the registration and disclosure requirements of these laws can not only be costly in terms of fines and damages, but can also result in disclosure items that will continue to haunt the franchisor in its quest to sell additional franchises long after matters are resolved. Federal and state franchise laws also provide for individual liability for control persons.

Moreover, a violation of the franchise laws is often discovered at what may be a very inopportune time. Due diligence for a financing or an acquisition of the franchisor can reveal issues relating to compliance with franchise law. That can result in financial repercussions that can affect the transaction, or even derail the value of the transaction altogether.

II. KEY ELEMENTS AND PLAYERS IN A COMPLIANCE PROGRAM

A. Developing and Training an Internal Sales Staff to Value Compliance

It is important to motivate the internal sales staff to value not only the accomplishment of closing franchise sales but also compliance with franchise laws. Holding periodic training sessions to make sure that sales staff is aware of updates to franchise sales laws is crucial. Sales personnel must be familiar with the delivery requirements of the Federal Trade Commission’s Trade Regulation Rule on Franchising\(^2\) (the “FTC Rule”). Significant amendments to the FTC Rule were adopted in 2007 and became mandatory in July 2008. In the two years since then, some states, but not all, have adopted the same delivery requirements. If a state’s laws impose more requirements than the FTC Rule, the state’s law must be observed. If a state’s requirements are less than those of the FTC Rule, the FTC Rule preempts state law. Therefore, unless a program is limited geographically, it may make sense for a franchisor to require that sales staff comply with the most onerous disclosure requirements in order to make sure that the franchisor is in compliance with all laws. If a particular transaction requires an early closing, the franchise sales staff can consult with legal staff to see if a shorter disclosure requirement period is effective in that location.

B. Determining Whether to Involve Outside Salespeople/Brokers

The decision to employ outside sales persons and brokers has its pros and cons. On the pro side, it gives the franchisor access to a larger database of prospective franchisees. Ideally, the quality of this group of prospective franchisees is also higher than the franchisor would have access to on its own. On the other hand, employing an outside sales force results in a loss of control over the sales process. Since the liability for a franchise law violation by an outside salesperson will affect the franchisor, it behooves the franchisor to make sure that the sales force is properly trained and motivated.

Some franchise systems include the concept of an area representative or development agent. This is a person, typically another franchisee, whose business is to refer prospective franchisees to the franchisor and to provide services on behalf of the franchisor to franchisees in a particular region. This person’s incentive is to have the franchisor sell as many franchises as quickly as possible, because the more franchisees in his or her region, the more the area representative will earn. While structuring a franchise program utilizing this method is attractive because of the speed with which the

\(^2\) 16 C.F.R. Part 436
program can grow, it also requires increased supervision of area representatives and their employees to make sure that they are not creating liability for the franchisor.

1. **Training**

   Franchise sales compliance training is essential to a franchise compliance program. There are a number of methods to accomplish this. The International Franchise Association ("IFA") has contracted for a training overview for franchisors.\(^3\) Periodic training is important because of frequent changes to applicable law. The IFA and the American Bar Association conduct periodic programs, as do private law firms.

2. **Oversight/Management**

   In addition to making sure that the franchisor’s sales staff is adequately trained, a franchise compliance program will involve a mechanism to monitor the actions of the franchise sales force. A franchisor must spend as much time monitoring as training its sales staff to ensure that the required procedures are followed. This can involve periodic attendance at sales meetings, requirements that sellers maintain records of discussions with prospects and the debriefing of prospective franchisees.

3. **Litigation Risks**

   State franchise laws that govern the offer and sale of franchises generally provide for recourse by the franchisee if the franchisor violates the law.\(^4\) Remedies afforded the franchisee include damages and, under some circumstances, rescission. The franchisee may be able to pursue these remedies not only against the franchisor and the franchise seller\(^5\), but also against officers, directors and managers of the franchisor individually.\(^6\) In addition, franchisee litigation resulting from franchise sales violations is generally a required disclosure in Item 3. If a violation is discovered while a prospective franchisee is still in the sales process, a franchisor should consider the pros and cons of proceeding with the sale. Some courts have held that a person who never signs a Franchise Agreement cannot make a claim under the franchise laws.\(^7\)

4. **Regulatory Issues**

   Another potential source of liability comes from enforcement actions by regulatory authorities. These can be triggered by complaints from franchisees, complaints by competitors, investigations by regulators (e.g., through attendance at

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\(^5\) A franchise seller is a person who offers for sale, sells or arranges for the sale of a franchise. It can include the franchisor and its employees, representatives, agents, subfranchisors and third-party brokers. 16 C.F.R. Part 436.1(1).

\(^6\) See, e.g., Sec. 80C.17 of the Minnesota Franchises Law; CCH Business Franchise Guide ¶3230.17

\(^7\) *North American Financial Group, Ltd. V. S.M.R. Enterprises, Inc. et al*, CCH Business Franchise Guide ¶8168
trade shows and review of newspaper and Internet advertisements) and by referral from a franchise examiner to enforcement based on actions by a franchisor in the registration process.  

C. **Appointing a Single Decision Maker or Compliance Leader**

As a compliance team grows, it is important to have at least one additional set of eyes to oversee the process and to conduct a compliance review before the sale of a franchise closes. This person is also a resource within the franchisor’s management who can answer questions as they arise. Since there are compliance issues that even the most seasoned franchise attorneys can struggle with, it is important to have a compliance leader who can make the determination as to when a question or issue should rise to the level of consulting in-house or outside counsel.

D. **Centralizing Calendaring and Organization of Materials and Information**

Obviously, a filing system (electronic and/or paper) that documents compliance with the requirements of the FTC Rule and any applicable state franchise law for each and every offer and sale of a franchise is crucial. The franchisee’s file should ideally include the following: documents provided to the franchisee in the sales process; the FDD Receipt and receipts to evidence the prospect’s receipt of any other disclosure (supplemental financial performance representation, unilateral changes by the franchisor to the Franchise Agreement, additional information required by Item 20); the application completed by the franchisee; agreements the franchisee signed including ancillary agreements such as a guaranty; memoranda documenting communication with the franchisee during the sales process such as telephone conversations, meetings and attendance at discovery day; certificates evidencing required insurance and the naming of the franchisor as an additional insured; copies of the franchisee’s lease; correspondence and emails between the franchisor and franchisee; the results of any quality assurance inspections; and default notices and responses.

In addition to calendaring important dates concerning obligations by franchisees, the compliance team must also maintain a calendar of due dates for updates and filings required by franchise laws. A sample form of calendar is attached as Appendix A. This will include not only the annual registration requirements, but also miscellaneous filing requirements such as Quarterly Sales Reports for Maryland, special Annual Reports required in Hawaii and New York and any reporting conditions imposed by a state regulator in the registration process. If the franchisor is not offering franchises in states that require the registration of the offer and sale of franchises, the quarterly updates required by the FTC Rule should also be included in the calendar.  

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8 See, for example, the enforcement action taken by the California Department of Corporations against Play N Trade Franchise, Inc. http://www.corp.ca.gov/ENF/list/p/PlayNTrade.asp

9 The FTC Rule requires an annual update within 120 days after a franchisor’s fiscal year end and quarterly updates for material changes. State franchise laws typically require a franchisor to amend its FDD if there is a material change “promptly”.

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The same is true for lawyers in private practice who represent a number of franchise clients. In addition to providing them each with their own franchise filing calendars, the franchise lawyer must also make sure a master calendar for all clients’ filings is prepared.\textsuperscript{10}

E. Creating Checklists for Compliance

Using checklists to document compliance is a widespread practice. These checklists typically chronicle the dates that the FDD was delivered and the date any additional documents were delivered. They will also include statements that the franchisee did not receive any franchise performance representations except for those in Item 19 of the FDD and similar statements that are intended to provide evidence that the franchisor did not violate applicable franchise laws in the franchise offer and sale.

There are different methods to consider in using these checklists. One school of thought is to include a compliance checklist that is prepared and delivered as part of the closing of the franchise sale and signed by the franchisee. A sample is attached as Appendix B. In practice, these checklists may not be filled out by the franchisee, but rather by the franchisor. Moreover, the franchisee is likely to sign the form without any comprehensive review. If a dispute ever surfaces, the franchisee may argue that he or she was told to sign the document or no franchi is would be granted.

Therefore, the better practice is to either require the franchisee and his or her adviser to complete the checklist and to certify to that effect, or to use the checklist as an internal double check to put in the franchisee’s file along with documentary evidence for each entry.

III. PRE-SALE COMPLIANCE

A. Preparation of FDD

This is likely a task undertaken by outside counsel at the outset. Some franchise practitioners will first prepare the FDD for a client’s review before preparing the agreements themselves. This is because the FDD must be prepared in plain English.\textsuperscript{11} It is a document that describes what is in the Franchise Agreement and any other agreements in the program, and also includes information about the franchisor itself, its parents, affiliates and its personnel. Therefore, it is easier to prepare the Franchise Agreement after the franchisor’s management team has approved the terms described in the FDD. Other practitioners will prepare the Franchise Agreement first, especially if the client is sophisticated or has in-house counsel.

Assembling the information to include in the FDD is a process that can take some time. Many practitioners use questionnaires that run through each of the FDD’s disclosure items and elicit details that the franchisor may wish to include in the Franchise Agreement. These questionnaires can run 60 to 70 pages. A sample of an

\textsuperscript{10} Franchise calendars are often maintained by paralegals, but an attorney should also supervise this process.

\textsuperscript{11} 16 C.F.R. Part 436.6(b)
excerpt is attached as Appendix C. These are likely to be returned incomplete and it will be necessary to gather the rest of the information through meetings and phone conferences. Another source of this information (and much more reliable) is a report by a franchise consultant who has studied the franchised business in depth, interviewed the franchisor about its existing operations, conducted a market study, and made recommendations which the franchisor has reviewed and approved.

Often overlooked are the exhibits to the FDD. Following is a list of the typical exhibits and specific pointers about what to include in them.

1. **List of State Franchise Administrators**

   This information is standard and should include the contact information for the state franchise administrators of all states with franchise registration and disclosure laws, whether or not the franchisor is registered to sell franchises in that state. The states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Periodically the contact information for one of the states changes. Be sure to update the tables periodically to ensure they are accurate. The list should not include states with business opportunity laws.

2. **List of Agents for Service of Process**

   Some practitioners attempt to combine this list with the list of franchise administrators. That is permissible but the franchisor should be careful not to indicate that it has appointed an agent in states in which the franchisor is not registered. Also important is to make sure that the correct agent is noted. In some states, the person or agency that a franchisor is required to appoint as its agent for service of process is different from the state franchise administrator.

3. **List of Parent Companies**

   A franchisor is permitted to include the information about parent companies required by Item 1 by exhibit. Disclosure of parents that own the franchisor both directly and indirectly through intermediary entities must be disclosed. If this is a long list, disclosure by exhibit is often clearer.

