American Bar Association
35th Annual Forum on Franchising

EFFECTIVE STRATEGIES FOR WORKING WITH STATE FRANCHISE REGULATORS

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October 3 – 5, 2012
Los Angeles, CA

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4811-4973-5952.1

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EFFECTIVE STRATEGIES FOR WORKING
WITH STATE FRANCHISE REGULATORS

I. INTRODUCTION

This paper is written for practitioners who have handled at least a handful of state franchise registration applications and have learned through their own beginners' mistakes that a successful state registration practice requires mastery of an extraordinary number of regulatory details, excellent organizational skills, and strategic nimbleness in working with state franchise regulators.

The state franchise registration experience in the United States is highly uneven and variable. The reason for the patchiness may be explained by: (i) differences among regulating states in their enforcement policies and practices; (ii) differences in the resources that states allocate to regulate franchise sales within their borders; (iii) a lack of uniformity among franchise regulators in the scrutiny they apply to registration applications and as to their individual "hot button" registration issues; and (iv) a continually evolving set of interpretative guidelines as judicial rulings and enforcement actions expose new patterns of franchise sales noncompliance.

Measuring "success" in addressing state franchise registration matters is not just a function of completing the registration of legally compliant franchise disclosure documents (FDDs) as efficiently as possible. It is equally important that practitioners educate their franchisor clients about franchise sales rules so that clients know the internal protocols to implement to ensure that they and their franchise sellers (*i.e.,* independent contractor franchise brokers and employees who engage in franchise sales) engage in lawful sales practices in their interactions with franchisee candidates.[1] To glide through the registration process more efficiently, practitioners will find that most state franchise regulators are accessible and willing to address particular state registration issues and comment letters informally by phone and occasionally by email. By taking a non-confrontational approach to interacting with state franchise regulators, practitioners can make the registration process less complicated and eliminate undue delay and aggravation.

One thing is certain: state franchise registration laws are not going away any time soon. The Federal Trade Commission ("FTC") made this point clear when it released the Amended Federal Trade Commission Franchise Rule[2] ("Amended FTC Rule") in 2007 stating that the Amended FTC Rule does not preempt the state registration process, which it regards as providing greater protection to franchisees. Despite a sea change in the profile of franchisee candidates from the "mom and pops" of the 1960s to today's considerably more business-savvy franchise buyer, federal and state franchise sales laws are rooted in consumer protection policy and are strictly construed and liberally applied to protect the investments that franchisees make in a franchise business.

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[1] As we explain in the text, the process of having to comply with state registration duties can often interrupt a franchisor's selling activities with "black-out" periods of indeterminable length while a material change amendment or annual renewal filing is pending. Consequently, a successful registration practice requires practitioners to teach their franchisor clients how to manage their band of franchise sellers. Practitioners need to have an excellent communications system in place with their franchisor clients so that when "stop" instructions are issued, the franchisor client can relay that message to their franchise sellers and halt franchise sales until the state issues a registration order - even at the risk of losing a franchise sale.

[2] FTC Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. §§ 436–437 (2007) (mandatory as of July 1, 2008).

We have organized this paper as a series of answers to "frequently asked questions" ("FAQs") about common registration practice issues and misconceptions in order to highlight important tips to help practitioners avoid bumps in the road, successfully clear registration hurdles, and effectively interact with state franchise regulators on registration and enforcement matters. We hope to contribute to the existing bank of excellent available resources guiding practitioners in franchise registration nuances so that practitioners may help their franchisor clients implement best practices.[3]

II. FEDERAL AND STATE REGULATORY SYSTEM

A. **<u>What laws govern franchise sales activities in the U.S.?</u>**

Franchise sales in the United States are subject to dual regulation at the federal and state level, depending on where the parties reside, do business, or the franchisee operates. The Amended FTC Rule regulates franchise sales in all 50 states, including wholly intrastate transactions. Roughly a third of the states regulate franchise sales. Franchise registration states can be broken into 3 types: "Full Review States," "Notice Filing States," and "Business Opportunity ("Bus/Op") Notice States."[4]

1. "**<u>Full Review States</u>**"

These are states in which a franchisor's franchise registration application and FDD are subject to full vetting by a state regulator before a registration decision is made: California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, and Washington.

2. "**<u>Notice Filing States</u>**"

These are states in which the franchise registration application is by statute deemed to be registered upon the state franchise agency's receipt of all required information: Indiana, Michigan, and Wisconsin. State regulators in these states have authority to review the documents filed with the state and issue comments, but seldom, if ever, do.

3. "**<u>Bus/Op Notice States</u>**"

These are states which require a franchisor to file a simple notice with a state agency in order to qualify for an exemption from the state's business opportunity law: Florida (annual filing), Kentucky (one-time filing), Nebraska (one-time filing), Texas (one-time filing), and Utah (annual filing). In other states with business opportunity laws, exemption or exclusion from the definition of a business opportunity depends on the franchisor awarding a license to the franchisee to use a *federally registered mark* or a *state registered mark* as part of the franchised business or offering a franchise in compliance with the Amended FTC Rule. When a franchisor does not meet the conditions for exemption or exclusion from the state business opportunity law, the franchisor will be deemed to be a business opportunity seller and must complete a

[3] *See infra* Appendix A.

[4] References in this paper to "registration states" are collectively to the full review states, notice filing states and bus/op notice states listed in the text.

disclosure and registration process that is comparable to, though less complex than, the franchise registration process.[5]

Generally, franchise registration states follow a similar jurisdictional approach for determining if the state law applies to a particular franchise transaction. See FAQ 3 for a discussion of jurisdictional considerations.

A franchisee may be able to sue for violation of a state's unfair trade practices law when a franchise sale violates either the Amended FTC Rule or the state's franchise sales law.[6]

Franchise sales laws do not abrogate the state common law which may also apply to a franchise sales transaction. The most frequently alleged common law claims are: (i) fraud and similar types of claims sounding in fraud; (ii) breach of contract; and (iii) breach of the implied covenant of good faith and fair dealing.

B. Does the Amended FTC Rule preempt state franchise sales laws?

No. While federal regulation supersedes all state efforts in many areas of law, that is not so with franchise sales. The Amended FTC Rule only supersedes, or preempts, state laws that provide prospective franchisees with *less protection* than the Amended FTC Rule. "State law is preempted to the extent that it actually conflicts with federal law."[7] As a result, franchisors must comply with both the Amended FTC Rule and more stringent state franchise laws. Registration with a state agency before offering or selling franchises in the state is a process that affords *greater protection* to state consumers. Therefore, state registration is not preempted by the federal Amended FTC Rule which has no filing component.

C. If a commercial arrangement does not meet the definition of a franchise in the Amended FTC Rule, is the arrangement exempt from state franchise sales laws?

Not necessarily. An arrangement that does not meet the Amended FTC Rule's definition of a franchise may still satisfy the definition of a franchise under state law. Although the statutory definitions are similar, they are not identical. Moreover, judicial and agency interpretation of the definitional elements of a franchise do not always align. This is particularly true with respect to what constitutes a *required fee*. For example, a franchisor may structure an arrangement to avoid application of the Amended FTC Rule by deferring all payments until six months after the franchised business opens. This structuring technique, however, will not work to avoid state franchise sales laws which consider all required payments during the entire year.

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[5] A discussion of the filing requirements under state business opportunity laws is beyond the scope of this paper. However, *see* JEFFREY A. BRIMER, FRANCHISE LAW COMPLIANCE MANUAL 102–103 (ABA Forum on Franchising, 2d ed. 2011); KEITH J. KANOUSE & CHRISTINA M. NOYES, THE PROPOSED NEW BUSINESS OPPORTUNITY RULE AND STATE BUSINESS OPPORTUNITY LAWS, ABA 2007 30TH ANNUAL FORUM ON FRANCHISING (2007).

[6] *See, e.g*, KC Leisure, Inc. v. Haber, 972 So. 2d 1069 (Fla. Dist. Ct. App. 2008); It's Just Lunch Int'l, LLC v. Polar Bear, Inc., No. 03-2485 2004 U.S. Dist. LEXIS 30506, at *13-15 (S.D. Cal. April 27, 2004).

[7] Amended FTC Rule Statement of Basis and Purpose, 72 Fed. Reg. 15444 (March 30, 2007), Bus. Franchise Guide (CCH) ¶ 6067 (July 2, 2012). ("The Federal Trade Commission Act does not include any clause directly preempting state law or authorizing the Commission to do so. Furthermore, the legislative history of the Act and of the 1975 amendments to the Act establishing the Commission's rulemaking authority indicate that Congress did not intend the Act to occupy the field of consumer protection regulation.")

Further, while the minimum required payment to trigger application of the Amended FTC Rule is $500/year,[8] in some states the minimum is only $100/year.[9]

State franchise sales laws also differ in their definitional approach. Consequently, an arrangement that is not a franchise in one state may be a franchise in another registration state. A discussion of definitional variations is beyond the scope of this paper, but there are excellent resources on this topic within the general purview of "accidental" franchises.[10] The important practice tip for practitioners is to remember that even if an arrangement is not a franchise under the federal definition it can be regulated as a franchise under state franchise sales laws. Similarly, an arrangement that is not a franchise under one registration state's definition may be regulated as a franchise under another state's franchise sales law with jurisdiction over the same transaction. Practitioners must check the definitions, exclusions, and exemptions in all laws with jurisdiction over a particular franchise transaction.

D. <u>What is the purpose of state registration</u>?

The registration process operates as a safety net to protect franchisees (aka consumers) by ensuring that (i) the FDD that they receive before signing any binding contracts or paying any consideration[11] for the franchise opportunity meets applicable disclosure standards; and (ii) franchisors are not so overly dependent on the franchisee's initial fees that it is unlikely that the franchisor can deliver promised pre-opening support to the franchisee without using the franchisee's initial fees to cover the franchisor's expenses.

Franchise review standards are not like the review standards under state securities laws which require state regulators to evaluate a securities offering under a "fair, just, and equitable" legal standard.[12] Franchise regulators do not vet FDDs to test the soundness of the franchise offer; they vet FDDs to confirm that the FDD addresses all mandatory disclosures in the North American Securities Administrators Association's ("NASAA's") 2008 Franchise Registration and Disclosure Guidelines ("NASAA Guidelines").[13] The NASAA Guidelines are, by and large,

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[8] The franchise rule requires that the FTC revise the amount of the monetary thresholds every fourth year based on the Consumer Price Index for all urban consumers published by the Department of Labor. On June 13, 2012, the FTC revised monetary thresholds for three exemptions under its franchise rule increasing the minimum payment threshold to $540, the large franchise investment threshold to $1,084,900 and the large franchisee threshold to $5,424,500. Revised Franchise Rule Exemption Thresholds Announced, Bus. Franchise Guide (CCH) No. 392 (June 22, 2012).

[9] *See, e.g.*, MD. CODE REGS. § 02.02.08.10.C (2012).

[10] *See, e.g.*, ANN HURWITZ & DAVID W. OPPENHEIM, YOU DON'T WANT TO BE A FRANCHISE? STRUCTURING BUSINESS SYSTEMS NOT TO QUALIFY AS FRANCHISES, ABA 34TH ANNUAL FORUM ON FRANCHISING (2011); KENNETH R. COSTELLO, BEATA KRAKUS & KRISTY L. ZASTROW, FROM LICENSE AGREEMENT TO REGULATED RELATIONSHIPS: THE ACCIDENTAL FRANCHISE, ABA 32ND ANNUAL FORUM ON FRANCHISING (2009); ROCHELLE B. SPANDORF & MARK A. KIRSCH, THE ACCIDENTAL FRANCHISE, ABA 24TH ANNUAL FORUM ON FRANCHISING (2001).

[11] Franchise sales laws define the payment of a required fee to include *any consideration* for the franchise. Besides paying money, this includes execution of a promissory note, discharging a debt that the franchisor or its affiliates may owe to a third party, or anything else recognized as legal consideration to support a contract.

[12] William L. Killion, *The Modern Myth Of The Vulnerable Franchisee: The Case For A More Balanced View Of The Franchisor-Franchisee Relationship*, 28 Franchise L.J. 23, 28 (Summer 2008) (retracing the legislative history of franchise sales laws and noting that franchise regulations were patterned after securities regulation, but without the "fair, just, and equitable" standard of the securities law.)

[13] *Franchise Resources*, N. AM. SEC. ADM'R ASSOC. (last visited June 17, 2012), http://www.nasaa.org/industry-resources/corporation-finance/franchise-resources/ ("Oversight of franchising is grounded in the traditional

identical to the requirements of the Amended FTC Rule.[14] By enforcing very technical FDD disclosure requirements to the letter, state franchise regulators aim to ensure that franchisee candidates can compare franchise opportunities "apples-to-apples."

There is no central "clearance" system for processing state franchise registration applications and no reciprocity among registration states whereby, for example, registration by one full review state is sufficient to register the franchisor in one or more additional registration states. As noted, there is *significant* unevenness from one registration state to the next in terms of the level of scrutiny that state franchise regulators apply in reviewing franchise registration applications. There is also an extraordinary amount of regulator redundancy when a franchisor simultaneously registers its FDD in multiple registration states since each state franchise agency is addressing the same NASAA disclosure standards and FDD technical requirements. As there is no chance of eliminating state regulatory redundancy through a federal solution, the only real hope of eliminating redundancy is through NASAA's leadership.[15]

E. What is NASAA and what role does it play in the implementation of state franchise sales laws?

NASAA is a non-governmental membership organization of state securities regulators that was originally formed 100 years ago to coordinate enforcement of state securities ("blue sky") laws and protect the public against fraudulent sales practices by companies selling their securities. NASAA "predates the creation of the federal Securities and Exchange Commission by almost two decades."[16] Since all registration states regulate franchise sales through the same state agency that regulates securities sales to state residents, NASAA was the logical body to coordinate state franchise regulation when states began adopting their franchise sales laws in the 1970s. Through NASAA, state franchise regulators have the opportunity to adopt uniform policies for the registration and disclosure process that individual states may implement through legislation or administrative action. NASAA also provides a communications conduit for state franchise regulators through which they can coordinate their enforcement activities and share confidential information about registration filings and state investigations of franchise sellers. State franchise regulators utilize the NASAA regulator "list serve" routinely to seek guidance from one another in a variety of areas germane to state franchise sales regulation in the same way that ABA Forum members use the ABA Forum list serve.