4. **Lists of Development Agents**

   Since FDDs are often drafted to be used in multiple states, they will include information about development agents or area representatives because it is required in some states. Therefore, if the franchise program includes franchise

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12 Commentary on 2008 Franchise Registration and Disclosure Guidelines adopted on April 27, 2009 by the North American Securities Administrators Association ("Commentary") Item 1.2; [http://www.nasaa.org/ContentFiles/FranchiseCommentaryfinal.pdf](http://www.nasaa.org/ContentFiles/FranchiseCommentaryfinal.pdf)

development agents, information about the development agents will often be disclosed in an exhibit.

5. **Copies of Financing Documents**

If financing is offered by the franchisor or its affiliates, copies of the financing documents must be attached. Sample documents may be attached and if there are material variations in the types of documents used or in their provisions, that information should be disclosed in Item 10 or in state-specific addenda.14

6. **Table of Contents of Operations Manual**

If a franchisor does not permit prospective franchisees to review the Operations Manual before signing the Franchise Agreement, the franchisor must include in the FDD the table of contents of the Manual current as of the franchisor’s latest fiscal year end. Franchisors generally attach this as an exhibit to the FDD.

7. **Information on Franchisees**

Item 20 requires that the FDD include a list of franchisees current as of the franchisor’s last fiscal year end, together with the addresses and telephone numbers of each of their outlets. In addition, there must be a list of the name, city and state and current business telephone number of each of the franchisees who have left the system during the previous fiscal year or who have not communicated with the franchisor within 10 weeks of the FDD issuance date. This information is frequently disclosed in an exhibit to the FDD.

**B. Registration of Franchise Offer**

All of the states that have enacted laws regulating the offers and sales of franchises require some form of registration, with the exception of Oregon.15 Registration requirements range from notice filings to a full and detailed review of the FDD by a state examiner.

1. **State-Specific Addenda**

When franchise examiners comment on the franchisor’s franchise registration application, their comments can relate to the disclosure requirements in general or to provisions that are required by the state’s own laws. Examples include specific statements that must be included in Items 3, 17 and 19 by California under certain circumstances.16 In order to prepare a uniform FDD, franchisors typically prepare state-specific addenda, both to the FDD and to the Franchise Agreement, as well as to ancillary documents. Examples of these addenda are attached as Appendix D.

14 See Commentary, Item 10.2
16 10 Cal. Code Regs. §310.114.1
2. **State-Specific Forms**

The registration states all require or will accept the filing forms set forth in the North American Securities Administrators Association ("NASAA") 2008 Amended Guidelines.\(^\text{17}\) In addition, there are some state-specific forms. California requires a Customer Authorization form as well as specific forms for qualification for its exemption for the Internet Advertising Exemption and, on renewal, its exemption for negotiated sales. Virginia has an optional form called an Affidavit of Compliance for filing upon renewal or amendment that provides for automatic effectiveness provided that the applicant meets certain conditions.

3. **Effective Dates**

The effective dates for a registration application vary according to the state. Some states provide that that the state must respond within a certain amount of time after the application is filed or the application is effective.\(^\text{18}\) As a result, the applicant may be asked for a waiver of automatic effectiveness. Refusing to provide the waiver is not a viable alternative. If the waiver is not provided, the state will file a stop order. It is advisable to provide the waiver conditioned on the applicant's response to the state's comments. In other states (and in the states in which the waiver is provided), the effective date is the date the state orders the application effective.

Michigan requires the filing of a notice only and the registration is effective upon receipt of that notice by the Attorney General's office. Indiana and Wisconsin are also considered "notice" filing states but the notice consists of filing the FDD itself along with application pages. Although the relevant statute provides for effectiveness on filing, the state sometimes sends a notice with a different date so it is advisable to wait until that letter is received. Hawaii's policy is that applications are effective seven days after filing, subject to the state's subsequent comments.

Renewal registrations are somewhat different. In many states, there is a due date for the renewal filing or annual report and, if timely filed, the registration will become effective upon the expiration date, subject to the receipt of comments from the state prior to that date. In Illinois, the renewal application is effective the day after filing, subject to the state's ability to provide comments at a later date. This is similar to the effective date in Hawaii, which is effective seven days after filing. The disadvantage of this automatic effectiveness is that there is the possibility that after several months of effectiveness, the state can issue comments. If those comments raise issues that relate to material noncompliance with disclosure requirements, then the offers and sales utilizing the non-compliant FDD are arguably in violation of the law.

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\(^\text{17}\) Adopted by NASAA on June 6, 2008; See [http://www.nasaa.org/content/files/2008UFOC.pdf](http://www.nasaa.org/content/files/2008UFOC.pdf)

\(^\text{18}\) See, e.g., Sec. 705/10 of the Illinois Franchise Disclosure Act or 1987; CCH Business Franchise Guide ¶3130.10
4. Responses to Comments

Applications for initial registration and even renewal applications can draw comments from franchise examiners. A very typical comment for an initial registration application relates to the financial condition of the franchisor, especially if the applicant is a new entity formed to conduct the franchise operations instead of the entity that owns the intellectual property or existing operations of a concept. If an applicant receives this comment, it typically will be able to choose among several alternatives. These include (1) escrowing the initial fee paid by the franchisee; (2) posting a surety bond; (3) deferring the initial franchise fee payment until the franchisor has fulfilled its pre-opening obligations to the franchisee; and (4) infusing additional capital. Franchisors should review the state’s requirements carefully because these options and the related compliance requirements, such as the size of a surety bond or type of escrowed bank, vary by state. In some cases, the examiner may agree that a shareholder (or other equity holder) loan will suffice if the creditor agrees that no payment will be made on the loan for some period of time, typically the registration period plus several months. For each of these alternatives, changes to the FDD are likely to be necessary, but are typically made by addenda to the FDD and the Franchise Agreement.

In Illinois, this comment is handled differently. The financial condition of a new applicant is reviewed first. If it is found to be deficient, the state will issue an Order of Denial. Once the applicant has responded in a manner acceptable to the state, the Order will be rescinded and the application reviewed with respect to issues other than the financial condition of the applicant. Occasionally, the state will take a similar action upon a franchisor’s filing of an Annual Report, and issue an Order of Suspension that is rescinded once the applicant addresses the financial issue to the state’s satisfaction.

a. Format

There is no specific format for a response to comments. An applicant should include both clean and blacklined copies of the changed documents. In Maryland, it is important to include a complete clean copy of the FDD even if no changes were made to some of the exhibits. A cd-rom should also be enclosed with the FDD in PDF format (text searchable), along with a statement in the cover letter that all of the information contained in the electronic file is identical to the paper documents. Check state requirements to ensure that the precise format is followed in order to avoid a comment letter regarding the submission’s format and unwanted delay.

b. Timing

Some states such as Maryland and Virginia will provide deadlines for an applicant to respond to comments. Failure to respond or to obtain an extension of the deadline will result in an abandonment of the application, and the franchisor will need to reapply. It can be useful to develop a tracking system for examiner comments, in order to ensure that all comments are addressed in a timely manner.
5. **Franchise Seller Disclosure Forms**

A Franchise Seller Disclosure Form must be filed with the registration application for every individual who is involved in the sales process on behalf of the franchisor. This includes those whose involvement is through franchise brokers with which the franchisor has a relationship. The Franchise Seller Disclosure Form is set forth in the Amended UFOC Guidelines. It is advisable to attach a certification form for the franchisor’s records when having the individual complete the form or verify its continued accuracy. This certification should not be filed with the state, but the franchisor should maintain it in its files. If a new franchise seller is added mid-way through a registration period, the franchisor must file the Franchise Seller Disclosure Form with the state. In California, this is considered an amendment to the franchisor’s registration and application forms and the $50.00 filing fee must accompany the form. It is also advisable to notify the registration states if a franchise seller is no longer representing the franchisor.

6. **Franchise Advertising**

Advertising materials directed at the sale of franchises must be filed with many of the states that require registration of franchise offerings. A requisite review period must expire before the franchisor can use the advertising material. Many states also include prohibitions on the use of certain content in advertising materials. A chart setting forth the filing requirements and content limitations of the franchise laws is attached as Appendix E. The definition of what constitutes “advertising” is frequently quite broad and can include letters, brochures, and articles about the franchisor provided to prospective franchisee, DVD's, recordings and even telephone messages. For example, adding the words “Interested in a __ Franchise? Contact us at ______ printed on a restaurant menu can convert the menu to advertising material.

7. **Effectiveness Letters**

Once an application is ordered effective in a state, it is important for a franchisor to be aware of specific provisions of that state’s laws that can affect the franchise sales process. Therefore, it is advisable for franchise counsel to provide an update on the state’s franchise laws. This letter will typically advise the franchisor of disclosure timing requirements, if different from those adopted by the FTC Rule, whether or not there is a special financial condition with which the franchisor must comply such as the deferral of payment of the initial fee, and the identity of any franchise sellers for whom Franchise Seller Disclosure Forms were filed.

C. **Registration Renewals**

Some of the states that require registration of franchise offerings provide that the registration expires a certain amount of time after the franchisor’s fiscal year end (e.g., 90 or 120 days after the fiscal year end). A renewal or other filing is due before the registration expires. The due date date varies depending on the state. For example,
California's due date is 15 business days before expiration.\textsuperscript{19} If the renewal registration application is filed after that date, then the registration will lapse if the expiration date arrives before the application is ordered effective.

Other states provide that the initial registration is effective for one year. In these states, a franchisor should be counseled to file the renewal application early the first year so that the annual filing will be coordinated with the issuance of annual audited financial statements. Otherwise, the franchisor will end up making two filings per year, one as an amendment to add the annual update information and audited financial statements, and the other the annual renewal.

1. **Annual Updates — Gathering Information**

Immediately following a franchisor's fiscal year end, the information gathering process begins. One method for assisting a franchisor in gathering this information is a questionnaire, crafted to highlight the typical types of information which annually require updates to add information for the franchisor's just-concluded fiscal year. In addition, officers, directors and management personnel disclosed in Item 2 should confirm, preferably in writing, the information included about them in Items 2, 3 and 4. Similarly, franchise sellers should confirm the information about them contained in the Franchise Seller Disclosure Form. Counsel representing the franchisor or other party for which disclosure is included in Items 3 or 4 should be provided with the existing disclosure, the FTC Rule disclosure requirements for the applicable Item and be asked to update the disclosure. Similarly, trademark and patent counsel should be provided with the same tools to update Items 13 and 14.

The franchisor should pay special attention to Items 6 and 7 to make sure they are up to date and reflect anticipated future increases.\textsuperscript{20} Information about franchisor revenues in Item 8 will require updates, likely from the franchisor's accounting staff, and the expenditures from the advertising fund for the previous fiscal year must be included in Item 11. Similarly, the information in Item 19, if any, and in Item 20 must be updated.

2. **Annual Reports**

In some states such as Illinois and Minnesota, annual reports are simply references to the annual update filing requirement and are the same as renewal registration applications. In other states, this is a reference to a different filing. Hawaii requires the filing of an annual report within 90 days after its fiscal year end that contains the number of franchises sold during the preceding fiscal year and the dollar amount of the proceeds from those sales. This is in addition to the renewal registration application that is required in Hawaii.

\textsuperscript{19} California Corp. Code §31121

New York requires that an annual report be filed within 120 days after the franchisor’s fiscal year end, including the franchisor’s audited financial statements for the fiscal year just concluded, and a report on franchise sales in New York including the name and address of each franchisee, the date of the sale, the name, address and telephone number of the person purchasing the franchise, and the price paid and credit terms for each sale. This is in addition to the annual update amendment required in New York.\textsuperscript{21}

3. **Going Dark**

As noted above, a franchisor will sometimes file an annual renewal application before the expiration of a registration, but after the due date. In some states such as California this will mean that the franchisor must suspend offers and sales once the registration expires until the franchise examiner orders the application effective. This is sometimes referred to as “going dark.” Of course, since the FTC Rule’s update requirements require that the annual update occur within 120 days after the franchisor’s fiscal year end, that date will also require a franchisor to go dark if a state registration has not been ordered effective.\textsuperscript{22}

Of course, if there have been material changes to the information contained in the FDD, the franchisor will need to cease offers and sales until the registration is updated.

D. **Common Problems**

Even after an FDD is prepared, and perhaps even registered, there are still many pitfalls to avoid in the franchise sales process. This section covers some of the common ones and methods for a compliance team to try to guard against them.

1. **Unregistered Offers and Sales**

Obviously, just preparing an FDD is not enough if a state that requires registration has jurisdiction over the offer and sale. The states that require the registration of franchise offerings (unless an exemption applies and all of the conditions to that exemption have been fulfilled) are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

a. **No FDD/Outdated FDD**

If the prospective franchisee does not receive an FDD or if he or she receives a version of the document that is outdated, a violation of both federal and state law may have occurred. Making sure that the prospective franchisee has been provided

\textsuperscript{21} In New York, the issuance of audited financial statements for the preceding fiscal year is a material change that requires the prompt filing of an amendment.

\textsuperscript{22} 16 C.F.R. Part 436.10(b)
with the correct FDD and returned the Receipt documenting this is an important part of the process that the compliance team must follow.

b. **Unregistered FDD**

A franchisor may not intend to violate the requirements of the law of a state that requires registration, but may not realize that the transaction has triggered that state’s jurisdiction. For example, a franchisor may negotiate with a prospect at a trade show in a state where neither franchisor nor franchisee is headquartered, but the meeting could trigger jurisdiction under some state laws. The types of factors to check are the location of the franchised business, the domicile of the franchisee and the states from which or to which communications have been directed. The latter is the hardest to track. The franchisor’s personnel must be trained to contact the compliance team if requested to send documents to a state or territory other than the state in which the prospective franchisee is domiciled or the state in which the franchisee’s business will be located.

c. **Disclosure Issues Relating to Negotiated Sales**

Some franchise programs do not permit negotiations – they have strong enough brands and enough franchisees to make negotiating special provisions an administrative nightmare. Other franchisors will be amenable to negotiating some of the provisions of the Franchise Agreement, especially if the franchise program is relatively new, entering a new geographic area or contemplating an arrangement with a powerful prospective franchisee such as an airport concessionaire. There are a range of positions that states take on the subject of negotiations. Virginia requires a franchisor to negotiate.  
23 States like Illinois  
24 permit negotiations so long as the same term is not routinely negotiated, in which case an amendment to the franchisor’s registration is required.

On the other end of the spectrum is California. California originally took the position that a negotiated term required the amendment of the franchise registration.  
25 This led cautious practitioners to advise their clients that if a franchisor wished to agree to a change proposed by the prospective franchisee, it would have to amend its registration, sell the franchise and then file another amendment to reflect the original offer.  
26 In the late 1980’s, California adopted the first of its negotiated sales exemptions, a revised version of which still exists in the California regulations.  
27 Subsequently, a statutory form of exemption was adopted.  
28 It requires: (i) that the

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25 See, e.g., Corporations Commissioner Opinion No. 72/26F (Aug. 9, 1972)
27 10 Cal. Code Regs. §310.100.2
28 California Corp. Code §31109.1
initial offer be the registered one; (ii) that the overall effect of the negotiated terms is to confer additional benefits on the franchisee; (iii) that certain information be provided to the prospective franchisee with whom the franchisor is negotiating by appendix\textsuperscript{29}; and (iv) that the franchisor file a certification with its renewal application that it has complied with the requirements of the negotiated sales exemption. If the prospective franchisee with whom the franchisor is negotiating requests a copy of the negotiated terms, the franchisor must provide that information within five days of the prospective franchisee’s request.

d. **Post-Registration Material Changes**

If there is a material change in any of the information contained in the FDD, state franchise laws require the franchisor to file amendments to its franchise registration in any state in which it is actively offering or selling franchises. Many of these states require that the amendment be filed “promptly” or “immediately.” The material change must be made to the FDD and the registration amended, if applicable, before another franchise sale is made.\textsuperscript{30}

Material changes can take a number of forms. They can include a substantial change in the franchisor’s financial condition or a significant change in Item 20 information, although some state examiners will not accept updates to Item 20 except in an annual renewal. Another type of change is a significant development in litigation or a bankruptcy proceeding, or a change in the franchisor’s personnel disclosed in Item 2. Sometimes the significant development in the litigation or bankruptcy disclosure is a positive one. Under those circumstances, some franchisors will forego filing an amendment because the positive nature of the updates would arguably mean they were not material.

Another type of change affects the franchise offered to prospective franchisees. This type of change can be timed to begin once the amendment is ordered effective, if the franchisor is willing to continue to grant franchises without the change prior to that time.

2. **Offer/Sale Using the Wrong FDD**

Franchisors typically strive to register an FDD that is uniform in all the states. It is typical, however, for certain states to require changes to the FDD and, therefore, the document registered in some states may be different from the one registered in other states. If there is more than one form of FDD, a franchisor’s

\textsuperscript{29} Information to be provided includes: (a) a summary description of each material negotiated term that was negotiated by the franchisor for a California franchise during the 12-month period ending in the calendar month immediately preceding the month in which the negotiated offer or sale is made under this section; (b) a statement indicating that copies of the negotiated terms are available upon written request; and (c) the name, telephone number, and address of the representative of the franchisor to whom requests for a copy of the negotiated terms may be obtained.

\textsuperscript{30} The FTC Rule contains quarterly and annual update requirements but does not preempt laws that afford prospective franchisees equal or greater protection, such as these laws concerning material changes.
representative may provide the wrong form to a prospective franchisee. The franchise compliance team should develop a system for making sure that the form of FDD is checked before it is delivered to a prospective franchisee. A prominent footer listing the state for which the FDD was prepared can eliminate mistakes.

3. **Offer/Sale Without Providing the FDD**

In most states, the delivery of the FDD is not required until 14 days before signing the Franchise Agreement or before the payment of any fee to the franchisor. If a signed copy of the Receipt is not obtained by the franchisor, it can leave the franchisor vulnerable to the allegation that it did not deliver the required document.

4. **Pre-Sale Disclosures Made Outside of the FDD**

Because there are likely many communications, both written and oral, to a prospective franchisee outside the FDD, a franchise compliance program must develop a method of monitoring these communications.

a. **Financial Performance Representations**

One of the most common issues with information provided to prospective franchisees outside of the FDD concerns representations about sales, income and profits. These are known as financial performance representations.\(^{31}\) Unless this information is provided to the prospective franchisee in Item 19 of the FDD or through some other permitted method, the franchisor and its representatives cannot discuss this information with the prospect.

There are a number of ways a franchisor can communicate this information to prospective franchisees that are permissible: (i) encouraging prospective franchisees to contact existing franchisees; (ii) providing information to the prospective franchisee’s lender with confirmation that the lender will not share this information with the prospective franchisee; or (iii) if the prospective franchisee is acquiring an existing location of the franchisor, the franchisor may provide the actual records from that location.

One question that is frequently asked is whether it is permissible to provide a prospective franchisee with a pro forma to complete. A blank pro forma, or one with cost information alone\(^{32}\), may be provided. It should be first filed as advertising material in the states that require such filings. A franchisor’s sales personnel must be trained not to comment on the pro forma or assist the franchisee in completing it because this will most likely result in an oral financial performance representation. Even accepting a completed pro forma without comment can be problematic because a

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\(^{31}\) Before the adoption of the amendments to the FTC Rule in 2007, these representations were referred to as earnings claims.

\(^{32}\) The cost information may be stated as a number or range of numbers, but not as a percentage of a stated level of revenue since that would enable a prospect to extrapolate earnings information. See Commentary, Item 19.1.
prospective franchisee may view this as tacit agreement with the information in the pro forma.

b. **Inaccurate Description of Deal Terms**

When a franchise program offering is registered, or when new terms are added by amendment, a franchisor will sometimes find that it needs to vary some of the terms. This decision may occur after it has offered the program for some period of time and has found that prospects react to certain provisions of the Franchise Agreement. Or the franchisor may discover that it is difficult to administer and enforce certain provisions. Without adequate communication about the necessity of amending the FDD, if the terms of the program change materially, the franchisor may end up unilaterally changing the provisions of the franchise without adequate disclosure.

In some circumstances, the franchisor will be able to address this by waiving certain provisions of the Franchise Agreement. If, on the other hand, the change that the franchisor wants to make adds to the obligations of the franchisee that may be difficult to accomplish after the documents have been signed.

5. **Timing and Disclosure Differences**

Some states have not amended their laws to conform to the delivery requirements adopted by the amended FTC Rule. Adopted in 2007 and mandatory in 2008, the FTC Rule requires disclosure 14 calendar days before the prospective franchisee signs any agreement or pays any consideration to the franchisor.

Some states still require that the FDD be provided to a prospective franchisee at least 10 business days before accepting any consideration or signing any agreement with the franchisee. Other states also retain the additional requirement that if the parties have a personal meeting to discuss the possible purchase of a franchise and that is earlier than the 10 business day period, the franchisor must deliver the FDD at that meeting. These potentially more onerous requirements apply in the following states:

- New York and Rhode Island still currently require disclosure at the earlier of the first personal meeting or 10 business days before the franchisee signs the agreement or pays consideration to the franchisor.33

- Michigan and Washington still require that disclosure be provided 10 business days before the payment of consideration or execution of franchise documents.

Franchisors must also be cautioned that there are some states with business opportunity laws that have not adopted the FTC Rule's relatively new disclosure requirements for exemptions for franchises.

33 Maryland also had these requirements until October 2010.
6. Incorrect Information on the Receipt

One of the most challenging requirements of the FTC Rule is the mandate to include information about the franchise sellers involved in a specific transaction on the Receipt. If the universe of possible franchise sellers is limited, one method of documenting this is to include all of the possible franchise sellers and check off those involved in any particular transaction.

Two FAQ’s issued by the Federal Trade Commission address the difficult issue of identifying the franchise sellers in a transaction.34 A franchise seller is a person who has significant contact with the prospective franchisee, for example, someone who assisted the prospect in completing an application or who was available to answer questions during the sales process. In particular, someone who receives a commission on the sale would be a franchise seller. The Federal Trade Commission offers some suggestions on ways to identify these individuals. The prospective franchisee can be instructed in Item 23 to write in the name or names of the individuals with whom the prospect had significant contact. Alternatively, the franchisor could attach a business card of a franchise seller to a previously signed Receipt and send a copy to the prospective franchisee. Suplementing the information on the Receipt will not trigger another 14-day disclosure requirement.