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commitment of grassroots officials to protect consumers whenever possible before they part with their money; and in those cases where money is lost in a fraudulent deal, to marshal the enforcement resources to shut down the violator and seek restitution if possible.")

[14] To the federal requirements for preparing the FDD, the NASAA Guidelines add a special state cover page and allow state regulators to require special risk factors. They also authorize each registration state to impose state-specific additional disclosures which a franchisor may place in a separate exhibit to the FDD outside of FDD Items 1-23.

[15] After the FTC amended the FTC Rule in 2007, NASAA suspended its "Coordinated Review" process, a system by which a franchisor seeking to register in multiple states could coordinate the review of its initial franchise registration application through Maryland, which would assign the application to a lead state that would collect comments from regulators in the other states where the application was filed and issue a single, consolidated comment letter. Comments still had to be cleared with individual state regulators. Coordinated Review was not available for renewal or material change amendments and did not universally result in swifter processing of initial registration applications. If anything, the Coordinated Review experiment showed that state regulators are highly territorial over franchise sales activities within their borders and unwilling to delegate regulatory responsibility to another franchise registration state.

[16] *NASAA History*, N. AM. SEC. ADM'R ASSOC. (last visited June 17, 2012), http://www.nasaa.org/about-us/nasaa-history/.

III. JURISDICTION

A. Does the federal franchise sales law apply to the award of a franchise for a location outside of the U.S.?

Nieman v. Dryclean U.S.A. Franchise Company, Inc.,[17] and the U.S. Supreme Court's decision not to review *Nieman*[18] finally settled the question of whether U.S. franchisors must comply with the Amended FTC Rule in dealing with overseas franchisees. The answer is that they do not. The Court in *Nieman* ruled that the FTC Act does not authorize the extra-territorial application of the federal franchise rule to pure outbound transactions, that is, franchise sales by domestic companies to foreign citizens, conducted in a non-U.S. jurisdiction for franchise businesses to be located outside of the United States.

B. Do federal or state franchise sales laws apply to the award of a franchise for a location in the U.S. either (i) by a foreign franchisor, or (ii) to a foreign national?

The nationality and citizenship of the franchisor and franchisee are each irrelevant to the jurisdictional analysis. Federal and state franchise sales laws apply to the award of a franchise for a location in the U.S. both in the case where a foreign franchisor grants the franchise or a foreign national purchases the franchise. Given the jurisdictional triggers of state franchise sales laws, it is still possible, however, for a state law to apply to the sale of a franchise to a foreign national to be operated outside of the U.S. These triggers are discussed in Section C below.

C. What activities in a particular state will trigger the requirement that a franchisor register in that state?

The applicability of a state franchise law to a particular franchise sale requires a two-step analysis. The first step examines the statutory definition of a franchise to identify the specific acts the statute regulates. Some state laws define a franchise according to whether the franchisor grants the franchisee the right to "offer, sell, or distribute" goods or services, while other state laws define a franchise according to whether the franchisor grants the right to "offer or sell" or just "sell."[19] The second step considers if a definitional triggering event takes place in the registration state.

Courts and state franchise agencies interpret these definitional triggers very broadly. For example, an "offer" of a franchise is broadly defined by all jurisdictions to include all methods of solicitation of an offer to buy a franchise. Thus, if a state has jurisdiction, a franchisor may not advertise in the state before it is registered to sell franchises unless the franchisor fits within an exemption to the advertising filing requirement as discussed below in FAQ XII.

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[17] Nieman v. Dryclean U.S.A. Franchise Co., Inc., 178 F.3d 1126 (11th Cir. 1999).

[18] Nieman v. Dryclean U.S.A. Franchise Co., Inc. 528 U.S. 1118 (U.S. 2000).

[19] These definitional variations can make all the difference as to whether a particular transaction is regulated by a registration state. *See, e.g.*, Gentis v. Safeguard Business Systems, Inc., 60 Cal. App. 4th 1294, 1299 (Cal. Ct. App. 1998). A more detailed discussion of state jurisdiction and definitional variations is beyond the scope of this paper.

The phrase "*in this state*" is the key determinant of jurisdiction. Although state franchise sales laws may be worded differently, generally speaking, an "offer" or "sale" is deemed to be made in the state where *any* of the following events occur:[20]

1. Meetings between the franchisor and prospective franchisee at which the parties have substantive communications about the franchise opportunity.

2. The offer to sell a franchise originates in the state (e.*g.,* from the franchisor's headquarters in the state).

3. The offer to sell a franchise is directed by the franchisor to the state and received by the prospective franchisee in the state where it is directed.

4. The prospective franchisee accepts the offer to buy the franchise in the state.

5. The offer or sale is made to a franchisee who is domiciled in the state. Under some state laws, the franchisee's domicile in the state is enough. Under other state laws, the franchisee must be a domiciliary *and* operate the franchise business in the state.

6. The offer or sale is made to a franchisee who resides in the state. Like domicile, in some states the franchisee's residence in the state is enough; in other states the franchisee must be a resident *and* operate the franchise business in the state.

7. The franchise business will be operated in the state or any portion of the franchise territory is in the state.

8. The franchise contemplates or requires the franchisee to establish or maintain a place of business in the state.

Under this approach, it is very possible for the franchise laws of two or more states to apply to the offer or sale of a single franchise.

Because of the broad jurisdictional scope of state franchise registration laws and the liberal statutory construction that courts and state agencies apply to these laws, franchisors must educate their franchise sellers to recognize the key jurisdictional triggers and take steps to ensure that their own sales activities do not inadvertently trigger application of a franchise sales law in a state in which the franchisor is not registered at the time substantive communications first begin. Otherwise, an unsuspecting franchisor may find that it is responsible for making an unregistered offer to a franchise candidate in violation of a state's franchise sales law.

When a single franchise sale triggers multiple franchise sales laws, the potential civil, criminal, and administrative penalties multiply if the franchisor is not then registered to sell franchises in each registration state.

The registration states of California, Hawaii, Illinois, Maryland, Michigan, Minnesota, Rhode Island, Virginia, and Wisconsin each provide an exemption from registration for, or simply do not cover, "*out-of-state*" sales. These are sales made by a franchisor headquartered

[20] These are general requirements. The state law jurisdictional section must be consulted in every case. *See* BRIMER, *supra* note 5, at Ex. 2-9, for a chart of the state franchise law jurisdictional requirements.

in one of these registration states to an out-of-state prospective franchisee who neither resides nor will operate the franchise business in the same state as the franchisor's headquarters. The out-of-state sales exemption allows a franchisor to have its principal place of business in a registration state without having to register to sell franchises there as long as (i) all sales activities are with non-residents who will operate franchises in a different state; and (ii) the franchisor complies with the Amended FTC Rule and all other state franchise sales laws that apply to the transaction.

D. <u>Must a franchisor be registered in a state before engaging in substantive communications with a state resident about the franchise opportunity</u>?

Yes. The jurisdictional analysis determines the franchisor's freedom to engage in solicitation and sales activities with a particular candidate. Typically, the franchisor will make the jurisdictional analysis (with or without input from legal counsel) on its own without communicating with a state regulator. It is not that soliciting the opinion of a state regulator is unhelpful; it is only that state regulators tend to see the ambit of their jurisdiction very broadly. When in doubt over whether particular communications will trip a state's jurisdictional wire, the best advice practitioners can give their clients is to register to sell franchises in the state.

State franchise laws generally define the offer of a franchise to include "every attempt to offer or dispose of, or solicitation of any offer to buy, a franchise or interest in a franchise for value."[21] Consequently, substantive communications between a franchisor or its franchise sellers and a prospective franchisee about a specific franchise opportunity is considered an "offer to sell" a franchise, which may trigger state jurisdiction. As a result, a franchisor may not engage in any substantive communications with a state resident about a franchise opportunity unless and until the franchisor is registered to offer or sell a franchise in each state which may have jurisdiction over the particular transaction according to the jurisdictional analysis described in FAQ III C.

What constitutes "substantive communications" or an "offer" is a factual question. However, it is best to keep in mind that franchise sales laws are consumer protection laws and courts interpret this standard very broadly. Any communication with a candidate about the terms and conditions of the franchise opportunity that are specific to that candidate, *e.g.,* potential locations, financing, franchise agreement rights and duties, regardless of whether the parties engage in negotiations of the standard contract, or due diligence inquiries, will likely be considered sufficient. The communications need not be face-to-face and may occur by telephone or email. Not infrequently, a franchise offer may happen totally impromptu at a trade show or in response to the franchisor's general franchise recruiting activities or advertising.

As soon as conversations cross the line and move from a general, non-specific discussion of the franchise opportunity to something that may liberally be described as relating to an individual candidate's opportunity, the conversation becomes an offer and the franchisor and its franchise sellers must apply the two-step jurisdictional analysis in FAQ III C to identify the specific states that are implicated in the franchise offer. Because it is very possible that a substantive communication may not hit a jurisdictional trigger until sometime late in the recruiting process, franchisors must educate their franchise sales team to remain vigilant about

[21] *See, e.g.*, CAL. CORP. CODE § 31018(b) (West 2012).

jurisdictional triggers and not close a sale without first confirming that the franchisor is registered to sell franchises in all registration states in which any of the jurisdictional triggering events have taken, or may take place, including the state in which the franchise agreement will be executed.

The "sale" of a franchise generally refers to the execution of a franchise agreement or other binding agreement (*e.g.,* an area development agreement, area representative agreement, option agreement, or binding letter of intent) or payment of any consideration for the franchise rights. Where these events take place (or are directed to and from) will, in their own right, independently trigger the jurisdiction of a franchise sales law.

Generally speaking, if activities constituting an offer take place at a point in time when the franchisor is *not* registered to sell franchises in a registration state, but the franchisor puts further discussions on hold while the franchisor (i) completes the registration process; (ii) delivers a registered FDD to the candidate; and (iii) waits at least 14 days before allowing the franchisee to sign a binding agreement or pay the franchisor any consideration for the franchise rights, the resulting sale will comply with state law. Although state franchise sales laws do not formally say that these steps will cure the prior unregistered offer, as a practical matter, the prior unregistered offer should not support a claim for rescission or damages or be of any enforcement interest to a state franchise regulator.

While an enforcement action technically might proceed based on an unregistered offer without a sale, state regulators are unlikely to show any interest in the matter unless a franchise seller repeatedly engages in activities constituting the "offer to sell," despite never closing any sales, without any effort to complete the registration process.[22]

Although jurisdiction may be triggered by activities constituting an "offer to sell," only *existing franchisees* have standing to bring claims for violation of state franchise sales laws; candidates who never buy a franchise lack standing to sue.[23]

Keep in mind that the acts that trigger jurisdiction of a state's franchise sales law are different than the acts that trigger when the FDD must be delivered. Except in Iowa, New York, Oklahoma, and Rhode Island, which still require a franchisor to deliver the FDD at the *first personal meeting*, all other states allow a registered franchisor to engage in substantive communications with a state resident about the franchise opportunity either face-to-face or otherwise *before* the franchisor has delivered a copy of its FDD. The delivery rules in the other 46 states simply require the candidate to have the FDD for at least 14 days before the candidate signs a binding agreement or pays the franchisor any consideration for the franchise rights. Thus delivery of the registered FDD in all 46 out of 50 states may occur late in the course of the parties' conversations about the franchise opportunity.[24]

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[22] While there are a number of reported cases involving plaintiffs suing to get into a franchise system after their application to buy a franchise was rejected by the franchisor, there are not a lot of reported decisions on whether particular activity rises to the level of an unregistered offer to sell a franchise. *See, e.g.*, Dollar Systems, Inc. v. Avcar Leasing Systems, Inc., 890 F.2d 165 (9th Cir. 1989).

[23] Non-franchisees who are not approved for a franchise can and do sue franchisors for unlawful discrimination based on a protected classification (e.g., gender, race, religion), but only a franchisee, i.e., someone who has bought a franchise, can bring a claim for a franchise sales law violation. *See, e.g.,* CAL. CORP. CODE § 31300 (West 2012) ("Any person who offers or sells a franchise in violation of [statutory sections] ***shall be liable to the franchisee or subfranchisor***, who may sue for …") (emphasis added).

[24] A franchisor must, however, deliver a copy of the FDD earlier if the candidate asks for it. *See* Amended FTC Rule, 16 C.F.R. § 436.9(e), (f) (2007).

E. <u>Must a franchisor be registered in a state before engaging in media advertising or other activities that promote the availability of franchises for locations in the registration state?</u>

It depends.

The franchise sales laws in California, Maryland, Minnesota, New York, North Dakota, Rhode Island, and Washington each require a franchisor to register to sell franchises in the state before engaging in media advertising or other activities constituting advertising that promote the availability of franchises, like participation in a trade show in the state. There are three exceptions to this requirement:

1. <u>National Advertising.</u> By informal rule in most states and by regulation in California, franchisors may engage in certain kinds of "national" advertising, i.e., advertising where at least two-thirds of the publication's paid circulation is outside of the registration state during the prior 12 months or where broadcast advertising originates outside of the registration state, but is received in a registration state. When franchisors engage in print advertising, they should verify with the publisher that at least two-thirds of the publication's circulation during the prior 12 months was outside of the registration state. Minnesota and North Dakota also informally require that the publication be published outside of the state.

2. <u>Internet Advertising.</u> Under a NASAA policy, a franchisor that merely posts information on a website that is viewed by a franchisee in a registration state does not thereby make an "offer to sell" a franchise in the registration state unless the franchisor directs the website to the prospective franchisee by sending the prospect a link to the website or otherwise directing the prospect to the website's URL. If the franchisor directs prospects to website content describing the franchise opportunity (whether the information is on the franchisor's own website or a third party's website), the activity is treated as an offer, the web content must be registered as advertising and the franchisor must be registered in the state to sell franchises. Regarding the process for registering Internet content as advertising, see FAQ XII.

3. <u>Exempt Franchisors.</u> A franchisor that qualifies for an exemption from registration is also exempt from having to register its franchise advertising in California, Maryland, New York, North Dakota, Rhode Island, and Washington, but not in Minnesota.