7. Errors in Delivery of the FDD

A franchisor may deliver the document in a number of ways. It can hand-deliver, fax or email the document to the prospective franchisee. Alternatively, it can provide directions for accessing the FDD on the Internet. Finally, the franchisor can provide a prospect with a paper copy or an electronic copy (CD-rom or computer disk) by mail.

There are some minefields in these provisions. First of all, if the FDD is sent by first-class mail, the franchisor must add three calendar days to the 14-day disclosure period.35 Second, there are some guidelines to follow in electronic disclosure. Since the FTC Rule requires that the FDD be delivered as a single document, free of external links and pop-ups, the franchisor may not email a separate copy of the Receipt along with the FDD itself. To facilitate the prospective franchisee’s ability to access the Receipt page and sign and return it to the franchisor, the FTC has indicated that the franchisor can either provide a link within Item 23 of the FDD to a separate web-based copy of the Receipt, or it can include an icon in Item 23 that allows the franchisee to print out a copy of the Receipt.

34 FTC Rule FAQ’s 12 and 23 at http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml
35 16 C.F.R. Part 436.2(c)(3)
IV. POST SALE COMPLIANCE

A. Record Keeping

1. Proof of Pre-Sale Compliance & Document Retention

In the event of a challenge to a franchise sale, franchisors will need to be able to produce records showing compliance with federal and state waiting periods and a list of the people involved in the sale of the franchise. Documents that franchisors should maintain in the event of a suit include the following:

- Franchisee application
- Original, executed FDD Receipt
- Correspondence from the franchisee indicating receipt of the FDD, if any
- Completed compliance checklist (if required by franchisor)
- Original, executed Franchise Agreement and ancillary agreements
- Records of first payments or other consideration from the franchisee
- Completed pre-sale interview form regarding franchise sales, if used
- Records of all subsequent modifications to the Franchise Agreement

2. Unit-Specific, Post Sale Compliance

In most established systems, Franchise Agreements are periodically modified or updated, reflecting the changing requirements or elements of the evolving system. This can result in a patchwork of different Franchise Agreements governing different units in the system, unless the changes are significant enough to trigger a system-wide effort to modify all the agreements. Although the changes can be subtle, it is important for franchisors to keep track of unit-specific distinctions between the terms applicable from one franchise to the next.

Franchisors should ensure that they maintain easily accessible records of the Franchise Agreements signed for each unit, and should train key corporate personnel to check the applicable Franchise Agreements before sending out notices regarding terms that are not uniform across the entire system.

B. Compliance Concerns Inside the System

1. Franchisor Compliance with Franchise Agreement Obligations

In some systems, the franchisor bears very few post-sale obligations. In other systems, however, the franchisor may have agreed to provide a minimum number
of meetings, training updates, unit inspections, annual reviews, or other forms of operational support to the franchisees.

Post-sale failures to comply with aspects of promised operational support are a basis for franchisee litigation and allegations that the franchisor is in breach of the Franchise Agreement or defrauded the franchisee through misrepresentations about the scope of support that the franchisee could expect from the system.

In addition to calendaring specific Franchise Agreement obligations and ensuring that all promised meetings, reviews and trainings are provided to the franchisees, a franchisor can protect its system by carefully documenting the efforts that it makes in connection with each unit franchise. Logs of phone calls, regional visits, meeting minutes, and rosters of franchisee attendance at franchisee conventions can reduce liability exposure by providing evidence of compliance.

Franchise systems that use development agents should require periodic updates or reports from agents with regard to fulfillment of these obligations, because the franchisor bears liability for compliance.

The compliance team may also choose to sample the services provided by the development agent by viewing a training session or a site visit or by interviewing franchisees in order to ensure that services are adequate.

2. **Advertising Fund Administration**

In many systems, the franchisor undertakes administration of the advertising fund and may be in charge of coordinating the election of a franchisee advisory council and participating in meetings with this council.

Conflicts over advertising are a rich ground for franchisee disputes and threats of litigation. Franchisors should ensure that they are following the letter of their Franchise Agreement obligations in the administration of the advertising funds. Some agreements require particular levels of expenditures on electronic or print media, or incorporate requirements for regional spending or certain portions of the advertising contributions from the units. In addition to ensuring compliance with these percentages, franchisors can often avoid franchisee suspicion about the use of the advertising fund contributions by circulating an annual summary of advertising fund expenditures or even an audit of the funds. In systems where the franchisees are also shareholders of the franchisor, they may have a right of inspection on the accounting records pertaining to these expenditures.\(^\text{36}\)

The percentage of the advertising fund spent on administration is a frequent point of contention with franchisees. While many systems do not have specific limits on the portion of advertising fund contributions that may be spent on administrative expenses, such as the salary of a marketing representative to run the

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\(^{36}\) This is common in consumer cooperatives which may operate under a franchise exemption but may still be subject to many franchise relationship laws.
fund, franchisors should be aware that spending a significant amount on administrative costs (often, more than 20%) can cause tension with franchisees.

C. Compliance Concerns Outside the System

There are innumerable laws which affect a franchise system that are not franchise-specific, ranging from employment regulations to zoning concerns, most of which are well outside of the scope of this paper. A few, however, are relevant to the scope of a compliance system. Advertising and antitrust laws deal with consumer protection and implicate some of the decisions that a franchise system can make on behalf of its franchisees. The reverse can also be true, in that independent efforts to advertise by a franchisee can trigger an investigation or a suit against the entire franchise system by an aggrieved consumer. Intellectual property policies also sound in consumer protection and are crucial to protecting the value of the franchise system.

1. Advertising Controls & FTC Regulations

Many franchisors control the administration of their systems' advertising funds. In addition to ensuring compliance with the terms of the Franchise Agreements with the franchisees, which may dictate how much may be carried over to the next year without being spent, and how much may be spent on administrative expenses, franchisors should also ensure that advertising complies with federal and state laws regarding deceptive advertising.

The FTC regulates advertising. In 2009, the FTC expanded on its interpretive guides regarding its advertising regulations. Among the significant changes were the following items which may affect franchisors that conduct advertising on behalf of their system:

a. The Demise of "Results Not Typical" in Endorsements

Franchisors of systems selling services intended to produce particular specific, desirable results for customers should evaluate whether or not their advertising disclaimers are adequate in light of the FTC's revisions and expansion of its commentary regarding advertising claims.

Specifically, the FTC's interpretive guides now require that advertisers provide more disclosure regarding the results that a consumer can expect from a product or service. Following tests on consumers, the FTC concluded that the disclaimer "results not typical" did not sufficiently reduce a consumer's belief that the results depicted were ones they were likely to obtain from use of the product or service. Accordingly, the FTC now requires that advertisers using endorsements either depict substantiated results or clearly explain the generally expected performance:

An advertisement containing an endorsement relating the experience of one or more consumers on a central or key attribute of the

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product or service also will likely be interpreted as representing that the endorser’s experience is representative of what consumers will generally achieve with the advertised product or service in actual, albeit variable, conditions of use. Therefore, an advertiser should possess and rely upon adequate substantiation for this representation. If the advertiser does not have substantiation that the endorser’s experience is representative of what consumers will generally achieve, the advertisement should clearly and conspicuously disclose the generally expected performance in the depicted circumstances, and the advertiser must possess and rely on adequate substantiation for that representation.38

b. Disclosure of Material Connections to Endorsers

The FTC’s new advertising rule interpretation clarifies that the Commission views blogging to be a form of advertisement if the blogger has a material connection to the source of the product or services. The mandatory disclosure of material connections is not new, but its impact on social media is important for franchisors to understand and monitor.

The FTC defines a "material connection" broadly: "When there exists a connection between the endorser and the seller of the advertised product that might materially affect the weight or credibility of the endorsement (i.e., the connection is not reasonably expected by the audience), such connection must be fully disclosed."39 The interpretive guides provide examples of material connections which can include a business' employees, its vendors, anyone it has paid to provide an endorsement even if the endorsement is given willingly, or anyone to whom it provides discounts or other benefits with the known goal of obtaining an endorsement.

In the era of social media, this can mean that if a franchisee provides free or discounted product to a customer who is known to be a blogger, and that customer subsequently provides a positive review of the product in his or her blog without disclosing that the product was provided free or at a discounted price, both the blogger and the advertiser (which in this case may be understood by the public to be the entire franchise system) may be accused of engaging in deceptive advertising.

In addition to ensuring that the corporate marketing arm of the business is aware of the disclosure requirements associated with any type of endorsements, franchisors should also educate franchisees in the system. A system is vulnerable to claims regarding its advertising if a franchisee engages in inappropriate advertising at a local level, particularly in businesses where local reviews are valuable to specific unit franchises, such as through Yelp.com, TripAdvisor, or other third party review sites. Franchisors should consider including advertising and social media guidelines in either their Franchise Agreements or their operation manuals if they permit franchisees to engage in advertising at all. Because of the rules regarding endorsements, even

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franchisors whose franchisees are not permitted to engage in their own advertising may choose to include training regarding improper invitations for endorsement for franchisees in order to avoid any violations of this rule.

c. Website Design Matters

The FTC's consumer protection laws regarding deceptive advertising include online advertising, and the FTC maintains guidelines regarding website design. These guidelines are intended to make website disclosures and disclaimers more easily understandable, and the guiding principles are largely predictable. Rules include ensuring that disclaimers or explanations are in a font size and color that is easy to read and that will be noticed by a consumer reviewing the website and, in particular, specifying the items to which the disclaimers or explanations relate. Hyperlinks to disclaimers or explanations about particular products or services must be well marked so that consumers recognize that there is pertinent information on a click-through screen.

The FTC’s guidelines with regard to design are easy to follow. In many systems, however, they can be overlooked because the marketing team may be accustomed to having legal review of content such as text but not website architecture such as the location of hyperlinks or font size and color. As a best practice, the compliance team should include someone with authority over the web design process who is familiar with the FTC guidelines on website design and can provide detailed instructions on the technical aspects of the process in order to comply with the FTC’s rules.

2. Antitrust

Monopolistic activities or restraints on trade are prohibited by antitrust laws at both the federal and state level. The applicable federal laws include the Sherman Act, the Clayton Act, the Robinson-Patman Act, and the Federal Trade Commission Act. At the state level, some states have specific antitrust statutes, while others have codified "little FTC Acts" which track the Federal Trade Commission Act and provide for a private right of action and damages under state law. Laws governing antitrust are complex enough that this paper can only briefly address the issues, and a franchisor with potential exposure to antitrust issues should carefully evaluate them.

42 The FTC has posted a paper discussing the Little FTC Acts on its website. The paper includes an appendix detailing those acts. A total of 27 states have statutes modeled on 15 U.S.C. § 45, providing for private rights of action. See http://www.ftc.gov/os/comments/section5workshop/537633-00002.pdf, Appendix A.
43 Antitrust Handbook for Franchise and Distribution Practitioners, American Bar Association, 2008
Among the actions which may expose a franchisor to liability for an antitrust violation are horizontal restraints on trade (an agreement between competitors at the same level in the market to fix prices, divide the market, or otherwise manipulate trade), vertical restraints on trade (an agreement between cooperators at different levels of the market, such as a manufacturer and a distributor), and tying (a requirement by a party with substantial market power that the other party purchase an undesirable product in order to purchase a desirable product).

Antitrust claims against franchisors have rarely been successful in recent years. Nevertheless, franchisors should proceed with caution before requiring franchisees to set minimum prices for goods or services or terminating a franchisee for pricing, before requiring franchisees to buy one product in order to acquire another product or permitting franchisees to set up a similar arrangement in their sales to the public, and before entering any agreements with competitors regarding territories or scope of sales.

3. Policing Your Intellectual Property, Trade Secrets, and Franchisee Disclosures/Representations Regarding the Brand

a. Trademarks

The most valuable asset in most franchise systems is the portfolio of trademarks which represent the system to the public. Often, the more popular and successful a franchise system becomes, the more frequently the system will see competitors copying its most popular attributes, including its trademarks.

Devising an approach to policing a system's trademarks requires a balance of the following factors: (i) the strategic goals of the business; (ii) the company's ability to fund litigation, and (iii) the likelihood of harm to its marks from infringement. No one solution is right for every system. On the one hand, there can be compelling reasons to engage in frequent policing of the system's trademarks. A system is rarely successful if the public cannot distinguish its brand from the infringing marks used by competitors. Furthermore, in a franchise system, permitting a minor competitor such as a small mom-and-pop business in a single geographic location to continue operating under an infringing mark may appear to be a minor infringement, but it can have a substantial effect on the local franchisee. That one franchisee may become a vocal opponent of the franchisor's decision not to undertake litigation in order to address the infringement, and those criticisms can spread from one franchisee to others and cause magnified problems for the system including franchisee distrust and resentment.

In addition, a system that becomes aware of infringement and elects not to act on it may eventually be barred from enforcing its rights if the infringer asserts a


45 Courts have rejected tying claims where one of the tied products is the franchise itself. See Rick-Mik Enterprises, Inc. v. Equillon Enterprises, LLC 532 F.3d 963 (9th Cir. 2008). However, tying claims involving multiple products sourced from the franchisor may still state a cause of action in appropriate circumstances. Bansavich v. McLane Co., CCH Business Franchise Guide ¶ 14,030 (D. Corp. 2008).
laches or waiver defense. Where a system has limited capital for litigation, the franchisor may be wise to delay an affirmative search for infringing uses so that it is not obligated to choose between spending money to protect against infringement of which it was previously unaware and ignoring legitimate infringement.\textsuperscript{46}

\textbf{b. Trade Secrets and Confidential Information}

It is equally important to ensure that information which the franchisor maintains as its confidential or trade secret material remains secret. Control of information is a challenging but important task for management in a franchise system, particularly in the current era when information can be scanned and posted to the Internet by anyone and viewed by millions within only a few hours.

Ensure that information which is trade secret or confidential is only disclosed to those who actually need to know it. Maintaining information in a password-protected Intranet or internal company website may be more secure than printing copies of materials and distributing them. Limitations on the persons who receive passwords and training to ensure that those who receive passwords are aware of the confidential nature of the information is also helpful.

Upon termination or expiration of the franchise relationship, it is important to make sure that confidential information, tools and other materials are collected from the departing franchisee. Ask the franchisee whether copies were made of any of the material and collect all copies, and obtain a written confirmation that it has done so.

\textbf{c. Franchisee Disclosures and Representations Regarding the Brand}

In the course of a franchise relationship, a franchisor can put a great deal of confidential information into the hands of its franchisees. The Franchise Agreement will specify that these materials and information are confidential, but the franchisor bears the burden of enforcing these terms. Particularly in larger systems, franchisors may wish to monitor Internet sites where their brands are frequently discussed to ensure that any franchisees discussing the brand are not posting or disclosing confidential materials that are not intended for public distribution. Commonly monitored sites include Facebook, Twitter, YouTube and, for businesses with retail products, EBay, Amazon.com and Craig's List.

To reduce the likelihood that a large portion of the public will view inappropriate information from a franchisee, the system can prohibit franchisee registration of a domain name that contains the brand name. Some systems permit individual franchisees to maintain unique subdomains or minorities within the franchisor-registered domain because these are easier to control if the franchisee is terminated. The Franchise Agreement also frequently prohibits disparagement of the brand or other

\textsuperscript{46} Of course, this does not mean that a franchisor should not have a full search done at the time it first begins using the trademark and setting up the franchise system.
conduct which reflects negatively on the system's public image. Periodic monitoring by a franchisor will help it ensure that its franchisees are complying with these terms.

V. COMMON RENEWAL, TRANSFER, AND TERMINATION COMPLIANCE PROBLEMS

A. State Relationship Laws and Limitations

1. Broad Scope of Coverage

When a franchisor makes the decision to terminate or refuse renewal of a Franchise Agreement, it should ensure that the basis for the termination or non-renewal is sound, both under the terms of the applicable agreements with the franchisee and with applicable state laws governing franchise relationships. In the instance of termination in particular, franchisors often feel an urgency to make a quick decision regarding termination when a previously unknown breach of the Franchise Agreement is discovered. However, it is important to ensure that management takes the time to review both the terms of the Franchise Agreement with the franchisee and the applicable state relationship laws, if any.

States with general franchise relationship laws include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Virginia, Washington, Wisconsin, and the territories of Puerto Rico and the U.S. Virgin Islands. In addition, some states have distributorship-specific relationship laws and most states have laws applicable to dealer or distributor relationships in specific industries such as the automobile industry.

The general state franchise relationship laws cover a broad variety of topics and include: (a) limits on permissible terminations or non-renewals; (b) timing requirements; (c) requirements to provide an opportunity to cure defaults; (d) prohibitions on restricting franchisee associations and on discriminating among franchisees in agreement terms or rebate program restrictions; and (e) restrictions on a franchisor's ability to require franchisees to litigate or arbitrate in foreign jurisdictions.

Some state laws also address the enforcement of non-competition agreements. California does not enforce post-termination non-competition agreements against employees or independent contractors, including franchisees. Several other states limit the enforcement of non-competition agreements in certain circumstances.

Because of the patchwork of sometimes contradictory rules created by these state laws, it is generally not feasible or desirable to draft a Franchise Agreement that tracks the exact limitations of each state's relationship laws. Therefore, a franchisor

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47 There is no restriction on termination or non-renewal in the FTC Rule.

48 California Business & Professions Code §16600

49 Peter Klarfeld, Covenants Against Competition in Franchise Agreements (Second Edition), American Bar Association, 2003
should not rely solely on the terms in the Franchise Agreement to determine the enforceability of an adverse action against a franchisee, such as termination, forcing or refusing a transfer of a franchise, refusing a renewal, or otherwise attempting to limit asserted rights.

2. **Timing of Notices & Good Cause Requirements**

Many states' relationship laws dictate the minimum amount of notice given for both termination and non-renewal. The amount of notice required differs from state to state and may significantly differ from the notice period contained in the applicable Franchise Agreement. For example, California permits termination for "good cause" in the form of a Franchise Agreement breach, provided that the franchisor provides the franchisee with up to 30 days in which to cure the default.\(^{50}\) Mississippi has no good cause requirement, but requires a minimum of 90 days' prior notice for all terminations except in the case of criminal misconduct, fraud, abandonment, bankruptcy or insolvency of the franchisee, or passing a bad check, in which case there is no notice requirement.\(^{51}\) Many states' laws also require that any termination notice must include the reasons for the termination and notice of the cure period, if any.

Decisions not to renew are similarly regulated, also with wide variations among the states' laws. Delaware, Hawaii, Iowa, New Jersey, and Wisconsin expressly require good cause for nonrenewal of a Franchise Agreement.\(^{52}\) Iowa requires 180 days' advanced notice in the case of nonrenewal, but does not require good cause.\(^{53}\) In Washington, nonrenewal is permitted only on one year's prior notice and where there is no noncompete provision or the franchisor repurchases the franchise from the franchisee.\(^{54}\) Because of these lengthy advance notice requirements, it is valuable to calendar the applicable dates in order to allow management to have enough time to make a decision about renewal and provide the requisite advanced notice in the event of a decision not to renew.

B. **Disclosure Issues**

1. **Renewals on New Terms**

Many franchisors require that upon renewal a franchisee execute a then-current form of the Franchise Agreement. This allows the system to ensure that none of its agreements are significantly out of date and to require that franchisees cooperate

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\(^{50}\) [California Business & Professions Code § 20020.](#)

\(^{51}\) [Mississippi Code § 75-24-53.](#)

\(^{52}\) Section 2552(b) of the Delaware Franchise Security Law, CCH Business Franchise Guide ¶4080.02; Section 482E-6(2)(H) of the Hawaii Franchise Investment Law, CCH Business Franchise Guide ¶4110.01; Section 523H-8 of the Iowa Franchises Law, CCH Business Franchise Guide ¶4150.08; Section 56:10-5 of the New Jersey Franchise Practices Act, CCH Business Franchise Guide ¶4300.05; Section 135.03 of the Wisconsin Fair Dealership Law, CCH Business Franchise Guide ¶4490.04

\(^{53}\) Iowa Code § 523H.8.

\(^{54}\) Revised Code of Washington § 19.100.180(i).
with updating their décor, systems, and operations to reflect any changes in the system since the date of their prior agreement. In addition to providing a copy of the new Franchise Agreement, the updated FDD should be provided so that the franchisee can review in plain English the changes to the agreement and the impact on their operation.

2. Transfers on New Terms

In a traditional transfer of a franchise from one franchisee to another, the franchisor is not involved in the offer or sale of the franchise and engages only enough to ensure that the incoming franchisee meets with its approval, passes training and otherwise is qualified to begin operation of the franchise. The franchisor is typically not deemed to have made an offer or sale of a franchise. This type of transfer can occur even where the franchisor does not have a current FDD registered.

Often, however, a franchisor will view a franchisee’s decision to exit the system and sell the franchise to a new owner as an opportunity to require that unit to operate under the then-current form of Franchise Agreement, where it is substantially different from the older Franchise Agreement currently in place for that unit. Alternatively, an incoming franchisee may agree to purchase the franchise only if the franchisor agrees to extend the term of the agreement, approve a relocation of the business, or agree to some other alteration of the terms of the existing Franchise Agreement.

Where the franchisor negotiates directly with the incoming franchisee and the new franchisee does not take over the existing contract from the old franchisee, but instead accepts a new Franchise Agreement on different terms, the franchisor will generally be deemed to have made an offer and sale of a franchise. In this instance, the franchisor should ensure that it has a current and effective FDD and ensure compliance with statutory requirements regarding disclosure.

C. Bankruptcy

Most franchisors have provisions in their Franchise Agreements which permit termination upon a franchisee’s insolvency or filing of a bankruptcy petition. In practice, a franchisor typically lacks notice that a franchisee is bankrupt until it receives a notice of the bankruptcy proceeding which has been filed. If a franchisor immediately sends a notice of termination upon notice of the bankruptcy filing, it will likely have violated the bankruptcy court’s automatic stay which protects debtors from adverse action by creditors named in the bankruptcy petition. The result is likely to be an action for damages by the franchisee against the franchisor within the bankruptcy proceeding. This compounds the franchisor’s trouble as a result of the insolvent franchisee, because disclosure of the litigation in the bankruptcy court may be required in Item 3.