F. <u>Is it possible for more than one registration state to have jurisdiction over a single transaction?</u>

Yes! See response to FAQ III C. When a single franchise sale triggers jurisdiction in multiple registration states, the franchisor must be registered in each registration state. All franchise sellers must be trained to ask relevant questions and identify key jurisdictional elements to determine if registration is necessary before closing a sale with a particular candidate.

IV. EXEMPTIONS FROM REGISTRATION

A. <u>What is the significance of qualifying for an exemption from registration?</u>

The primary advantage of an exemption from state registration is that it can save franchisors time and money by allowing them to bypass the process of submitting their FDD for review by a state regulator and having their in-state activities held up until their registration application is approved. An exemption from state registration eliminates all filing duties, *i.e.* initial registration, annual renewal applications, material change amendments (and in some cases, advertising filing duties).

It is important to note that an exemption from state registration does not necessarily relieve a franchisor of its disclosure obligations. Further, there is no uniformity among the states regarding qualifications for exemptions. Indeed, the most popular of the statutory exemptions, the large franchisor exemption, is not available in all states. Franchisors that sell franchises in multiple registration states may piece together several different state exemptions to minimize the number of states in which they must register. Practitioners still need to research each state's requirements and keep good records to support each exemption. So, while getting an exemption from registration sounds appealing, it still requires careful attention to details, good record keeping, and at best, results in a patchwork of benefits.

B. What are the most useful exemptions from state franchise laws?

The most useful exemptions are exemptions from registration.

Generally there are three types of state exemptions from registration. These are commonly based upon the characteristics of: the franchisor, the franchisee, and the nature of the transaction.[25] Within these three categories, certain exemptions are fairly uncommon (such as the exemption for cooperatives).

The most popular exemption from registration applies to franchisors with substantial net worth and/or business experience – the large franchisor. Recognizing that franchisors must be able to provide pre-opening support to new franchisees, many states are satisfied that large franchisors can readily satisfy this obligation. A large franchisor is typically defined by its net worth (in some circumstances a parent's net worth may also be used in the equation if the parent guarantees the franchisor's performance). The net worth threshold varies by state. Some states also consider a franchisor's business experience (years in franchising or other operational experience). States that consider business experience and have a large franchisor net worth threshold include California, Illinois, Indiana, New York, and Washington ($5 million); Maryland, North Dakota, Rhode Island ($10 million); and Virginia ($15 million).[26]

Transactions with certain franchisees, i.e., "insiders" are exempt from registration in some states. Typically an insider has intimate knowledge of the franchise operation, owns 50% of the prospective franchisee, and has served in a key role at the franchisor for the past two years.

Finally, two kinds of sales transactions are exempt from registration in some states. The first is known as the "limited offer" exemption. This typically involves the sale of one or two franchises in a state where the franchisor has not solicited sales. This is not available in all states, however, and may be a trap for the unwary.

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[25] A detailed discussion of the requirements under state exemption laws is beyond the scope of this paper. However, for a comprehensive review of state exemption laws *see* PATRICK J. MASLYN, TIMOTHY O'BRIEN, ANNE CONNELLY & DENNIS E. WIECZOREK, GO TO THE HEAD OF THE LINE: HOW TO GET REGISTERED, AMENDED, RENEWED OR EXEMPTED, ABA 34TH ANNUAL FORUM ON FRANCHISING (2011). For a more general discussion, see BRIMER, *supra* note 5, at 100-102.

[26] *Id.*

The sales transaction, and a potentially useful exemption for local and regional businesses seeking to expand, is the exemption for sales of a fractional franchise.[27] Generally speaking, a fractional franchise is a smaller business located within an existing business that is not expected to generate more than 20% of the existing business' sales in the first year. Starbucks has successfully used this to place its coffee shops in other existing stores, airports, and hotels.

C. <u>Is there any benefit in claiming an exemption from registration in one state if the franchise offer will not qualify for an exemption from registration in other registration states where the franchisor plans to sell franchises?</u>

Yes. The ability to qualify for an exemption from registration in even just one state is a benefit since it provides relief from that state's review process. Given the uneven scrutiny applied to the registration process by different state regulators, any exemption from state registration should be considered a win for the franchisor. If a franchisor is able to shorten the registration and renewal process in a state, it will be able to continue its sales process there uninterrupted.

D. <u>If, after a franchisor qualifies for the large franchisor exemption, the franchisor's net worth falls below the statutory threshold, what should the franchisor do?</u>

The franchise practitioner should determine which states are implicated by this development and carefully review the requirements for the applicable exemption.[28] If a franchisor no longer meets the eligibility requirements for an exemption, it must immediately cease sales activities and notify the state of its change in status (and that it has halted sales). It may at a minimum have to file a material change amendment, but will likely need to file a new application.[29] See FAQs XIV B and C.

E. <u>If a franchise is sold based on the fractional franchise exemption, i.e., the franchise parties reasonably anticipate that the franchise line will not represent more than 20% of the franchisee's annual sales or revenue, and it turns out that, in fact, the franchise line represents 25% of a franchisee's first year sales or revenue, what should the franchisor do?</u>

It depends. In all states where there exists a fractional franchise exemption, the parties must, at a minimum, have a reasonable basis for believing that the sales from the relationship will not exceed 20% of the existing business' gross sales in the first year to qualify for the exemption. However, there are vast differences among states for how franchisors may claim the fractional franchise exemption. In California, a franchisor must file a notice of exemption

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[27] A detailed review of fractional franchises is beyond the scope of this paper, however we recommend the following article for a good discussion of this topic: Leonard D Vines, Beata Krakus & Karen Satterlee, *Fractional Franchise Exemption: Friend or Foe*?, 30 Franchise L. J. 2, pages 72-87 (2010).

[28] *e.g.* ILL. ADMIN. CODE tit. 14, § 200.202(e)(4) (2012); *but see* California's large franchisor exemption which allows the franchisor and the parent (when necessary) to rely upon the immediately preceding fiscal year's audited statement for 15 months from that fiscal year end date. CAL. CORP. CODE § 31101(a) (West 2012).

[29] *e.g.* ILL. ADMIN. CODE tit. 14, § 200.600 and § 200.603 (2012).

and pay a fee before making any offer of sale.[30] That annual notice expires on December 31, and should be filed between July 1 and December 31 of the year before the exemption is claimed. There is no filing required in Illinois or Minnesota to claim the fractional franchise exemption. In Michigan, there is no filing required, but, as a condition of the exemption, a franchisor that has an FDD must provide that with a notice to the prospect.[31] In New York, the franchisor must pay a fee and notify the Department of Law about the transaction.[32] In South Dakota, there is no filing, no registration, and no disclosure required when a fractional franchise exists. Similarly, because Virginia has determined that a fractional franchise falls outside the definition of a franchise, no filing, registration, or disclosure is required. Finally, Wisconsin also requires no registration or disclosure if its definition of a fractional franchise is met.

Therefore, the franchisor's reaction depends upon where the unexpectedly successful franchise is located. The first step is to carefully review the respective state exemption language and see if there are any advisory opinions on the topic. In those states where filings and reports are required, the safest course is to contact the state regulator and seek guidance.

F. When an exemption is based on the nature of a particular transaction (large initial investment, fractional franchise, limited offer, minimum required payment) or the franchisee's characteristics (large/experienced/seasoned franchisee, insider), what are best practice tips for how the franchisor should document that a particular transaction meets the exemption conditions?

The franchisor should keep meticulous records substantiating each of the elements and requirements of the exemption. For those transactions based upon a franchisee's characteristics, this includes requiring updated financials from the franchisee and garnering supporting documents demonstrating experience and positions associated with the franchisor. For those particular transactions where the nature of the sale qualifies for the exemption, the franchisor should document those elements very carefully. This includes financial projections, business plans, sales materials, and verification of payments made. The franchisor should maintain these records from the initial inquiry or contact so that it can demonstrate that its reliance on the exemption is justified.

G. What are the most compelling factors influencing state franchise regulators to grant a discretionary exemption from registration to a particular transaction?

States typically set a high bar for any discretionary exemption.

California exercises its discretion by not exercising it. Those who wish to seek a discretionary exemption may ask for one via the Interpretive Opinion process.[33] However, it is more realistic and efficient to review and rely on the exemptions that are available in the California's Franchise Investment Law (as discussed above).

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[30] CAL. CORP. CODE § 31108 (West 2012). In California, the 20% threshold applies not only to the first year of the fractional franchise relationship, but to each year. An exemption notice therefore must be filed annually per transaction.

[31] MICH. COMP. LAWS §§ 445.1506(2), 445. 1508(3) (2012).

[32] N.Y. Comp. Codes R. & Regs. tit. 13, §§ 200.10(2)(f), 200.10(3) (2012).

[33] (Commissioner's Release 61C) CAL. CORP. CODE §§ 31100-31109 (West 2012).

Illinois considers each request for a discretionary exemption on a case by case basis and sparingly grants this exemption. Illinois considers many factors such as investor sophistication, whether jobs will be created in the state, the number of sales projected for the prospective franchisee, whether there are complex financial arrangements included, and other special circumstances presented by the applicant.

It is important to remember that even if a state grants a registration exemption, the franchisor will likely still have to present a compliant FDD and comply with the federal and state disclosure requirements. A registration exemption is not necessarily a disclosure exemption.

H. What are best practice tips for expediting state regulator review of applications for discretionary exemptions from registration?

A franchise practitioner seeking a discretionary exemption should place a courtesy call to the applicable regulator to let them know that the exemption request is coming. During that call, the franchise practitioner should be prepared to explain the reason for the exemption and have the relevant facts at hand. The regulator will most likely then request a clear and detailed cover letter describing the franchisor's business and the facts that support a request for the exemption.

An important consideration for franchisors considering seeking a discretionary exemption is the breadth of information they may be required to provide. In particular, a regulator will request disclosure of the names of the parties and deal points that provide a compelling reason for the discretionary exemption. Since this potentially could become a matter of public record, confidentiality considerations may dissuade a franchisor from seeking a discretionary exemption.

States typically do not receive many requests for discretionary exemptions (several regulators reported 1-3; others said less than 5 in a year). These requests are reviewed on a case by case basis. Some common themes: a one-time transaction involving a large investment (multi-million dollar deal); the sale of multiple units to a single entity; or a sophisticated franchisee with access to financial and other experts. Some states report receiving occasional requests for a discretionary exemption from foreign franchisors who are selling a single master franchise in the U.S. During an informal poll of regulators, none could recall whether any foreign franchisors were granted an exemption.

V. EXPEDITING THE INITIAL REGISTRATION PROCESS

A. What are best practice tips for expediting the initial franchise registration process?

A successful franchise registration process begins long before a franchise practitioner prepares the initial franchise registration application. A prudent practitioner has a keen attention to detail, conducts the necessary research, and follows very strict guidelines for preparing the FDD. What follows are some best practice tips for expediting the initial franchise registration process. These are not a substitute for checking each state's particular filing rules as state variations exist.[34]

[34] In addition to the resources cited in FAQ 1, we recommend the following paper for a more thorough discussion of the registration process: DALE E. CANTONE, HALIMA MADJID & LEONARD D. VINES, BEST PRACTICES FOR STATE FRANCHISE

1. Make the FDD Compliant with the Federal Rule. This seems so obvious, yet every year at the annual ABA Forum state regulator workshop, regulators lament the fact that they still see forms from the old UFOC days, or are faced with woefully inadequately prepared FDDs. So, franchise practitioners need to start at the top: review the Amended FTC Rule, NASAA Guidelines, and NASAA Commentary. The FTC FAQs are also especially helpful. We asked several regulators whether they referred to the Compliance Guide in reviewing FDDs. Many of the larger states do.

2. Make the FDD Compliant with State Law. Next, go to the individual state statutes, guidelines, and commentary. This research will need to be updated yearly.

3. Double Check and Seek Guidance. If, after researching and seeking help from others, a franchise practitioner is still unclear about something, she or he should call on the relevant state regulator. They are not going to do a franchise practitioner's job, but are generally willing to assist those who are diligently trying to comply with the nuances of conflicting regulations. Respond promptly and completely to all communications with regulators. Keep in mind that each state allocates different resources to its franchise department, so, especially during busy times of the year, one cannot always expect an immediate response. Above all, remember that courtesy and professionalism will go a long way to engendering goodwill with the regulators – which may be useful to the practitioner (or his or her franchisor client) some day.

4. Confirm that the Business Information Will be Accepted. A franchise practitioner should not blindly prepare an FDD based upon information or documents provided by a franchisor client and accept everything presented without independent review as is. It is important to scrutinize the information supplied by franchisor clients that make up the FDD. For example, many practitioners ask their clients to supply information responsive to FDD Items 3 (litigation) and 4 (bankruptcy) in the form of a declaration that the practitioner keeps in its file to demonstrate its independent due diligence.[35]

This is especially true of the financial statements. It is prudent for franchise practitioners to contact the CPA preparing the financial statements early in the process to ensure that they adhere to the requirements and understand the need to file a "consent of accountant." Review the prescribed text of the consent with the CPA. Many large accounting firms want to substitute their own language or remove "consent" from the title of the document. Some state regulators insist that the exact language of the NASAA consent form be used.

REGISTRATION, ABA 32ND ANNUAL FORUM ON FRANCHISING (2009). *See also* PATRICK J. MASLYN, TIMOTHY O'BRIEN, ANNE CONNELLY & DENNIS E. WIECZOREK, GO TO THE HEAD OF THE LINE: HOW TO GET REGISTERED, AMENDED, RENEWED OR EXEMPTED, ABA 34TH ANNUAL FORUM ON FRANCHISING 1–6 (2011); KERRY OLSON, ROBIN M. SPENCER & LARRY WEINBERG, THE ANNOTATED FRANCHISE AGREEMENT, ABA 33RD ANNUAL FORUM ON FRANCHISING (2010); JOSEPH J. FITTANTE, SUSAN MEYER, & CRAIG TREGILLUS, FUNDAMENTALS 201: DRAFTING A DISCLOSURE DOCUMENT, ABA 32ND ANNUAL FORUM ON FRANCHISING (2009); SUSAN GRUENEBERG & DAWN NEWTON, BEST PRACTICES FOR ESTABLISHING A FRANCHISE COMPLIANCE PROGRAM, ABA 33RD ANNUAL FORUM ON FRANCHISING (2010); BRIMER, *supra* note 5.