In response to a notice of a franchisee’s bankruptcy filing, instead of immediately sending a notice of termination or calling the franchisee to demand an

explanation, which can be interpreted as an adverse action by a creditor which also violates the automatic stay, franchisors should either wait to see if the franchisee will accept the Franchise Agreement within the time permitted under the bankruptcy statute or petition the court to set an earlier deadline for this decision. If the franchisee rejects the Franchise Agreement, the franchisor can elect to treat the Franchise Agreement as terminated and take back the territory. If the franchisee accepts the Franchise Agreement, it must cure its defaults and stay current in its obligations to the franchisor.

Where possible, a franchisor that sees that a franchisee is in serious financial trouble may save itself the trouble and delay of this process by terminating the Franchise Agreement in advance of the bankruptcy. Another measure to protect the franchisor’s interest is to require the franchisee to grant the franchisor a security interest in the franchised business as part of the Franchise Agreement. That may allow the franchisor the right to control the cash flow of the business after the franchisee files for bankruptcy.

D. **Proper Documentation of Transfers, Renewals and Terminations**

As with initial sales of a franchise, it is crucial to maintain records and documentation of the negotiation and acceptance process for changes of franchise ownership, renewals of agreements and terminations. These documents should be maintained at least as long as the statute of limitations governing an offer or sale of a franchise.

While optional, many franchisors require a franchisee who voluntarily exits the system before the end of its Franchise Agreement term (by transfer or abandonment) to execute a general release in favor of the franchisor as a condition of the franchisor’s consent to the transfer or abandonment of the franchise and the franchisor’s agreement not to enforce any rights against the exiting franchisee, such as the payment of outstanding obligations. Some states, like Maryland, impose limitations on the scope of a release that can be required by a franchisor.

VI. **HOW TO ADDRESS PROBLEMS**

From time to time, franchisors may discover that franchise violations have already occurred. In determining how to address and ideally cure these problems, a good place to begin is with an analysis of which laws govern the issue. Because there is no private right of action under the FTC Rule, discovery of a disclosure violation in a non-registration state can be handled differently than discovery of that same violation in a registration state. For violations relating to termination or non-renewal, individual

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56 The Franchise Agreement will typically be listed as an executory contract, which the trustee must accept within a specific period of time (60 days from the order for relief in a Chapter 7 proceeding, or prior to the plan confirmation in a Chapter 11 or 13 proceeding). If not expressly accepted, it is deemed rejected. 11 U.S.C. § 365(d)(1)-(2).

57 *Id.*

58 Code of Maryland Regulations, Section 02.02.08.16.(1), CCH Business Franchise Guide ¶5200.16

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states' relationship laws may be implicated and should be reviewed in order to
determine what liability exists for violations.

In the case of a discovered disclosure or registration problem be sure to assess
whether there are any state and federal exemptions which would protect the franchisor
from liability. If the failure to disclose or register is not covered by an exemption, the
next step is to review the potential liability and whether any remedies are available.
Some registration states have statutory provisions which provide opportunities for
franchisors to disclose violations to franchisees and to examiners in exchange for a
limitation of their liability for damages or a shortened statute of limitations.\(^{59}\)

Also consider affirmative defenses, including applicable statutes of limitation,
whether the franchisee in question has signed a release, or whether there are grounds
on which to argue a lack of reliance or a waiver of the conduct at issue.

Where there is a clear violation and no applicable defense appears to be
available, then where there is a violation of state law the franchisor must determine
whether or not to self-report the violation to the regulators. As a preliminary step, it can
be crucial to evaluate and understand the scope of liability including the persons and
entities liable and the damages or other penalties which may be imposed. For example,
California imposes liability for registration and disclosure violations individually on all
officers, directors and partners with knowledge of the violation, and prison time of up to
one year for willful violations. In Indiana, a knowing violation of the registration and
disclosure law is a Class C felony.\(^{60}\)

An informal survey of state regulators several years ago indicated that most
regulators agreed that the most significant factor in their evaluation of the penalty to a
franchisor was whether or not the franchisor self-reported the violation, followed by the
franchisor's history of violations and litigation.\(^{61}\) Additional guidance for how to
approach state regulators in order to self-report a violation is available in a paper co-
authored by regulators for the 2007 ABA Forum on Franchising.\(^{62}\)

For violations of federal law, there is no private right of action under the FTC
Rule, but violations can trigger enforcement actions by the FTC. Such actions are
unlikely for minor violations, given the volume of matters addressed by the FTC, but are
always possible in every instance. The FTC's Franchise Rule Enforcement Protocol

\(^{59}\) See, e.g., New York General Business Law, Article 33, Section 691(2); California Corp. Code § 31303.

\(^{60}\) California Corp. Code § 31302; Indiana Code, Title 23, Art. 2, Chapter 2.5, Sec.37; see also Martin Cordell, Joseph
Ponturo and Mary Beth Trice, A Basic Guide to Handling Disclosure and Registration Violations, ABA Forum on
Franchising 2007, which contains an appendix of state laws and penalties.

\(^{61}\) Leonard Vines, Gina Bishop and Rupert Barkoff, Damage Control for Violations of Registration and Disclosure

contains a list of issues and questions that the FTC evaluates in order to determine whether or not an enforcement action is appropriate.\textsuperscript{63}

In addition to addressing the violation with applicable state regulators, a franchisor should also evaluate what action, if any, it wants to take with regard to franchisees. Many state laws provide for rescission offers which can limit a franchisor's exposure to damages, but which may also trigger large losses if a violation affects multiple franchisees and all of them accept the offer.

\textbf{VII. CONCLUSION}

Thorough record-keeping, involvement of key personnel in the franchise system, and education about the distinctions between franchise laws governing various jurisdictions are at the heart of a good compliance program. While large systems can face challenges in communication due to layers of management which can separate the compliance team from existing problems, small systems and start-ups often struggle to understand fully the applicable laws and to create the infrastructure necessary to track and ensure compliance. However, a relatively small investment of time and capital can be used to create checklists, and routine conferences between members of either an in-house or an outside legal counsel compliance team and the individuals directly interacting with franchisees can eliminate the lack of communication that can contribute to compliance problems.

We have cited a number of other papers and guidelines which can provide more detailed information on many of the topics addressed in this paper, and we recommend review of those materials in the event of specific compliance concerns.

\textsuperscript{63} 16 C.F.R. § 14.17; Bus. Franchise Guide (CCH) ¶8376.
# APPENDIX A

## [NAME OF FRANCHISOR]

### 2010 – 2011 FRANCHISE CALENDAR

<table>
<thead>
<tr>
<th>CLIENT</th>
<th>STATE</th>
<th>DOCUMENT</th>
<th>REMINDER DATE</th>
<th>STATE DUE DATE</th>
<th>EXPIR. DATE</th>
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<td>8/20/10</td>
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*Filing fee for Annual Report is $100; additional fee for material amendment is $50.

**File early to avoid interim financial statement filing requirement.
APPENDIX B

DISCLOSURE QUESTIONNAIRE

You (either individually or as a principal of a corporation, partnership or limited liability company and on such entity's behalf) are preparing to enter into a Franchise Agreement for the operation of a [Name of Franchise]. The purpose of this Questionnaire is to determine whether any statements or promises were made to you that were not authorized and that may be untrue, inaccurate or misleading. Please review each of the following questions carefully and provide honest and complete responses to each question.

1. Have you received and personally reviewed the Franchise Agreement and each exhibit and schedule attached to it?
   Yes ___  No ___

2. Do you understand all of the information contained in the Franchise Agreement and each exhibit and schedule attached to it?
   Yes ___  No ___
   
   If no, what parts of the Franchise Agreement do you not understand? (Attach additional pages, if necessary)

3. Have you received and personally reviewed the Franchise Disclosure Document we provided to you?
   Yes ___  No ___

4. Did you sign a receipt for the Franchise Disclosure Document indicating the date you received it?
   Yes ___  No ___

5. Do you understand all of the information contained in the Franchise Disclosure Document?
   Yes ___  No ___
   
   If no, what parts of the Franchise Disclosure Document do you not understand? (Attach additional pages, if necessary)
6. Have you discussed the benefits and risks of operating the license with an attorney, accountant or other professional advisor, and do you understand those risks?

Yes ___ No ___

7. Do you understand that the success or failure of your franchised business will depend in large part upon your skills and abilities, competition from other businesses, interest rates, inflation, labor and supply costs, lease terms and other economic and business factors?

Yes ___ No ___

8. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise concerning the revenue, profits or operating costs of outlets operated by the Franchisor or its affiliates or franchisees?

Yes ___ No ___

8.A. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise concerning the revenue, profit or operating costs of outlets operated by the Franchisor or its affiliates or franchisees that is contrary to, or different from, the information contained in the Franchise Disclosure Document?

Yes ___ No ___

9. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise regarding the amount of money you may earn in operating the franchised business?

Yes ___ No ___

9.A. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise regarding the amount of money you may earn in operating the franchised business that is contrary to, or different from, the information contained in the Franchise Disclosure Document?

Yes ___ No ___

10. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise concerning the total amount of revenue the franchised business will generate?

Yes ___ No ___
10. A. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise concerning the total amount of revenue franchised business will generate that is contrary to, or different from, the information contained in the Franchise Disclosure Document?

Yes ___ No ___

11. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise regarding the costs you may incur in operating the franchised business?

Yes ___ No ___

11.A. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise regarding the costs you may incur in operating the franchised business that is contrary to, or different from, the information contained in the Franchise Disclosure Document?

Yes ___ No ___

12. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise concerning the revenue, profits, operating costs or the likelihood of success that you should or might expect to achieve from operating the franchised business?

Yes ___ No ___

12.A. Has any employee or other person speaking on behalf of the Franchisor made any statement or promise concerning the revenue, profits, operating costs or the likelihood of success that you should or might expect to achieve from operating the franchised business that is contrary to, or different from, the information contained in the Franchise Disclosure Document?

Yes ___ No ___

13. Has any employee or other person speaking on behalf of the Franchisor made any statement, promise or agreement concerning advertising, marketing, training, support service or assistance that Franchisor will furnish to you that is contrary to, or different from, the information contained in the Franchise Disclosure Document?

Yes ___ No ___

14. If you have answered “Yes” to any of the questions 8 through 13, please provide a full explanation of your answer in the following blank lines. (Attach additional pages, if necessary, and refer to them below.)
You understand that your answers are important to us and that we will rely on them in entering into the Franchise Agreement with you.

By signing this Questionnaire, you are representing that you have responded truthfully to the above questions.