35 The subject of franchise counsel's due diligence duties has been the subject of many articles and is beyond the scope of this paper. For a scholarly article on the subject, see Alexander M. Meiklejohn, *UFOCs And Common Law Claims Against Franchise Counsel For Negligence*, 25 Franchise L. J. 45 (2005).

In many states, the regulators begin every review of a franchise application with the financial statements. Experience shows that this is the quickest way to screen out a non-conforming registration application. For instance, if the application is missing or contains the incorrect financial statements, the application will be denied with no further review. Franchise practitioners will save themselves time by confirming with the CPA before they file the application that the financial statements have been compiled according to U.S. generally accepted accounting principles ("GAAP").

All states consider the financial condition of the franchisor. If the franchisor has a negative net worth or an auditor's "going concern opinion," the regulator will impose a financial assurance requirement. See FAQ VII D. In Illinois, such a requirement is also likely if the financial statements show less than $100,000 in owner's equity. Knowing this, a franchisor can plan ahead, or include a financial assurance in the application.

Confirm other aspects of the franchisor's business transactions. For instance, be sure that the franchisor has not engaged in previous illegal franchising and licensing activities. See FAQ XIV B and C.

If the practitioner is unsure about any element of this process, she or he should contact the regulator to seek guidance. This pre-filing planning will help keep the review on track and speed up the registration process.

B. May a franchisor designate a particular registration period or expiration date?

Not technically, but practically-speaking it can. The registration period is determined by state law. All registration states (except for Kentucky, Nebraska, and Texas, which require a one-time filing) provide that franchise registrations expire at a fixed period after the initial registration date. Usually this is one year from the registration date.[36] However, in some states, state registrations expire a certain number of days after the franchisor's fiscal year end. [37] For most franchisors with a calendar fiscal year, this means that their renewals will be due sometime in April.

In a multi-state system, to avoid having to file renewals throughout the year, a franchisor may file a particular state's renewal early and request that the state amend its renewal date to the earlier date to conform more closely with other state filing due dates. Aligning filing deadlines not only spares a franchisor from the inefficiency and expense of having to file renewals throughout the year, it also allows it to avoid filing a material change amendment during the registration period when its audited financials are released at the end of its fiscal year. The availability of a more recent audit is, in and of itself, a material change to a registration even if the audit shows an improved financial condition.

Importantly, those registration states with fixed registration periods have an "automatic effectiveness" rule. This provides for continuous registration in the state. While this means that when timely filed, a franchisor may continue its sales activities without interruption, the prudent franchisor would not close deals solely on the basis of a timely renewal filing – it would wait for

[36] *e.g*. Florida, Indiana, Maryland, Michigan, North Dakota, South Dakota, Utah, Virginia, Washington, Wisconsin.

[37] *e.g*. 90 days in Hawaii; 110 days in California; 120 days in Illinois, Minnesota, New York, and Rhode Island.

the formal order from the state confirming the registration of the renewal FDD. Illinois is the only registration state where the franchisor is entitled to rely on that timely filing and continue selling franchises while a renewal application is pending. Though, Illinois does have the right to issue post-registration comment letters. Depending upon the content and outcome of such a comment letter, a franchisor may have to re-disclose to a prospect. In addition, in other registration states, regulators routinely request a waiver of the automatic effectiveness rule. Franchise practitioners are hard pressed to deny such a request.

It is important to note that there is great discrepancy among the states as to when a renewal must be filed and when the filing is due that will allow for the automatic effectiveness rule.[38] And that date must be calculated carefully taking into account state-specific holidays (like California's Cesar Chavez day) in determining the filing deadline to qualify a renewal application for automatic effectiveness. For many franchisors, they internally calendar these earlier filing dates as their renewal filing date.

There is even discrepancy among the states in how they deal with renewals filed after the expiration date. In Illinois, for example, the consequence of filing a 'renewal' application after the expiration date is that this "late renewal" filing will be treated as a new application. Sales must be halted after the expiration date, and may not be resumed until the application is approved. In addition, the franchisor will be charged the higher fee for new applications. This year, Illinois received 200 late renewal filings. In stark contrast, other registration states give applicants some leeway on what they consider a "late renewal" application that is received after the expiration date. In all circumstances, it is prudent to tender a blacklined FDD so that the regulators can readily appreciate the scope of the changes from the FDD filed the previous year.

As must be clear from this discussion, there is great variation among the states' laws and practices, so it is crucial to have a good system for keeping track of dates for filings, renewals, comment letters, or other outstanding communications with regulators.

C. How long does it normally take a state regulator to respond to an initial franchise registration application?

Registration states provide a fixed time during which regulators must register or deny an application, or the registration application is deemed registered.[39] In some states with fully staffed departments, the regulators meet that deadline. However, in many other states, the reality is that regulators routinely take longer than the prescribed period. With a deadline looming, some regulators will request that a franchisor waive the automatic effectiveness deadline (and faced with a possible stop order most franchisors will grant that waiver). Others will issue comment letters describing some deficiency (or listing boilerplate deficiencies) which tolls the automatic effectiveness. In some states, if the application significantly fails to comply with registration standards, the regulators will stop reviewing the FDD and simply deny the

[38] For example, the deadlines for filing renewal to obtain the benefit of automatic effectiveness is same as the expiration date in Florida, Hawaii, Indiana, Minnesota, New York, South Dakota, Utah, and Wisconsin. The deadline is one day before expiration date in Illinois, 15 business days before expiration date in California, Maryland, North Dakota, and Washington and 30 days before expiration date in Rhode Island and Virginia. *See generally* Bus. Franchise Guide (CCH) (2012); *see also* BRIMER, *supra* note 5 at Exhibit 2-6.

[39] For example, the time limit in California is 15 business days from the filing dat. In Illinois, the time limit is 21 business days from filing date. In Maryland, the time limit is 30 business day from application or amendment.

application. If this happens, the franchisor may have to restart the entire process. More importantly, such a denial of registration will have to be disclosed if the franchisor seeks to register the same FDD in another state.

It is important to note that regulators may be more responsive at different times of the year. Beginning in March and continuing through June, states are inundated with renewals and annual filings. If a new franchisor has the option to file at a different time of the year, it may get more timely attention from regulators.

D. <u>How do state regulators communicate registration application deficiencies and what are best practice tips for responding?</u>

Registration states generally grant regulators wide authority in reviewing FDDs. This review is not necessarily limited to the four corners of the FDD. Regulators may ask about the backgrounds of the franchisor's executives, its financial condition, its past sales practices, or other substantive areas of the company's business. Regulators have been known to do their own research on an applicant. For instance, they may review a company's website and find listings of locations that do not match those in Item 20.

When an FDD is deficient in some manner, regulators notify a franchisor via a "comment" or "deficiency" letter. Such deficiencies may range from technical comments (failure to bold a table heading) to substantive comments like capitalization questions (which may require a financial assurance). Sometimes a simple exchange with the regulator will resolve the regulator's concerns; other times, the franchisor may have to make significant revisions to its FDD, or will need to produce materials to resolve a regulator's objections.

Until recently, comment letters were only sent by mail, but today many regulators are taking advantage of e-mail, facsimiles, and informal telephone calls in addition to the official written comment letters. Not all regulators follow a consistent method of contacting counsel. Franchise practitioners should double-check that communications from state regulators do not end up being blocked by a spam filter or otherwise misdirected within their office.

Upon receipt of a comment letter, the practitioner must first understand what the regulator is asking. Collect and review all information available, including references to the state regulations or other resources. If the practitioner is still unclear about or disagrees with a comment, contact the regulator and seek clarification about what is being requested before responding. Most regulators prefer that franchisors or their legal counsel seek clarification regarding comments directly by e-mail and for sensitive issues via a telephone call.

States have very particular requirements for how they want to receive materials from franchisors. For instance, some require a complete blacklined copy of the FDD; others want only the pages that show the changes. Some regulators want a copy on a CD; others want only hard copies (but no changes marked in color, only black). Address all comments in a single response. The prudent practitioner will communicate in a manner that makes an appropriate record, but is also responsive to the content and form required by the regulator.

E. **<u>What factors explain the significant disparity in the level of scrutiny of franchise application reviews and response time among franchise regulators comparing one registration state to the next?</u>**

The primary factors affecting the disparity in scrutiny among regulators are staffing, state budgets, and the scope of regulators' duties. In some states, franchise regulators are also responsible for regulation of other state laws.

F. **<u>When a franchisor and state regulator cannot agree on whether the FDD is deficient or how a deficiency should be corrected, does the franchisor have any recourse to obtain review from another franchise regulator in the state?</u>**

As an initial best practice tip, respectful rather than confrontational communication goes a long way to expedite the resolution of outstanding comments. That being said, if a franchisor is unhappy with a comment letter, there is no formal recourse for lodging objections. Objections must be addressed through direct negotiation with the regulator. There may be some informal process to raise a particular comment to another regulator, but that is not available in all states.

For instance, Illinois does not have a second level of review. In rare situations the Chief of the Franchise Bureau may be consulted along with the regulator assigned to the particular franchisor to help resolve outstanding issues.

In California, once a file is assigned to a regulator it stays with that regulator until she or he retires or leaves the Department. If there is a disagreement over a comment, a practitioner may ask to speak to the Deputy Commissioner of the Securities Regulation Division.

G. **<u>Under what circumstances will state regulators deny registration?</u>**

The basis for a denial of a registration varies from state to state. Generally a denial will result when (i) the FDD is grossly deficient; (ii) no response is provided to a comment letter for a prolonged period which varies by state; (iii) the facts demonstrate an unreasonable risk to the public (as when the FDD disclosures demonstrate principals have a pattern and practice of not complying with the law); or (iv) there is a failure to adequately capitalize the franchisor and/or a failure to provide financial assurances or resolve other concerns raised by the financial statements.

VI. MANAGING MULTI-STATE REGISTRATIONS

A. **<u>What best practice tips should a franchisor adopt for identifying currently effective documents, tracking multiple simultaneously filed state registration applications, and monitoring expiration dates and filing deadlines?</u>**

Once a franchise practitioner establishes a successful registration practice (with a concomitant document management and docketing system), it should be readily scalable to a multi-state registration practice. Practitioners must keep meticulous records of their documents, versions, filings, amendments, and supporting materials.[40]

[40] A detailed description of establishing a multi-state registration practice is beyond the scope of this paper. We note that the NASAA Franchise Project Group is working on a commentary for the multi-unit FDD disclosures; *see also* BRIMER, *supra* note 5.

As a best practice tip, many experienced franchise practitioners create template FDDs based upon a form that has been successfully registered in multiple states. They may adopt non-material (and non-contradictory) edits to the FDD from one state for inclusion into later filings elsewhere to expedite the process of preparing a single FDD for the next year's renewal application. In addition, some keep a running log throughout the year of items to discuss with their clients when preparing renewal documents. These topics may range from updates to the social media policy or adoption of 'green' standards to required edits from various state regulators (or changes in the law) to revisions to a franchise agreement based upon the outcome of a lawsuit.

Franchisors should maintain an always-current "state-by-state selling list" that it shares with all of its franchise sellers regularly so that franchise sellers have an accurate resource they can consult before engaging in activities constituting an "offer to sell" or before closing a franchise sale.

B. <u>Must a franchisor register the identical franchise offer in all states? How should a franchisor handle state differences?</u>

No, but from a practical standpoint since the franchisor is likely selling the same franchise program in all states, it is usually most efficient to register the same offer.

Typically, state differences are managed through detailed record keeping and employing appropriate state addenda. If one state requires a financial assurance or another requires its law to apply, such differences can be presented in the relevant state addendum. Keeping accurate properly labeled documents organized makes locating the appropriate FDD easier for selling and later for preparing a renewal.

Sometimes a regulator may require a negative disclosure on a cover page. Some franchisors may be tempted to contain such a requirement by creating a single state-specific FDD. At the end of the day, however, franchisors should adopt a realistic approach that balances the inconvenience and difficulty of properly managing multiple FDDs against the goal of confining the negative disclosure to the state requesting the disclosure. They should consider whether the risk of delivering the wrong FDD and the extra administrative cost of updating multiple FDDs exceeds the benefit of confining the single negative disclosure to the one state asking for it.

C. <u>Is it advisable that a franchisor coordinate its state registrations so that they all expire at approximately the same time of the year?</u>

Yes. Coordinating expiration dates streamlines the renewal process. It is also more cost effective because it minimizes the expense of preparing multiple documents throughout the year. From a logistical standpoint, coordinating the expiration dates is easier to manage. It reduces the number of versions of the disclosure documents. The goal in managing multi-state registrations is to maintain one version of the disclosure document that has addenda for each state attached at the end. Any adjustments should be made at the annual renewal, so long as there are no mid-year material updates required.

D. <u>When one state regulator requires a special risk factor, is inclusion of the risk factor a material change that must be registered in all other registration states before the franchisor may offer franchises in the other registration states?[41]</u>

It depends on the system-wide implications of the risk factor. For instance, if the special risk factor is state-specific, but not material to the overall system (such as the financial assurances required in Illinois where the franchisor has less than $100,000 in owner's equity, but relatively few sales planned), then it is appropriate to address that requirement in the (Illinois) state addendum, not on the FDD state cover page, and there is no need to alert other states. If, on the other hand, a state regulator asks for a special risk factor with system-wide implications, then such a risk factor would be material to the system and trigger the need to file an amendment in the other registration states. In such a case, the franchisor may be asked to disclose the risk factor on the FDD state cover page. Either way, it is not the regulator's requirement that constitutes the material change – it is the underlying circumstance noted by the regulator that needs to be disclosed.

E. <u>If after obtaining a registration order from one state another registration state asks the applicant to revise its FDD, must the franchisor inform the state where it is already registered of the FDD changes?</u>

It depends. Generally, a revision required by one state does not trigger a duty to inform any other states unless the revision results in a material change to the FDD. The standard for materiality varies from state to state. Information is considered "material" if a potential franchisee might consider the information important in making a decision whether to invest in a franchise. If there are material changes, the franchisor must update the FDD and file an amendment in each state where it is currently registered. Consequently, a material revision to the FDD made at the behest of one registration state triggers a duty to update the registrations in all other states where the franchisor is then registered.

A franchisor need not re-file its FDD in any of the other states where it is then registered when the revisions requested by one state regulator to the franchisor's FDD incorporate technical, non-material changes or conditions that only apply to state residents, like a fee deferral or other financial assurance. In this situation, it is acceptable for the other registration states to be alerted to the non-material changes when the franchisor makes its next state filing which may not be until the franchisor's next renewal filing.

Again, as a best practice tip, franchisors are advised to try to avoid having separate state-specific FDDs causing them to have to manage multiple FDDs at the same time since the administrative burdens will outweigh any benefit (especially when state-specific revisions are not material).

F. <u>Do state regulators communicate with one another regarding a pending application that the franchisor has filed in more than one state? Do state regulators compare notes about what their comment letters should say?</u>

Absolutely! The Attorneys General and regulators responsible for franchise compliance subscribe to a regulator-only listserv. This gives them a forum to raise concerns, discuss

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[41] MARISSA FAUNCE, NATALMA MCKNEW & NICOLE ZELLWEGER, ASSESSING MATERIALITY – WHAT TO INCLUDE AND WHEN TO AMEND, ABA 35TH ANNUAL FORUM ON FRANCHISING (2012).

issues, and compare notes. Franchise practitioners who complain loudly to a regulator that "no other state required this" can be sure that the regulator will check. And, if it turns out that the franchise system is not registered anywhere else, then that practitioner's credibility is greatly tarnished throughout the regulator network.

The regulators will also check with each other when faced with (i) a particularly difficult filing; (ii) an application with material deficiencies that a regulator believes should be shared with regulators in the other states where the franchisor has filed the application: (iii) a franchisor whose website is grossly inconsistent with its FDD claims; (iv) information suggesting or indicating a pattern of illegal sales activities; or (v) information raising suspicion that something is just not right with the franchise system or when a state receives many complaints about a franchisor.

VII. FINANCIAL REQUIREMENTS

A. Must a newly organized franchisor or an existing business with no audit history include audited financial statements in its initial FDD?

Although the Amended FTC Rule permits a newly organized franchisor with no audit history to phase-in the use of audited financial statements over two years, California, Minnesota, New York, Rhode Island, and Virginia[42] each require a new franchisor to file audited financial statements even if the first audit shows little besides a bank account with the amount of the company's initial deposited capital and start-up legal and accounting expenses to organize the franchisor entity and prepare the FDD and audit. Without submitting audited financial statements with the initial franchise registration application, a new franchisor will not get registered in these states.

The remaining registration states permit a new franchisor under certain conditions to satisfy the financial statement requirements by a phase-in over three years:[43]

1. First partial or full fiscal year: an unaudited opening balance sheet.

2. Second fiscal year selling franchises: an audited balance sheet as of the end of the first partial or full fiscal year selling franchises.

3. Third fiscal year and later: all required audited statements required by the Amended FTC Rule for the prior year plus the audited financial statements previously disclosed.

In FTC FAQ #11, the FTC reminds start-up franchisors that while the Item 21 phase-in rule allows them several years to ramp up to the same financial statement disclosure

[42] As of June 30, 2012.

[43] Individual registration states may specify particular financial reporting standards in their regulations. Practitioners need to consult these regulations to identify state-specific requirements that go beyond GAAP or GAAS standards. For example, Section 200.600 of the regulations under the Illinois Franchise Disclosure Act, ILL. ADMIN. CODE tit. 14, § 200.600 (2012), specifies inventory accounting rules that franchisors must adopt for preparing unaudited financial statements during the phase-in period.

requirements applicable to experienced franchisors, it nonetheless requires them to prepare audited financial statements "as soon as practicable."[44]

Acknowledging that unaudited financial statements need not be prepared by an accountant, the FTC instructs start-up franchisors to look to GAAP for guidance. The Amended FTC Rule states that unaudited financial statements "must be prepared in a format that conforms as closely as possible to audited statements."[45]

The phase-in rule does not apply to spin-offs, affiliates, or subsidiaries of a franchisor that has previously been engaged in franchising or has prepared audited financial statements for any other purpose.

A start-up franchisor that relies on the phase-in rule must prominently state in Item 21 and on the unaudited financial statements themselves: "No certified public accountant has audited the figures disclosed or expressed an opinion with regard to their content or form."

If a franchise registers in California, Minnesota, New York, Rhode Island, or Virginia where audited financial statements are still required, a new franchisor cannot sell franchises with unaudited financial statements elsewhere based on the phase-in rule because the franchisor has audited financial statements and therefore does not meet one of the phase-in conditions.

For other reasons, new franchisors may find it advisable to have audited statements from the start. Among other things, independently prepared audited financial statements, even if bare-bones, may help the start-up franchisor overcome any perception-based doubts over the company's legitimacy.

B. <u>What are the minimum standards for satisfying financial statement disclosure and registration requirements?</u>

Financial statements in Item 21, including auditor's notes, must be prepared according to GAAP as revised by any future U.S. government-mandated accounting principles or as permitted by the Securities and Exchange Commission (SEC). Except for start-up franchisors phasing-in financial statements, Item 21 financial statements must also be audited "by an independent certified public accountant using United States generally accepted auditing standards (GAAS)."[46]

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[44] *Amended Franchise Rule FAQ's*, FEDERAL TRADE COMMISSION, at FTC FAQ #11, (last visited March 28, 2011), http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml#11.

[45] *Id.*; Amended FTC Rule, 16 C.F.R. §§ 436.1 -436.11 (2012).

[46] In an effort to accommodate the internationalization of franchising and expansion of foreign franchise systems into the United States, the FTC, in Amended Franchise Rule FAQ #17, clarified who may prepare the audited financial statements that must be included in the FDD. *Amended Franchise Rule FAQ's*, FEDERAL TRADE COMMISSION, at FTC FAQ #17 (last visited March 28, 2011), http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml#17. FTC FAQ #17 explains that the reference to "independent certified public accountant" in Item 21 means, in addition to U.S. public accounting firms or certified public accountants, foreign accounting firms and accountants that (i) register with the Public Company Accounting Oversight Board ("PCAOB") established by the Sarbanes-Oxley Act of 2002, and (ii) meet additional SEC qualifications based on recent audits prepared by the foreign accounting firm or accountant that have been accepted for filing by the SEC. The foreign firm's or accountant's recent SEC audit performance must demonstrate appropriate quality controls, personnel qualifications, knowledge of professional standards, and knowledge of U.S. GAAP policies. The FTC noted that foreign PCAOB registered accountants that file audited

Item 21 must include the franchisor's (i) audited balance sheet presented in tabular format for the last 2 fiscal year-ends before the FDD's issuance date so that a prospective franchisee can instantly compare line-item fiscal year-end results and identify financial trends; and (ii) a statement of operations, stockholders equity, and cash flows for each of the previous 3 fiscal years. A franchisor that has not been in business for 3 fiscal years will include this information for the shorter time that it has been in business.

In lieu of disclosing its own financial statements, a franchisor may substitute comparable financial statements of any of its affiliates if the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under all franchise agreements entered into during the period that the guarantee is in place.[47] The affiliate's guarantee runs only in favor of franchisees, not to third parties. It must remain in place for as long as the franchise agreement is in effect, even if, at a later date, the franchisor in subsequent FDDs replaces its affiliate's financial statements with its own financial statements in connection with later franchise sales. A franchisor that wishes to rely on an affiliate guarantee must reference the affiliate guarantee in Item 21 and attach a copy of the affiliate guarantee to the FDD.

When a franchisor owns a controlling financial interest in a subsidiary, the franchisor must present a consolidated financial statement that reflects the financial condition of the franchisor and its subsidiary.

Finally, the Amended FTC Rule expanded the requirement for whose financial statements must be included in Item 21. Besides the franchisor's financial statements, a franchisor must also include separate financial statements for (i) any subfranchisor; and (ii) any parent that commits to perform *post-sale obligations* for the franchisor or guarantees the franchisor's obligations.

In FTC FAQ #4, the FTC clarified what "*post-sale obligations*" means in relation to the franchisor's parent. If a franchisor is obligated to provide goods and services to franchisees and the parent assumes that responsibility, or the franchisor arranges for the parent to provide goods and services directly to franchisees on its behalf, then the franchisor's parent's financials must be disclosed even if the parent does not guarantee the franchisor's obligations to franchisees.[48] On the other hand, if the parent is an approved supplier, but not the sole approved supplier, the parent's financial statements need not be disclosed since the franchisee can opt to buy from unrelated suppliers. The financial disclosure obligation only extends to parents that provide "*post-sale obligations;*" it does not extend to the franchisor's non-parent affiliate that provides "*post-sale obligations.*"

While the FTC has articulated who qualifies as a *subfranchisor* (see FAQ X B below), it has not clarified if a franchisor with a network of subfranchisors must disclose in its FDD the financial statements of *each and every existing subfranchisor* in connection with selling new

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financial statements with the SEC are subject to the same independence requirements and enforcement policies as American PCAOB registered accountants.

[47] Amended FTC Rule, *supra* note 45.

[48] *Amended Franchise Rule FAQ's*, FEDERAL TRADE COMMISSION, at FTC FAQ #4 (last visited March 28, 2011), http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml#4; Bus. Franchise Guide (CCH) ¶ 6090 (2012).

subfranchises or franchises.[49] It is also assumed that subfranchisor financial statement disclosure only applies to U.S. subfranchisors, not subfranchisors operating outside of the U.S. (often referred to as "master franchisors"), though this point is also not addressed by the FTC in any of its guides clarifying the Amended FTC Rule.

In an initial or renewal application, some states require the financial statements to be dated within 90 days of the date of the franchise application.[50] If a franchisor files a state registration application beyond these deadlines, the franchisor must also file interim unaudited financial statements that are dated within 90 days of the application date.

Some states' franchise regulators are accountants or have an accounting or financial background and vet the franchisor's financial statements very closely. When a particular filing involves unusual circumstances pertaining to financial statements, it is advisable a call each state where the franchisor plans to register its program and speak with a state regulator before filing the financial statements to discuss the situation and arrive at a workable solution. While state regulators are not bound to accept the same solution that another state regulator proposes, they may have seen this unusual circumstance discussed on the regulator-only list serv.

C. If one state regulator requires some type of financial assurance from a franchisor after reviewing the franchisor's financial statements submitted with an initial franchise registration application, must the franchisor offer the same type of financial assurance to franchisees in other registration states?

No. A franchisor is under no obligation to volunteer to offer some type of financial assurance before being asked for one by a state regulator. The fact that one state requires some type of financial assurance does not require the applicant to notify other states where its registration application is pending or has been approved.

There is very little practical guidance in the resource materials (including in those listed in the Appendix to this paper) that explains the criteria used by state regulators to analyze if a franchisor is undercapitalized. This is not to suggest that individual state regulators are unwilling to provide an explanation when they impose a financial assurance condition; it is just to say that there is no written guidance issued by registration states for practitioners to check to determine if their franchisor clients will be considered adequately capitalized. There is wide variation in the thoroughness of state regulators in reviewing registration applications and in the financial measures, minimum liquidity, and net worth standards they apply in judging if a franchisor has adequate financial resources to provide promised pre-opening support to franchisees. Some states seem to require financial assurance from every start-up franchisor based on the franchisor's lack of prior franchising experience even though the franchisor's net

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[49] Presumably, a franchisor (i) would not need to disclose any subfranchisor audited financial statements in the franchisor's FDD offering subfranchises since subfranchisors would have no liability for the contents of the franchisor's FDD that they themselves rely on to purchase their own franchise rights; and (ii) would only need to disclose in its FDD offering unit franchises the audited financial statements of the particular subfranchisor who will provide post-opening support to the franchisee and need not include audited financial statements of other subfranchisors with no relationship to the franchisee. These assumptions, however, are not confirmed in the FTC or NASAA guides.

[50] *See, e.g.*, CAL. CODE REGS. tit. 10, § 310.111.2(b) (2012). The Amended FTC Rule imposes a 120-day deadline for updating the FDD. Amended FTC Rule, *supra* note 45.

worth would otherwise be sufficient to avoid a financial assurance condition if the franchisor were filing a renewal registration application.

In our experience, practitioners should not expect to be able to talk a state regulator out of a decision to impose a financial assurance condition. Furthermore, the fact that only one registration state requests a financial assurance when the same application is filed in multiple states will not persuade the requesting regulator to change his or her mind.

D. When a state regulator requires some type of financial assurance from a franchisor, what are the franchisor's options and when is one option preferable over another?

All registration states vest in the state regulator the authority to condition approval of the franchise registration upon demonstration of the franchisor's financial ability to provide promised services and pre-opening support to franchisees without resort to the franchisee's own initial fees. The financial review is designed to prevent a franchisor from selling more franchises than it is capable of servicing. The goal is to prevent an undercapitalized franchisor from being overly dependent on a franchisee's initial fee payments in providing the franchisee with promised pre-opening support.

As noted, there is very little practical written guidance of the tests state regulators use to determine the adequacy of the franchisor's capital to avoid a financial assurance condition and little to no uniformity in the standards that registration states apply. State regulators say that there is no "one size fits all" rule when it comes assessing a franchisor's financial statements. Generally speaking, state regulators seem to focus on three criteria: (i) positive net worth; (ii) a current assets to current liabilities ratio of at least 1; or (iii) an operating profit during the prior fiscal year.

Since adequate capital is measured according to the franchisor's ability to provide *promised pre-opening services*, state regulators begin their assessment of the adequacy of a franchisor's capital by multiplying the franchisor's estimated per-unit cost of providing promised pre-opening and opening services and support as disclosed on Form B of the NASAA Uniform Franchise Registration Application (Franchisor's Cost and Source of Funds), by the number of franchises the franchisor estimates it will sell in the next year as disclosed in Table 5 of Item 20 of the FDD. The product of per-unit cost[51] and total projected sales is then compared to the financial resources indicated by the franchisor's financial statements. In all cases, the franchisor's liquid assets on hand must at least be equal to this product, but some state regulators require that available cash be at least some multiple of this product.