________________________
Signature

________________________
Print Name
APPENDIX C
FRANCHISE QUESTIONNAIRE

for

___________________________
(the “Company”)

THE COMPANY AND ANY PARENTS, PREDECESSORS AND AFFILIATES

A. Exact Company name: ________________________________

B. Any other names under which the Company will do business as a franchisor?

____________________________________________________

C. The Company’s principal business address:

____________________________________________________

D. Principal telephone number(s): ________________________

E. Business Form (check one):  ___ CORPORATION  ___ PARTNERSHIP
   ___ SOLE PROPRIETORSHIP  ___ OTHER
   ___ LIMITED LIABILITY COMPANY

F. Agent for Service of Process:

____________________________________________________

G. If a corporation:

1. Date of incorporation:

2. State of incorporation:

3. Names of stockholders (unless a public company, in which case advise where listed, or identify market maker)

   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________
   __________________________________________________

C-1
H. If a partnership:

1. Date of formation: __________________________

2. Type of partnership: General _____ Limited _____

3. Names of partners (designate whether general or limited):

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

I. If a limited liability company:

1. Date of formation: __________________________

2. State of formation: __________________________

3. Names of members:

________________________________________________________________________
________________________________________________________________________
________________________________________________________________________
________________________________________________________________________

J. Please describe the Company's business experience.

1. Please describe the Company's proposed franchise program.

a. Does the Company anticipate that it will be selling franchises for single locations? Yes ___ No ___

b. If the Company intends to sell for single locations franchises describe whether those who will sell such franchises will be the Company's officers, employee-salesmen, independent franchise brokers, subfranchisors, development agents, or others

________________________________________________________________________
________________________________________________________________________
c. Does the Company anticipate that it will sell area development franchises (the franchisee will be required to open and operate a specified number of franchised businesses within a geographic area within a given time period)?
   Yes ___ No ___

d. Does the Company anticipate that it will sell subfranchises (a subfranchisor, for a fee, receives the right to sell the Company’s franchises to others within a geographic area)?
   Yes ___ No ___

2. The Company has conducted a business of the type to be operated by the franchisee since (date):
   ____________________________________________

3. The Company has offered franchises for such businesses since (date):
   ____________________________________________

4. Generally describe the business to be conducted by the franchisee:
   ____________________________________________
   ____________________________________________
   ____________________________________________
   ____________________________________________

5. Describe the market for the company’s goods and services (i.e., is the market developed or developing? Will goods or services be sold primarily to a certain group, such as teenagers, business people, students, etc.?)
   ____________________________________________
   ____________________________________________
   ____________________________________________
   ____________________________________________

6. Please provide a general description of the businesses with which the Company’s franchisees will have to compete.
   ____________________________________________
   ____________________________________________
   ____________________________________________
   ____________________________________________
7. Describe any goods, supplies, fixtures or equipment manufactured by the Company. Will any of these also be sold to non-franchisees?

Yes ___ No ___ (If "Yes", please indicate with an asterisk which items will be sold to non-franchisees.)

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

8. List any goods, supplies, fixtures or equipment sold at wholesale by the Company. Will any of these be sold to franchisees? To others?

Yes ___ No. ___ (If "Yes", please indicate with an asterisk which items will be sold to franchisees or non-franchisees.)

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

9. Please specify which, if any, of the goods or services described in paragraph 7 and 8 are proprietary.

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

10. Describe present techniques for maintaining the quality of the Company's goods and services sold.

__________________________________________________________________________
11. If the Company has offered franchises in other lines of business, please describe such franchise lines, and specify (a) the dates during which each such franchise was offered, (b) how many were sold, and (c) the states in which they were sold.

12. Does the Company have other business activities?
   
   Yes ___ No ___
   
   (If "yes," please describe.)

K. Does the Company have any affiliates? An affiliate is defined as a person controlled by, controlling or under common control with the Company?
   
   Yes ___ No ___

L. If your answer to paragraph K is "yes", please provide the following information on attached extra sheets:

1. As to each corporation:
   
a. Its name;
   
b. Any other name under which it conducts its business;
   
c. The date of incorporation;
The state of incorporation;
The names of stockholders;
General description of its line(s) of business.

2. As to each partnership:
   a. Its name;
   b. Any other name under which it conducts its business;
   c. Names of partners (if it is a "limited partnership" please so indicate);
   d. General description of its line(s) of business.

3. As to each limited liability company:
   a. Its name;
   b. Any other name under which it conducts its business;
   c. Names of members;
   d. Names of officers and identification of office;
   e. General description of its line(s) of business;

4. Do any of the Company's subsidiaries or affiliates offer franchises?
   Yes ___ No ___
   (If yes, please name subsidiary or affiliate and franchises offered)

5. Do any of these subsidiaries or affiliates provide products or services to the Company's franchisees?
   Yes ___ No ___
   (If yes, please name subsidiary or affiliate and identify products or services provided)
M. Name all predecessors of the Company during the past 10 years (a "predecessor" is a company or a person from whom the Company has acquired the major portion of its assets, directly or indirectly). Please indicate as to each:

1. Predecessor

a. Its name: ________________________________

b. Principal business address: ___________________________

c. Business Form (check one): ____________________
   Corporation
   Partnership
   Sole Proprietorship
   Other
   Limited Liability Company

d. Names of stockholders or partners: ________________________
   _______________________________________
   _______________________________________
   _______________________________________

e. Any other names under which it is doing business:
   ________________________________________
   ________________________________________
   ________________________________________

N. Please provide the following information relating to the predecessor’s prior business experience:

1. The Company’s predecessor has conducted a business of the type to be operated by the franchisee since (date): ____________________________

2. The Company’s predecessor has offered franchises for such business since (date): ____________________________

3. If the Company’s predecessor has offered franchises in other lines of business, please describe such franchise lines, and specify the dates during which each such franchise was offered, how many were sold, and the states in which they were sold.
O. Are there any regulations specific to the industry in which the franchised business operates? If so, please describe in general terms below.

P. Please list the name and principal business address of each of the Company's parents. A parent is an entity that controls the Company directly, or indirectly through one or more subsidiaries.
APPENDIX D

SAMPLE STATE-SPECIFIC ADDENDA TO FDD

ADDENDUM

TO THE FRANCHISE DISCLOSURE DOCUMENT OF
[NAME OF FRANCHISOR]
REQUIRED BY THE STATE OF CALIFORNIA

1. Neither [Name of Franchisor] nor any other person listed in Item 2 of the Franchise Disclosure Document is subject to any currently effective order of any national securities association or national securities exchange, as defined in the Securities Exchange Act of 1934, 15 U.S.C.A. 78a et seq., suspending or expelling such persons from membership in such association or exchange.

2. CALIFORNIA BUSINESS AND PROFESSIONS CODE SECTIONS 20000 THROUGH 20043 PROVIDE RIGHTS TO THE FRANCHISEE CONCERNING TERMINATION OR NONRENEWAL OF A FRANCHISE. IF THE FRANCHISE AGREEMENT CONTAINS A PROVISION THAT IS INCONSISTENT WITH THE LAW, THE LAW WILL CONTROL.

3. THE CALIFORNIA FRANCHISE INVESTMENT LAWQUIRES THAT A COPY OF ALL PROPOSED AGREEMENTS RELATING TO THE SALE OF THE FRANCHISE BE DELIVERED TOGETHER WITH THE DISCLOSURE DOCUMENT.

4. THE FRANCHISE AGREEMENT PROVIDES FOR TERMINATION UPON BANKRUPTCY. THIS PROVISION MAY NOT BE ENFORCEABLE UNDER FEDERAL BANKRUPTCY LAW (11 U.S.C.A. Sec. 101 et seq.).

5. CALIFORNIA CORPORATIONS CODE SECTION 31125 REQUIRES THE FRANCHISOR TO GIVE THE FRANCHISEE A DISCLOSURE DOCUMENT, APPROVED BY THE DEPARTMENT OF CORPORATIONS, PRIOR TO A SOLICITATION OF A PROPOSED MATERIAL MODIFICATION OF AN EXISTING FRANCHISE.

6. THE FRANCHISE AGREEMENT CONTAINS A COVENANT NOT TO COMPETE WHICH EXTENDS BEYOND THE TERMINATION OF THE FRANCHISE. THIS PROVISION MAY NOT BE ENFORCEABLE UNDER CALIFORNIA LAW.

7. THE FRANCHISE AGREEMENT CONTAINS A LIQUIDATED DAMAGES CLAUSE. UNDER CALIFORNIA CIVIL CODE SECTION 1671, CERTAIN LIQUIDATED DAMAGES CLAUSES ARE UNENFORCEABLE.

10. THE FRANCHISE AGREEMENT REQUIRES BINDING ARBITRATION. THE ARBITRATION WILL OCCUR AT __________ WITH THE COSTS BEING BORNE BY THE PARTY WHO DOES NOT PREVAIL. PROSPECTIVE FRANCHISEES ARE ENCOURAGED TO CONSULT PRIVATE LEGAL COUNSEL TO DETERMINE THE APPLICABILITY OF CALIFORNIA AND FEDERAL LAWS (SUCH AS BUSINESS AND PROFESSIONS CODE SECTION 20040.5, CODE OF CIVIL PROCEDURE SECTION 1281, AND THE FEDERAL ARBITRATION ACT) TO ANY
PROVISIONS OF A FRANCHISE AGREEMENT RESTRICTING VENUE TO A FORM OUTSIDE THE STATE OF CALIFORNIA.

11. OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF CORPORATIONS. ANY COMPLAINTS CONCERNING THE CONTENT OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF CORPORATIONS AT www corp.ca.gov.
ADDENDUM
TO THE DISCLOSURE DOCUMENT OF
[NAME OF FRANCHISOR]
REQUIRED BY THE STATE OF HAWAII

THESE FRANCHISES WILL BE/HAVE BEEN FILED UNDER THE FRANCHISE INVESTMENT LAW OF THE STATE OF HAWAII. FILING DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION OR ENDORSEMENT BY THE DIRECTOR OF COMMERCE AND CONSUMER AFFAIRS OR A FINDING BY THE DIRECTOR OF COMMERCE AND CONSUMER AFFAIRS THAT THE INFORMATION PROVIDED HEREIN IS TRUE, COMPLETE AND NOT MISLEADING.

THE FRANCHISE INVESTMENT LAW MAKES IT UNLAWFUL TO OFFER OR SELL ANY FRANCHISE IN THIS STATE WITHOUT FIRST PROVIDING TO THE PROSPECTIVE FRANCHISEE, OR SUBFRANCHISOR, AT LEAST SEVEN DAYS PRIOR TO THE EXECUTION BY THE PROSPECTIVE FRANCHISEE, OF ANY BINDING FRANCHISE OR OTHER AGREEMENT, OR AT LEAST SEVEN DAYS PRIOR TO THE PAYMENT OF ANY CONSIDERATION BY THE FRANCHISEE, OR SUBFRANCHISOR, WHICHEVER OCCURS FIRST, A COPY OF THE DISCLOSURE DOCUMENT, TOGETHER WITH A COPY OF ALL PROPOSED AGREEMENTS RELATING TO THE SALE OF THE FRANCHISE.

THIS DISCLOSURE DOCUMENT CONTAINS A SUMMARY ONLY OF CERTAIN MATERIAL PROVISIONS OF THE FRANCHISE AGREEMENT. THE CONTRACT OR AGREEMENT SHOULD BE REFERRED TO FOR A STATEMENT OF ALL RIGHTS, CONDITIONS, RESTRICTIONS AND OBLIGATIONS OF BOTH THE FRANCHISOR AND THE FRANCHISEE.