Given the lack of uniformity among state regulators, it is difficult to advise start-up franchisors about an adequate level of capital for a newly-formed franchisor entity. As noted, in some states, the lack of a franchising track record may result in a financial assurance condition regardless of the start-up franchisor's initial capital shown on audited financial statements. The capital requirements on initial registration appear to be scrutinized more closely than on renewal. A track record of franchise sales, openings, and documented growth is often helpful to

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[51] Franchisors may focus on *incremental* per-unit pre-opening costs instead of absolute costs. In other words, a franchisor is not required to factor in their indirect overhead expenses to maintain a franchise sales department, training department or advertising department, or include rent for their headquarters or fees paid to consultants or salary to the employees to write the operations manual, or the like.

convince a state regulator to accept a lower current assets to current liabilities ratio on renewal. Existing franchise units generate continuing royalty fees that franchise regulators will consider in assessing the renewing franchisor's financial condition. However, a financial assurance condition is unavoidable on renewal when the current assets to current liabilities ratio is less than 1.

A franchisor will compound its own problems by puffing up its franchise expansion plans for the next year in Item 20 or in public statements on its website. Franchise regulators read the franchisor's website for many different things including representations of past or future success and undocumented financial performance representations. Item 20 estimates of franchise sales in the next fiscal year should be realistic - particularly since this is the key multiplier used by state regulators in determining the franchisor's minimum capital needs.

When a franchisor is asked to provide financial assurance, the franchisor has six main options in most states: (i) infusing more capital into the company; (ii) providing a third party guarantee of the franchisor's performance; (iii) posting a surety bond; (iv) agreeing to defer collecting initial fees until the opening date; (v) depositing initial fees into a third party escrow account until the opening date; or (vi) in some states, providing an informal undertaking.[52] The franchisor will need to amend the state-specific addenda to reflect the financial assurance condition. Some state regulators may require the franchisor to add a risk factor to the FDD state cover page. All franchisors must keep detailed records documenting how they dealt with initial fees paid by franchisees in the registration state during the time period that the financial assurance condition is in place.

1. <u>Capital Infusion</u>

An obvious solution for an undercapitalized franchisor is to obtain additional capital, *i.e.,* make additional capital contributions to the franchisor entity. Short-term loans, *i.e.,* loans repayable on demand or within 12 months, will equally increase both current assets and current liabilities and, therefore, not improve the franchisor's ratio or net working capital. However, long-term loans, *i.e.,* loans that are not repayable for at least 12 months, of a sufficient amount will work to correct an undercapitalized franchisor even if the loan is from an officer or stakeholder. In some cases, state regulators might require an undertaking that loans will be paid from retained earnings, not from current income, and that repayment will be expressly subordinated to the franchisor's obligations under all franchise agreements. This includes existing franchise agreements, not just any new franchise agreements signed during the next registration year.

2. <u>Guarantee of Performance</u>

An undercapitalized franchisor may offer a guarantee by an affiliate of its performance of franchise agreement obligations if the guarantor has audited financial statements that the franchisor includes in the FDD along with a copy of the affiliate's guarantee. Consequently, a

[52] In California, when a franchisor cannot meet its obligations in the FDD without relying on the proposed franchisee's funds, the state may impose an impound option. In this case, all initial fees paid by the franchisee are impounded and the franchisor must submit a copy of the Purchase receipt and a written consent of the depository where the funds reside. CAL. CODE REGS. tit. 10, §§ 310.113-310.113.5 (2012). A franchisor can avoid an impound if it a) increases capitalization; b) obtains a performance guaranty with guarantor's audited financials (where the guarantor can meet the FDD obligations); c) provides a surety bond; or d) defers the initial franchise fee until all franchisor's initial obligations are complete. Such a fee deferral must be disclosed in the FDD.

guarantee is not an option unless an affiliate has audited financial statements, which most non-public companies do not have. Some states may require that the guarantor be a parent and not a brother/sister affiliate. Even if the franchisor has an affiliate with audit history, this option sacrifices one of the main benefits of forming a new, separate legal entity as the franchisor: protecting the franchisor's operating company from claims by franchisees. Additionally, a significant drawback of an affiliate guarantee is that the guarantee is not limited to the franchisor's performance of pre-opening obligations and applies to the franchisor's performance throughout the term of the franchise agreement for each agreement signed during the period that the guarantee is in effect.

Illinois is the only registration state that requires a franchisor that relies on an affiliate guarantee to also file with the registration application a copy of the affiliate's corporate resolutions and secretary's certificate ratifying the affiliate's agreement to guarantee the franchisor's obligations. The franchisor need not include these documents in the FDD except for the affiliate guarantee itself.

3. <u>Surety Bonds</u>

With the exception of Indiana, South Dakota, and Virginia, all other franchise registration states permit a franchisor to satisfy a financial assurance condition by posting a surety bond. The bonding company must be a registered surety in the registration state. Consequently, if multiple registration states each impose a financial assurance condition, the franchisor will need a separate surety bond for each state. Most surety companies do not write franchisor bonds mainly because there is little demand for them and the bond risk is not well understood. The franchisor's existing insurance provider is a good place to start if this option is being considered. The amount of the bond typically is the product of the initial fees multiplied by the number of franchises the franchisor intends to sell in the state during the coming year. The advantage of the surety bond option is that the franchisor has access to the initial fees as soon as they are paid, which may be the principal source of cash flow for a start-up franchise company. Additionally, the bond covers only the franchisor's performance of pre-opening services and may be terminated once the franchisor's capitalization has improved. The disadvantage is that bonds can be very costly and a franchisor will need a separate bond for each registration state that imposes a financial assurance condition. As a practical matter, surety companies will be reluctant to write a bond for a franchisor who cannot otherwise meet the minimum capitalization standards asked for by the state regulator or will require an officer or shareholder to personally guarantee the bond, which diminishes the attraction of the bond option.

4. <u>Deferral of Initial Fees</u>

Deferring payment of initial fees until the franchised business' opening date is the simplest option for complying with a financial assurance condition. Some states may waive the impound requirement if the franchisor agrees to modify its franchise agreement so that no monies are payable to the franchisor until after the franchised business opens. From the state regulator's perspective, an initial fee deferral ensures that the franchisor will have other available working capital and cannot use a franchisee's initial fees to fund the cost of discharging pre-opening duties owed to that franchisee. Of course, the franchisor is at risk if it turns out that the franchisee lacks sufficient funds to pay the initial fees on the opening date. To reduce this risk, it is permissible to have the franchisee sign a promissory note stipulating that the initial fees are all due and payable on the franchised business' opening date. The promissory note coupled with threatened termination for breach of the franchise agreement will make it easier for the franchisor to recover the initial fees if the franchisor must initiate a legal proceeding.

5. Escrowing Initial Fees

All registration states allow a franchisor to satisfy a financial assurance condition by setting up an escrow account with a third party escrow company or bank where initial fees will be deposited and held until the franchisor and franchisee provide mutual instructions to release the funds by affirming that the franchisor has fulfilled all promised pre-opening obligations and the franchisee's business has opened. The advantage of the escrow option over a fee deferral is that the escrow requires the franchisee to pay the initial fees when the parties sign the Franchise Agreement and have real "skin in the game" early on. The primary disadvantages are the cost (escrow fees can be several percentage points) and complication if the franchisee refuses to sign mutual instructions for the release of funds when it is time to do so.

6. Informal Undertaking

In cases where a state regulator finds the franchisor's financial statements to be marginally adequate, the state may condition registration on a corporate officer agreeing to maintain a minimum cash balance in the franchisor's operating account throughout the registration period of some multiple of the initial fees (*e.g.,* two times) to be used as a fund to guarantee performance of pre-opening obligations to franchises sold during the registration year. There is no prescribed form of undertaking; a letter on the franchisor's letterhead is typically sufficient. The registration is issued in reliance on the franchisor's promise to maintain a minimum fund, so a breach of this promise would expose the franchisor to an independent statutory claim for fraud or filing false statements. Additionally, the state may require the marginally capitalized franchisor, either in addition to, or in lieu of, a written undertaking, to file quarterly unaudited financial statements so the state can stay abreast of changes in the franchisor's financial condition during the registration year.

VIII. NEGOTIATED SALES

A. Once a franchisor registers its offer, may a franchisor entertain negotiations of the terms of the registered franchise agreement?

Yes.

All registration states accommodate negotiation of the franchise agreement by franchise parties. State policies on negotiation are in keeping with the FTC's policy expressed in Section 436.9(h) of the Amended FTC Rule which states that the prohibition against contract disclaimers "is not intended to prevent a prospective franchisee from voluntarily waiving specific contract terms and conditions set forth in his or her disclosure document during the course of franchise sales negotiations."[53] The FTC's 2007 Compliance Guides also make clear that "franchise sellers and prospective franchisees may negotiate contract terms" without violating the disclaimer prohibition of the Amended FTC Rule.[54]

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[53] Amended FTC Rule, *supra* note 45.

[54] FEDERAL TRADE COMMISSION, FRANCHISE RULE COMPLIANCE GUIDE 142 (2008), *available at http://business.ftc.gov/documents/franchise-rule-compliance*-guide.

The Amended FTC does not require a franchise seller to redisclose the modified FDD or franchise agreement when the franchisee initiates negotiations even if negotiations result in *give-and-take* changes, some benefitting the franchisor. Only when the franchisor initiates negotiation (which in our experience is seldom) must the franchise seller redeliver the modified franchise agreement and wait another 7 days after its delivery before allowing the franchisee to sign a binding agreement or pay any fees for the franchise rights. This does not apply to non-substantive "fill-in-the-blank" provisions, such as the date, name, and address of the franchisee.[55]

California is the only registration state to go beyond federal law by imposing an extra disclosure and filing duty on franchisors that negotiate.[56] Illinois, Rhode Island, Washington, and Wisconsin each address negotiated sales in their franchise rules, but only to clarify that franchisors that negotiate (regardless of who initiates the negotiations) do not have to file any type of material change amendment before selling a franchise on terms materially different than the registered franchise agreement.[57]

California's rules on negotiated sales are intended to accommodate negotiations while informing any later prospective franchisees in the state about negotiated sales with California franchisees during the prior 12 months. A discussion of the California rules follows.[58]

Virginia's franchise sales law gives franchisees 30 days after signing a franchise agreement to void the agreement unless the agreement was negotiated.

Although this FAQ is directed at pre-sale negotiations, it is worth nothing that California and North Dakota also regulate post-sale modifications that the franchisor and an existing

[55] *Amended Franchise Rule FAQ's*, FEDERAL TRADE COMMISSION, at FTC FAQ #10 (last visited March 28, 2011), http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml#10.

[56] California's regulatory approach theoretically provides greater protection to prospective franchisees so it is not preempted by the Amended FTC Rule.

[57] The registration issue that led California to adopt its rule on negotiated sales is whether material terms negotiated with a prospect that differ from the terms of the registered offering constitute a new offer that must be registered as a material change amendment before a franchisor may close the franchise sale on the materially different negotiated terms. Under this logic, a separate amendment filing would need to be made, and an amended FDD redelivered, for each and every counteroffer in accordance with federal and state delivery rules - an extraordinarily burdensome requirement. That said, negotiated changes that are repeated and represent a pattern of deviation from the registered offering do require an amendment to the registration for future offerings: a franchisor would violate state franchise sales laws by submitting an FDD disclosing that its offer is X, but then routinely informing prospective franchisees that the franchise terms are materially different than X.

[58] *See* CAL. CORP. CODE § 31109.1 (West 2012) and CAL. CODE REGS. tit. 10, §§ 310.100.2, 310.100.4 (2012). To claim the exemption, Section 31109.1 requires a franchisor to file the Notice of Exemption set forth in Regulation 310.100.4. Regulation 310.100.2, however, also exempts negotiated sales without the need to file an exemption notice if different conditions are met. California's franchise regulators interpret and enforce these requirements by allowing franchisors to comply with either the statute or the regulation. However, neither Section 31009.1 nor the Regulation 310.100.2 expressly says that compliance with one excuses the franchisor from having to comply with the other. This means that while franchisors have little risk from regulators if they properly follow one path, such a choice may put them at risk for claims from franchisees pointing to a statute that does not spell out the option. Accordingly, some practitioners advise their franchisor clients to comply with both. At the time of this paper, the California State Bar Franchise Law Committee is studying solutions to eliminate the confusion.

franchisee may negotiate to an in-force franchise agreement. Neither the Amended FTC Rule nor any other state franchise law regulates post-sale contract amendments.

1. Two Approaches to Negotiated Sales in California[59]

California's law related to negotiated sales was enacted to give prospects more information about a franchisor's prior negotiating practices by requiring franchisors to file a notice with the California Department of Corporations about recently concluded negotiated sales. The need to make the public filing, however, may have had the unintended consequence of discouraging franchisors from negotiating at all.

In 2008, California amended its negotiated sales law to provide a method by which a franchisor could negotiate provisions of its franchise agreement with a prospect without having to make a filing with the state about the past negotiations. At the same time, California maintained its original filing requirements in the Regulations related to negotiated sales. Each of these methods is discussed below.

a. California's Statutory Negotiated Sale Procedure[60]

Under Cal. Corp. Code § 31109.1, changes to the Franchise Agreement which are negotiated in the sales process do not have to be registered with the California Department of Corporations so long as the initial offer is the offer registered in California, the negotiated terms confer additional benefits on the prospect and the prospect receives all of the following in a separate written appendix to the disclosure document: (i) a summary description of each material[61] negotiated term for a California franchise during the 12-month period ending in the calendar month immediately before which the negotiated offer or sale is made;[62] (ii) a statement indicating that copies of the negotiated terms are available upon written request; and (iii) contact information for the person in the franchisor's management from whom a copy of the negotiated terms may be obtained. The franchisor must also certify or declare in an appendix to its application for renewal that it has complied with all of the requirements of this section, if this exemption is claimed.

b. California's Regulatory Negotiated Sales Procedure

The regulatory requirements for California's negotiated sales exemption are considerably more onerous than the requirements in Cal. Corp. Code § 31109.1. The regulations require a franchisor to amend its Franchise Disclosure Document and file notices with the Commissioner. Not surprisingly, most franchisors choose to comply with the less burdensome requirements of § 31109.1. Practitioners should be mindful, however, of the

[59] CAL. CORP. CODE § 31109.1 (West 2012); CAL. CODE REGS. tit. 10, §§ 310.100.2, 310.100.4 (2012).

[60] CAL. CORP. CODE § 31109.1 (West 2012).

[61] Material is defined in this section to mean "that a reasonable franchisee would view the terms as important in negotiating the franchise." The franchisor must maintain copies of all material negotiated terms for which this exemption is claimed a period of 5 years from the effective date of the first agreement containing the relevant negotiated term.

[62] The franchisor must provide a copy of the negotiated terms described above to the prospective franchisee within 5 business days following the request of the franchisee.

specific requirement in § 31109.1 that requires that "the negotiated terms, on the whole, confer additional benefits on the franchisee."[63] Although negotiated agreements typically favor the franchisee, there may be instances where the net outcome of the give-and-take negotiated changes might not confer additional benefits. For instance, in the case of a prospective franchisee that might not otherwise qualify for a franchise program, the franchisee could suggest taking a smaller territory for the same fee, or putting more stringent payment terms in the agreement in order to get the deal. In these instances, the franchisor will be limited to the regulatory exemption in California.

Under California's regulatory negotiated sales procedure, the offer or sale of a franchise on terms different from the terms of the offer registered with California is exempt from the registration requirements if all of the following conditions are met:

i. The initial offer is the offer most recently registered, renewed or amended in California

ii. The prospective franchisee receives the Franchise Disclosure Document and all copies of all Notices of Negotiated Sales of Franchises filed with California within the last 12 months, if any.

iii. Before selling another franchise, the franchisor amends its Franchise Disclosure Document to provide that:

> "The terms of Items(s) _____ of this disclosure document have been negotiated with other franchisees. A copy of all Negotiated Sales Notices filed in California in the last 12 months is attached as Exhibit ____."

This disclosure should be made in the disclosure document Item that was negotiated or in an appendix to the document. This disclosure must be made if the negotiated sale occurred with 12 months of the offering being made. An amendment making only this disclosure is effective when filed.

iv. The Notice of Negotiated Sale of Franchise must be filed with the Commissioner within 15 business days after the negotiated sale is consummated.

v. The franchisor certified or declares in an appendix to its application for renewal that all notices have been filed with the Commissioner.[64]

This requirement applies even when negotiations are initiated by the prospective franchisee.

[63] CAL. CORP. CODE § 31109.1(a)(4) (West 2012).

[64] CAL. CODE REGS. tit. 10, § 310.122 (2012).

B. **<u>If a franchisee initiates negotiation of the terms of the registered offer, is a franchisor free to counter with other changes that would materially adversely modify the terms of the registered offer?</u>**

Yes!

However, bear in mind that the California rule on negotiated sales still applies even when the franchisee initiates the negotiations.

Also, if the franchisor counters with its own negotiated changes and, on the whole, the franchisee ends up with a worse deal, the franchisor in California will not qualify for the statutory negotiated sales exemption, which means that, unless the franchisor satisfies the requirements of California's regulatory exemption, the franchisor must make a separate amendment filing for each and every counteroffer it proposes in the negotiation exchange. As noted, a franchisor only qualifies for the statutory negotiated sales exemption when the negotiated deal, on the whole, is a better deal than the franchisor's registered offer in California. While there is no objective measure for judging a franchisee's net gain from negotiation, the fact the franchisee accepts the negotiated deal and signs a negotiated franchise agreement is not, in and of itself, dispositive that the overall deal is a better deal for the franchisee since the same predatory sales practices that franchise sales laws aim to combat could explain why the California franchisee took the negotiated deal.

Despite publicly reported California enforcement actions against franchisors for not filing a Notice of Negotiated Sale,[65] there is no known case or enforcement action against a franchisor for claiming the negotiated sales exemption despite closing negotiated franchise sales that left the franchisee worse off.

C. **<u>After concluding a negotiated sale, does a franchisor owe a duty to subsequent prospective franchisees to disclose either the fact that the franchisor has negotiated the terms of its franchise agreement with earlier prospects or the specific terms of the negotiated sale?</u>**

Yes in California; no in all other franchise registration states. See the discussion in FAQ VIII A. Additionally, all franchisors must disclose in Item 5 of the FDD if initial fees are uniform and, if not, the range or formula that the franchisor used to calculate the initial fees paid in the fiscal year before the FDD issuance date and the factors the franchisor considered in determining initial fees in the prior year.

IX. RENEWAL APPLICATIONS AND ANNUAL REPORTS

A. **<u>What is the difference between a renewal application and an annual report?</u>**

The distinction is basically in the terminology used by different states. For instance, in Illinois, regulators refer to "renewal applications" as applying to registered franchisors and "annual reports" as those forms filed by a franchisor claiming the annual large franchisor exemption. In contrast, in New York, registered franchisors are required to file "annual reports" each year. Typically the franchisor seeking to renew a registration is required to provide a

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[65] Yakety Yak Wireless, Inc., Case Nos. 995-3725, 993-5995, (Cal. Dept. of Corps. April 14, 2009), *available at* http://www.corp.ca.gov/ENF/list/y/YaketyYak.asp.

revised FDD, current audited financial statements, pay a fee, and submit other supplemental documents depending on the state.

B. How is the renewal process different from the initial registration process?

Regulators scrutinize initial registration applications more closely than they do renewals of existing franchisors. As a practical matter, renewal applications include a blacklined FDD showing the changes against a previously approved document. This necessarily can speed up the review process.

Thus, the renewal process should be a faster and less costly exercise than the initial registration when there are few changes to the franchise program and franchisor and the franchisor's latest audited financial statements are both compliant and demonstrate adequate liquidity and net worth. Even if all the elements appear to be in order, in updating the FDD in connection with renewal, practitioners should review all 23 items in the FDD with the franchisor's management and independently confirm that the audited financials are compliant.

Generally, the filing fees for renewals are only slightly less than for initial registrations. For example, in Minnesota the initial fee is $400 and the annual report fee is $200.[66] If the annual report contains a material change, the amendment fees are added on to the $200.

C. May a franchisor continue to engage in substantive conversations with a state resident about the franchise opportunity while a renewal registration application or annual report is pending in the state?

The law varies from state to state. For example, in Illinois, absent a denial order, the franchisor's registration is continuous, providing it timely files (one business day prior to its expiration date) a renewal application. Hawaii, Indiana, Michigan, South Dakota, and Wisconsin all have varying forms of continuing renewals based upon the filing of an updated FDD by the automatic effectiveness date. See FAQ V B.

California requires delivery of a written statement to a prospect while the renewal application is pending.[67] Section 31107 only exempts offers, not sales, and the exemption depends on complying with these conditions.

It is important to remember that the existence of a more recent audit is a material change so until the renewal application is approved, the franchisor may not close a deal on the about-to-expire FDD. Best practice is to tell the client to halt closing any sales until the new FDD is approved and it is delivered to the prospect.

D. What is the consequence if a franchisor decides to allow a state registration to lapse based on the franchisor's decision not to pursue franchise sales in that state?

Allowing a state registration to lapse can be a legitimate business decision. In fact, even if a franchisor's headquarters is located in a registration state, and there are existing franchisees

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[66] MINN. STAT. § 80C.18 (2012).

[67] *See* CAL. CORP. CODE § 31107 (West 2012).

in that state, there is no requirement to maintain a registration in the state if the franchisor does not plan to make any new offers in that state.

However, if a registration lapses and the renewal period passes without filing, the franchisor may not sell franchises in that state unless the franchisor re-files a new initial franchise registration application. The franchisor will not be able to rely on its previous filings as the basis for a renewal. They will have to wait until their new application is reviewed and approved before making any offers or sales. However, it may be smart to file a blacklined FDD to show the state the specific changes made to the FDD since the franchisor's last registration expired as this may expedite the state regulator's review of the FDD.

X. MANAGING FRANCHISE SALESPERSONS AND BROKERS

A. What is the difference between a franchise salesperson and a franchise broker?

The primary distinction between a franchise broker and franchise salesperson is that the former is an independent contractor while the latter is an employee of the franchisor. Both are "franchise sellers" under the Amended FTC Rule which defines a "franchise seller" as a person that offers for sale, sells, or arranges for the sale of a franchise."[68] Consequently, franchise sellers who are employed by the franchisor (aka franchise salespersons) and those who work as independent contractors (aka brokers) are treated alike under the Amended FTC Rule for purposes of whose name must appear on the FDD Receipt page and who may face personal liability for statutory violations.

Distinguishing between franchise sellers who are employed by the franchisor and those who work as independent contractors is important in registration states for two reasons:

1. A special risk factor must be added to the state cover page when the franchisor uses franchise brokers or third parties that provide lead generation services;[69] and

[68] Amended FTC Rule, *supra* note 45 at§ 436.1(j). "Franchise sellers" include the franchisor's employees (including officers) and other sales representatives regardless of their title or affiliation with the franchisor. The term, "franchise seller" is intentionally broadly defined. It includes persons who may (i) be identified in Item 2 of the FDD; (ii) own an interest in the franchisor entity; (iii) in their own right be a franchisee of the franchisor, like a subfranchisor; or (iv) undertake duties on the franchisor's behalf to recruit new prospects and provide post-sale support to franchisees in a designated geographic area as in the case of a development agent or area representative, even if they do not enter into a franchise agreement with the franchisee. The term, "franchise seller" also includes independent contractors that act as finders, brokers or provide lead generation services.

"Franchise broker" is not defined in the Amended FTC Rule. It had been defined in the original FTC Rule, which had made brokers jointly and severally liable with franchisors for the accuracy and timely delivery of the franchisor's disclosure document. The Amended FTC Rule relieved brokers from joint and several responsibilities and, consequently, the FTC found no reason to retain a separate broker definition given the breadth of the new franchise seller definition.

The FTC clarified in the 2007 Statement of Basis and Purpose that existing franchisees who sell their own franchise business or are compensated by the franchisor for providing leads or referring candidates who ultimately buy a franchise, *but are not otherwise engaged in franchise sales for the franchisor on a regular basis*, are *not* franchise sellers. *See* Amended FTC Rule Statement of Basis and Purpose, *supra* note 7.

[69] "We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our

2. New York and Washington impose additional registration obligations on brokers. A franchisor is responsible for making sure that its brokers operating in New York and Washington comply with the additional registration requirements before they engage in activities constituting an "offer to sell" the franchisor's franchises in the state.

All registration states except Virginia require identification or registration of all franchise sellers, franchise salespersons and brokers alike, which in all states (including New York and Washington) is accomplished by filing a Franchise Seller Disclosure Form (Form C of the NASAA Uniform Franchise Registration Application). As noted, New York and Washington additionally require franchise brokers to separately register with the state to signify their authority to sell franchises on behalf of the named franchisor.[70]

In all registration states except California, franchisors may add new franchise sellers during a registration year very simply by submitting the NASAA Franchise Seller Disclosure Form with a cover letter and without paying a fee. California is the only registration state where franchisors must file a post-effective amendment and pay a $50 filing fee to add a new franchise seller mid-year. In New York and Washington, of course, when the new franchise seller qualifies as a franchise broker under the state's definition, the broker cannot represent the franchise in franchise sales activities until the broker separately registers with the state regardless of when during the franchisor's registration cycle the broker's services are retained.

As a practice tip, franchisors should promptly notify each registration state by letter after severing ties with a previously registered franchise seller to avoid being held responsible under agency theories for any unauthorized representations by the former franchise seller.

Each franchise seller who is instrumental in effecting a particular franchise sale must be named on the FDD Receipt. This duty is further discussed *infra* at FAQ X D.

B. <u>What factors determine if a development agent, regional developer or area representative is a (i) franchise broker; (ii) subfranchisor; or (iii) franchisee?</u>

The terms "development agent," "regional developer" and "area representative" lack a common definition in federal and state franchise sales laws and in colloquial franchise parlance. The terms are used interchangeably to refer to an agent of the franchisor who performs pre-sale and/or post-sale services to franchisees and who may, in addition, be authorized to recruit prospective franchisees. The name given to the person, be it development agent, regional developer, area representative, area developer, regional developer or something else, is unimportant. However, classifying agents regardless of their title as a (i) franchise broker; (ii) subfranchisor; or (iii) franchisee is important because each classification imposes on the franchisor different statutory duties vis-à-vis each relationship. When individuals are classified as a franchise broker or subfranchisor, it also results in their having their own statutory duties under franchise sales laws.

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franchise or referring you to us. You should be sure to do your own investigation of the franchise." N. AM. SEC. ADM'R ASSOC., FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES § III(B)(6) (2008).

[70] The New York franchise broker registration form can be found at Bus. Franchise Guide (CCH) ¶ 5320 (2012) or on the New York Attorney General's website, http://www.ag.ny.gov/. The Washington broker registration form can be found at http://www.dfi.wa.gov/sd/franchiseformsapps/fba.pdf (last visited June 20, 2012).

1. **Franchise Broker**

To determine if a party referred to as a development agent, regional developer or area representative is a franchise broker one must go through two steps: first, determine if the party qualifies as a "franchise seller" (see FAQ X A); and, second, determine if the party is an employee of the franchisor or an independent contractor. Regardless of the party's title, if a party undertakes to perform the franchisor's pre-sale and/or post-sale duties to a franchisee, the party is the franchisor's agent as a matter of law. Agency status typically implies independent contractor status, but not always, so the relationship between the franchisor and agent must be separately tested under the state's labor laws determining employer status.

2. **Subfranchisor**

A key fact, but not necessarily the defining fact in all states, for determining if a party referred to as a development agent, regional developer or area representative is a subfranchisor is whether the party is required to pay a *fee* for the right to enter into franchise agreements in its own name with a franchisee.

The FTC identifies the *payment of a franchise fee and the right to enter into contracts directly with the franchisee* in Amended FTC Rule FAQ #9 as the essential facts for determining subfranchisor status.[71]

California adopted a similar policy in Commissioner's Release 18-F despite the fact that its franchise sales law defines a subfranchise in the disjunctive according to whether the agent has the right to "*sell or negotiate the sale*" of a franchise. The right to *negotiate the sale* of a franchise is not an activity that requires the agent to actually enter into a franchise agreement.[72]

Several other registration states also use the same disjunctive "*sell or negotiate the sale*" of a franchise phrase found in California's law: Hawaii, Illinois, Maryland, New York, North Dakota, Rhode Island, Wisconsin, and Washington. In *Pinchin v. Nick-N-Willy's Franchise Pizza Co.,*[73] the Washington Supreme Court ruled that an area developer was a subfranchisor under the Washington Franchise Investment Protection Act based on the area developer's role in discussing the franchise agreement with prospective franchisees even though the area

[71] *Amended Franchise Rule FAQ's*, Federal Trade Commission, at FTC FAQ #9 (last visited March 28, 2011), http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml#9. The Amended FTC Rule defines a "subfranchisor" within the definition of "franchisor" and defines the latter as: "any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. Amended FTC Rule, *supra* note 45. For purposes of this definition, a "subfranchisor" means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance." *Id.*

FTC FAQ #9 clarifies that "in order to be considered a subfranchisor, a party must have - as a franchisor has - (1) the authority to enter into a franchise agreement (or another agreement relating to the franchise), and (2) as a result of entering into such an agreement, that party is obligated to perform after the purchase of the franchise is consummated." Brokers may be instrumental in recruiting and sometimes screening franchisees, but are typically not a party to the franchise agreement and have no post-sale commitments to franchisees.