Registered agent in the state authorized to receive service of process:

Commissioner of Securities
335 Merchant Street
Honolulu, Hawaii 96813

Registration of franchises or filings of offering circulars in other states. As of the date of filing of this Addendum in the State of Hawaii:

1. A franchise registration is effective or an offering circular is on file in the following states:

2. A proposed registration or filing is or will be shortly on file in the following states:

3. No states have refused, by order or otherwise to register these franchises.

4. No states have revoked or suspended the right to offer these franchises.
5. The proposed registration of these franchises has not been withdrawn in any state.

The provisions of this Addendum only apply if the jurisdictional requirements of the Hawaii Franchise Investment Law are met independently without reference to this Addendum and to the extent they are then valid requirements of the statute.

Dated: ___________________________

__________________________
FRANCHISEE

__________________________
PRINT NAME
SAMPLE STATE-SPECIFIC ADDENDA TO FRANCHISE AGREEMENT

ADDENDUM
TO THE FRANCHISE AGREEMENT OF
[NAME OF FRANCHISOR]
REQUIRED BY THE STATE OF ILLINOIS

1. The following language is added to Paragraph ___ of the Franchise Agreement:

"Provided, however, that the provisions of the Illinois Franchise Disclosure Act will govern franchises located in the State of Illinois. Section 41 of the Illinois Franchise Disclosure Act states 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."

2. The following language is added to Paragraph ___ of the Franchise Agreement:

"The parties acknowledge that Illinois law provides that any provision in a franchise agreement that designates jurisdiction or venue in a forum outside of Illinois is void provided that a franchise agreement may provide for arbitration in a forum outside of Illinois."

3. Pursuant to the requirements of Section 41 of the Illinois Franchise Disclosure Act (the "Act"), Sections ___, ___, and ___ of the Franchise Agreement are hereby deleted.

The provisions of this Addendum only apply if the jurisdictional requirements of the Illinois Franchise Disclosure Act are met independently without reference to this Addendum and to the extent they are then valid requirements of the statute.

FRANCHISOR:

By: ___________________________

By: ___________________________ Date: __________________________

Address: ______________________

FRANCHISEE:

By: ___________________________

Address: ______________________

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ADDENDUM
TO THE FRANCHISE AGREEMENT OF
[NAME OF FRANCHISOR]
REQUIRED BY THE STATE OF MARYLAND

1. The following provisions are hereby added to Paragraphs _______ and ___ of the Franchise Agreement:

"The general release required as a condition of renewal, sale and/or assignment shall not apply to any liability under the Maryland Franchise Registration and Disclosure Law."

2. The following sentence is hereby added to Paragraph ___ of the Franchise Agreement:

"Nothing in this paragraph shall prohibit a franchisee in Maryland from bringing a lawsuit in Maryland for claims arising under the Maryland Franchise Registration and Disclosure Law."

The Maryland Franchise Registration and Disclosure Law currently provides that any claims arising under it must be brought within three (3) years after the grant of a franchise.

3. The following sentence is hereby added to Paragraph ___ of the Franchise Agreement:

"Representations requiring the Franchisee to assent to a release, estoppel or waiver of liability are not intended nor shall they act as a release, estoppel or waiver of liability incurred under the Maryland Franchise Registration and Disclosure Law. These representations are not intended to nor shall they act as a release, estoppel or waiver of any liability incurred under the Maryland Franchise Registration and Disclosure Law."

The provisions of this Addendum only apply if the jurisdictional requirements of the Maryland Franchise Registration and Disclosure Law are met independently without reference to this Addendum and to the extent they are then valid requirements of the statute.

Dated:______________________

FRANCHISOR: ___________________________  FRANCHISEE: ___________________________

By:__________________________  By:__________________________

Title: ___________________________  ___________________________
APPENDIX E

FRANCHISE ADVERTISING

Following is a list of states, the number of copies necessary to submit and the review period.

<table>
<thead>
<tr>
<th>State</th>
<th>Number of Days</th>
<th>Number of Copies</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>3 business days</td>
<td>1</td>
</tr>
<tr>
<td>Maryland</td>
<td>7 business days</td>
<td>1</td>
</tr>
<tr>
<td>Minnesota (1)</td>
<td>5 business days</td>
<td>1</td>
</tr>
<tr>
<td>New York (2)</td>
<td>7 days</td>
<td>1</td>
</tr>
<tr>
<td>North Dakota</td>
<td>5 business days</td>
<td>1</td>
</tr>
<tr>
<td>Rhode Island (3)</td>
<td>5 business days</td>
<td>1</td>
</tr>
<tr>
<td>Washington</td>
<td>7 days</td>
<td>1</td>
</tr>
</tbody>
</table>

Notes:
(1) **Minnesota**

The file number assigned to the franchisor in Minnesota must appear in all advertising and promotional materials which are disseminated in the state of Minnesota. In addition, the name and address of the person who is placing the advertisement or making the offer and the name of the primary commercial symbol of the franchisor must also be included.

(2) **New York**

All sales literature in connection with franchise offerings must contain the following statement:

"This advertisement is not an offering. An offering can only be made by a prospectus filed first with the Department of Law of the State of New York. Such filing does not constitute approval by the Department of Law."

However, in all classified type of advertisements not more than five inches long and no more than one column of print wide, and in all broadcast advertising thirty seconds or less in duration, the following statement may be used:

"This offering is made by prospectus only."

New York requires a statement signed by the franchisor stating that the advertisement is not inconsistent with the offering circular (see Tab 8 for sample).

(3) **Rhode Island**

A filing fee of $10.00 per item is required.
STATE FRANCHISE LAWS AND REGULATIONS
ADVERTISING

CALIFORNIA
Sections 31156 and 31157 of the California Franchise Investment Law; Section 310.156 of the California Administrative Code

ILLINOIS
Subpart C (Sections 200.300 et seq.) of the Regulations under the Franchise Disclosure Act of 1987

MARYLAND
Section 14-225 of the Maryland Franchise Registration and Disclosure Law; Section .09 of the Code of Maryland Regulations

MICHIGAN
Sections 445.1524 and 445.1525 of the Michigan Franchise Investment Law

MINNESOTA
Section 80C.09 of the Minnesota Franchises Law; Section 2860.4100 and 2860.4200 of the Minnesota Rules

NEW YORK
Section 200.09 of the Codes, Rules and Regulations of the State of New York

NORTH DAKOTA
Section 51-19-10 of the North Dakota Franchise Investment Law

RHODE ISLAND
Section 19-28 1-12 of the Rhode Island Franchise Investment Act

SOUTH DAKOTA
Section 37-5B-23 of the South Dakota Franchise Investment Law

WASHINGTON
Sections 19.100.100 and 19.100.110 of the Washington Franchise Investment Protection Act; Sections 460-80-500 et seq. of Washington Administrative Code
APPENDIX F

COMPLIANCE PROGRAM TIPS & TOOLS
<table>
<thead>
<tr>
<th>Title</th>
<th>Publication/online location</th>
<th>ABA Forum on Franchising publication &amp; program number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchise Rule Compliance Guide (Contains plain English explanations regarding preparation of the FDD and illustrative examples)</td>
<td><a href="http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf">http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf</a></td>
<td>N/A</td>
</tr>
<tr>
<td>NASAA Commentary on 2008 Franchise Registration &amp; Disclosure Guidelines</td>
<td><a href="http://www.nasaa.org/content/Files/FranchiseCommentary_final.pdf">http://www.nasaa.org/content/Files/FranchiseCommentary_final.pdf</a></td>
<td>N/A</td>
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<tr>
<td>FTC Staff Opinions</td>
<td><a href="http://www.ftc.gov/bcp/franchise/netadopin.shtml">http://www.ftc.gov/bcp/franchise/netadopin.shtml</a></td>
<td>N/A</td>
</tr>
<tr>
<td>Statement of Basis and Purpose (To help determine if the new rule is similar enough to the old rule for old case law or FTC guidance based on the former FTC Rule to still apply)</td>
<td><a href="http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf">http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf</a> (includes full text of the new rule)</td>
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<td>Topic</td>
<td>Source</td>
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<tr>
<td>----------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>FDD Drafting Tips</strong></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td><strong>State Registration Best Practices</strong></td>
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<tr>
<td><strong>Enforcement powers of state agencies &amp; available civil remedies, comparative charts</strong></td>
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<tr>
<td><strong>Exemptions available in different U.S. jurisdictions, comparative charts</strong></td>
<td>N/A</td>
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</tr>
<tr>
<td><strong>Business Opportunity laws, state by state summary of laws</strong></td>
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<td></td>
</tr>
<tr>
<td>Topic</td>
<td>Reference</td>
<td>Resource</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Additional contracts typically used by franchisors, discussion</td>
<td>Nancy G. Gourley and David W. Koch, <em>The Other Contracts in the Franchise Relationship</em>, 2006 Forum, W24</td>
<td>N/A</td>
</tr>
<tr>
<td>ABA Forum on Franchising ListServ</td>
<td><a href="http://new.abanet.org/Forums/franchising/Pages/ListServ.aspx">http://new.abanet.org/Forums/franchising/Pages/ListServ.aspx</a></td>
<td>N/A</td>
</tr>
</tbody>
</table>
**Susan Grueneberg** is a Partner in the law firm of Snell & Wilmer L.L.P. in Los Angeles, California. She practices in the area of franchise and distribution law. Ms. Grueneberg is a Past Chair of the American Bar Association Forum on Franchising and serves as Chair of the Industry Advisory Committee to the North American Securities Administrators Association (NASAA) Franchise Project Group. She is also a member of the IFA's Legal/Legislative Committee. She serves as a member of the California State Bar Franchise and Distribution Law Commission, the commission that oversees the certification of legal specialists in franchise and distribution law in California. Ms. Grueneberg also formerly served on the California State Bar Business Law Section Executive Committee, as Chair of the California State Bar Franchise Law Committee and as a member of the Board of Governors of the Century City Bar Association. She has written and lectured extensively at programs conducted by the California State Bar, the ABA Forum on Franchising, the International Franchise Association and California Continuing Education of the Bar. A graduate of UCLA Law School, Ms. Grueneberg also taught at the Chinese University of Hong Kong as a U.S. State Department Fellow, and received a National Academy of Sciences Fellowship for post-graduate study in economics at the University of Beijing. She is co-editor of the ABA publication “The FTC Franchise Rule”.
Dawn Newton is a Partner in the law firm of Fitzgerald Abbott & Beardsley LLP in Oakland, California. Her practice focuses on franchise law and distribution law as well as intellectual property, including licensing, trademark, copyright and domain name issues. She has helped to establish and manage franchise systems ranging from start-ups to established networks. Ms. Newton is a Certified Specialist in the field of Franchise and Distribution Law by the State Bar of California Board of Legal Specialization. She is a past Chair and continuing advisory member of the State Bar of California Business Law Section’s standing committee on Franchise Law. She also serves as a member of the Steering Committee for the Intellectual Property section of the Alameda County Bar Association, and is a member of the San Francisco Intellectual Property Law Association and the Women’s Intellectual Property Lawyers Association. She was named a SuperLawyers "Rising Star" in 2010. Ms. Newton received her J.D. from the University of California Hastings College of the Law, and her undergraduate degree with High Honors and Distinction in General Scholarship from the University of California, Berkeley.