[72] California Dept. of Corps., Release No. 18-F: Franchisors, Subfranchisors and Development Agents (2008), *available at* http://www.corp.ca.gov/Commissioner/Releases/pdf/18F.pdf.

[73] Pinchin v. Nick-N-Willy's Franchise Pizza Co., Case Nos. 63417-8-I, 63418-6-I, 2009 Wash. LEXIS 1069 (Wash. Ct. App. July 22, 2009).

developer did not enter into the franchise agreement in its own name with the franchisee and lacked authority to commit or bind the franchisor to the specific terms discussed with the franchisee in the franchise agreement.[74]

Illinois law has long spoken to the right to "sell or negotiate the sale" of franchises in its definition of a subfranchise. Similar to California, the right to "sell or negotiate the sale" does not correspond only to the execution of a franchise agreement. In fact, the definition of a subfranchise is silent regarding agreements and their execution. Prior to October 1, 2009 the Illinois Franchise Disclosure Act was more expansive regarding the right "to service franchises or to sell or negotiate the sale of franchises" when defining a subfranchise.

Whether Hawaii, Maryland, New York, North Dakota, Rhode Island, and Wisconsin follow California's, Illinois's, or Washington's interpretation of the pivotal "*sell or negotiate the sale*" language will determine if a development agent, regional developer or area representative that operates and pays a fee to a franchisor to become a franchise seller in the state is a subfranchisor. These states have not formally articulated their policies on this issue to our knowledge. Practitioners should consult state law interpretations and confer with the chief state regulator to verify the state's policy on this issue.

Excepting Illinois, the significance of finding a development agent, regional developer or area representative to be a subfranchisor is two-fold:

a. The franchisor will need to have a separate registration to sell subfranchises in the state or states covered by the subfranchisor's territory and in any other registration states with jurisdiction over the franchisor-subfranchisor arrangement independent of the franchisor's registration to offer unit franchises in the subfranchisor's territory (assuming the franchisor retains the right to sell unit franchises within the subfranchisor's territory); and

b. As a subfranchisor, regardless of the title given to the party, the development agent, regional developer or area representative will need to have its own registration to offer and sell franchises (i) in any registration state in the subfranchise territory, and (ii) in any other registration states with jurisdiction over the subfranchisor-franchisee arrangement.

Illinois does not require separate offerings, registrations, or FDDs distinguishing sales by and/or from the franchisor and its subfranchisors. A franchisor may offer the sale of subfranchisors and unit franchises within a single filing. And to enhance efficiency even more, that same filing/FDD also enables a subfranchisor to "piggy-back" on the franchisor filing. The proviso to these combined registrations/disclosures is comprehensibility, for both the prospect and the franchise examiner. Illinois law still cites the requirements to file separately with

[74] The Washington court was persuaded that the area developer was a subfranchisor based on evidence that the area developer discussed the franchise agreement with prospective franchisees. "In communicating with Pinchin and laying the groundwork for Nick-N-Willy's interview of Pinchin it seems unavoidable that Moore's role was part of the negotiation process. The inability to enter into binding franchise agreements is not critical where the area developer satisfies the disjunctive or provision of the statutory definition." *Pinchin v. Nick-N-Willy's Franchise Pizza* Co., Nos. 63417-8-I, 63418-6-I, 2009 Wash. LEXIS 1069, at *6 (Wash. Ct. App. July 22, 2009).

clarification as to applications.[75] However, the Illinois Rules are in the process of being rewritten to conform with the amendments to the Act.

3. Franchisee

The key fact in determining if a development agent, regional developer, or area representative is a franchisee is if the party pays a *required fee* to become the franchisor's agent. In other words, who pays whom in the arrangement: does any money flow up from the agent to the franchisor or does all compensation flow down from the franchisor to the agent? Typically, development agents, regional developers, area representatives and parties with equivalent sales and support roles receive an agreed-upon percentage of the fees that the franchisor collects from the franchisee as sales commission. This money flows down (from franchisor to the development agent, regional developer, or area representative, not up to the franchisor). In many cases, however, the development agent, regional developer, or area representative will pay a fee upon execution of the agency contract to acquire the agency rights. When the fee exceeds the minimum payment in the state franchise sales law, the payment is a franchise fee and the sales agency arrangement is a franchise.

The significance of finding a development agent, regional developer, or area representative to be a franchisee is that the franchisor will need to be registered in each state with jurisdiction over the arrangement.

C. What best practice tips should a franchisor take to ensure that its franchise salespersons and brokers have not made unauthorized representations in presenting the franchise program to a prospect?

Franchisors should conduct some type of closing interview with the prospect or have the prospect complete a "closing acknowledgement" form immediately before the franchisee is allowed to sign the franchise agreement that asks the franchisee a series of questions to expose any unauthorized representations. Unauthorized representations frequently involve statements amounting to financial performance representations, promises about the franchisee's right to buy additional franchises, and changes to the franchise agreement. It is easy enough to ask the candidate broadly if (i) any representations were made to them about the prospect's likely financial results or about the operating results of existing outlets; or (ii) any terms and conditions were promised to them that are not in the franchise agreement or are contrary to the franchise agreement. The advantage of using a "closing acknowledgement" form is that it preserves a written record whereas statements made at an in-person closing interview that is not videotaped can later be forgotten or refuted.

Both the Amended FTC Rule and all state franchise sales laws either by statute or public policy prohibit a franchisor from using a contract integration clause to deny claims by franchisees about promises made outside of the franchise agreement by the franchisor's officers or representatives to induce the franchisee to enter into the franchise agreement. A written "closing acknowledgement" entered into by the franchisee at the closing is not per se illegal in the same way as a contract integration clause. If the "closing acknowledgement" is signed by the franchisee immediately before the franchisee signs the franchise agreement, it provides a contemporaneous record of the franchisee's state of mind at the time of execution of the franchise agreement as to whether the franchisee is relying on off-contract promises and

[75] ILL. ADMIN. CODE tit. 14, § 200.701.

should be persuasive evidence in helping the franchisor defeat claims by the franchisee that any off-contract promises were made. That said, if the franchisee lied in the "closing acknowledgement" by representing that no off-contract promises were made, but later claims they were made, the public policy forbidding contract integration clauses will allow the testimony, though the franchisor may have a legitimate defense that it would have never closed the sale had the franchisee told the truth.

When a prospect reveals at a closing interview or in a written closing acknowledgement that, in fact, unauthorized representations were made, the franchisor should hold up the closing and have the prospect identify the unauthorized representations. The franchisor should memorialize the unauthorized representations in writing for the purpose of creating a written record in which the franchisor expressly disclaims the unauthorized representations. The franchisor may go forward in selling a franchise to the prospect, but it is advisable that the franchisor first wipe the slate clean symbolically by re-disclosing the prospect and restarting the minimum waiting period. Once the waiting period expires, the parties may repeat the closing process including having the franchisee complete a closing interview or sign a new closing acknowledgment. A franchisor should never close a sale with a prospect who reveals at a closing interview or in a written closing acknowledgement that unauthorized representations were made.

The franchisor should also use the opportunity to discipline the sales agent responsible for making the unauthorized representations. If this is not the sales agent's first infraction, the franchisor should consider terminating the relationship with the sales agent for cause. At a minimum, the franchisor should remind the sales agent responsible for making the unauthorized representations that if the franchise relationship does not work out and the franchisee brings an action against the franchisor based on the sales agent's unauthorized representations, the sales agent will be jointly and severally liable as a franchise seller for any liability to the franchisee.

D. What should a franchisor do if, before signing a franchise agreement, a prospect identifies someone from the franchisor's organization with whom the prospect had substantive conversations about the franchise opportunity who is not named on the acknowledgement of receipt page of the FDD that the franchisee signed at the time the FDD was originally delivered?

Franchisors have the burden of making sure the FDD Receipt identifies all franchise sellers, but they do not have to figure this out independently without asking prospects with whom they met to discuss the franchise opportunity. Amended FTC Rule FAQs #12, #15, and #23 endorse the practice of having franchisees identify all individuals with whom he or she had significant contact during the sales process leading up to the closing before allowing the franchisee to sign the franchise agreement.[76] If the franchisee identifies additional franchise

[76] See *Amended Franchise Rule FAQ's*, FEDERAL TRADE COMMISSION, at FTC FAQ #12, 15, 23 (last visited March 28, 2011), http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml, which discuss alternative ways for a franchisor to ensure that the FDD Receipt identifies all persons instrumental in a sale, even those who only first become involved after the FDD is delivered and the FDD Receipt is signed by the franchisee. As noted in the text at FAQ X C, a safe bet for franchisors to ensure that they capture all franchise sellers before the franchise is sold is to add the information at the franchise closing or immediately before the franchisee signs the franchise agreement. Amended FTC Rule FAQ # 23 indicates that the minimum waiting period for FDD delivery does not apply to updating the FDD Receipt to add additional franchise sellers. ("If, for example, a franchisor invites prospective franchisees to its headquarters for one or more days of discussions concluding with a franchise sale, as is not uncommon, the franchisor should know which of its officers and employees will have significant contacts with the prospect during those discussions.")

sellers besides those listed on the FDD Receipt attached to the FDD that the prospect signed when the FDD was originally delivered, the franchisor may add the additional names at the closing. A best practice tip is to add the names to two copies of the *original FDD Receipt* that the candidate signed to acknowledge the FDD's delivery and give one copy of the updated FDD Receipt to the candidate and retain the other copy for the franchisor's records so that both franchise parties have an identical record of all franchise sellers. Contact information for each franchise seller must appear on the FDD Receipt. When new franchise seller information is added to the FDD Receipt, a franchisor should also add a notation with the date that the franchise seller information is added and have the franchisee initial the date.

Even when there is no formal closing where parties come together to sign the franchise agreement, updating the FDD Receipt can be accomplished by collecting the information *before* the candidate signs the franchise agreement, adding the names supplied by the candidate to the original FDD Receipt, and emailing the updated FDD Receipt as a PDF document to the candidate *before* the candidate signs the franchise agreement. As noted, Amended FTC Rule FAQ # 23 makes clear that the minimum waiting period applicable to execution of the franchise agreement or payment of consideration *does not apply* to updating the FDD Receipt to add the names of all franchise sellers. Thus, taking care of this immediately before the candidate signs the franchise agreement, whether at a formal closing or otherwise, is a reliable safety net for ensuring that no one who qualifies as a franchise seller in the franchisee's mind is left off the FDD Receipt.

Asking a prospect to identify the individual franchise sellers that they have dealt with does not shift the burden of identifying franchise sellers to the prospective franchisee. The burden of proof remains with the franchisor.

Franchisors should not add the franchise seller information to a blank FDD Receipt. However, it is acceptable to add the franchise seller information to a copy of the original Receipt that the franchisee signed even if the document does not bear the franchisee's original signature, only a copy of the franchisee's signature. The goal here is simply to prove that complete franchise seller information was added at or before the time the franchisee signed the franchise agreement. Consequently, the franchise seller information need not be on the original document.

XI. REGISTRATION DUTIES WHEN A FRANCHISOR AWARDS SUBFRANCHISES

A. <u>What factors determine if a third party is a subfranchisor?</u>

The Amended FTC Rule and state franchise sales laws do not uniformly define a "subfranchise." Because a subfranchise is a franchise, all definitions require the putative subfranchisor to pay a fee for the rights received. Where the definitions differ is whether a subfranchise is created when the rights awarded in exchange for the fee paid give the subfranchisor the right to enter into franchise agreements in its own name with a franchisee, or whether a subfranchise exists even when the subfranchisor has no authority to sign the franchise agreement, but may discuss or negotiate the terms of the franchise agreement with the candidate with the understanding that the deal is still subject to the franchisor's final approval and execution of the franchise agreement. See discussion in FAQ X B 2.

B. When a franchisor (aka "master franchisor") awards subfranchises, what information about the master franchisor must be included in a subfranchisor's FDD? What information about the subfranchisor must be included in the master franchisor's FDD?

A franchisor has the same registration and disclosure obligations to subfranchisors as it has to a unit franchisee. The franchisor's subfranchise FDD must disclose the material terms and conditions of the subfranchise relationship including required payments by the subfranchisor and the parties' respective duties to unit franchisees. A franchisor that offers to sell subfranchises must register the subfranchise FDD in each registration state where the franchisor offers subfranchises. If the franchisor will also award unit franchises in the registration state, the franchisor would have to maintain two state franchise registrations, one to sell subfranchises and one to sell unit franchises.

Typically, subfranchises are awarded for larger geographic areas and there may only be one or a handful of subfranchises awarded for the same state. A franchisor may be tempted to "sell out" the state and let its subfranchise registration lapse. If the franchisor has no current registration to sell subfranchises and if the subfranchisor later wants to assign its subfranchise agreement to a buyer, the franchisor will not be able to change the selling subfranchisor's deal. The franchisor will further be required to allow the proposed buyer to assume the selling subfranchisor's subfranchise agreement unless the franchisor becomes registered again to sell subfranchises in each registration state with jurisdiction over the transaction.

A subfranchisor has independent registration (except in Illinois) and disclosure obligations in connection with its own franchise sales activities. The Amended FTC Rule makes the franchisor and subfranchisor each responsible for the accuracy of the disclosures contained in the FDD that apply to the other, and they can be held jointly and severally liable for each other's conduct. For that reason, a franchisor with a subfranchise network will typically prepare a template FDD with most items completed that explain the franchise program and give the subfranchisor detailed instructions for how to complete the remaining FDD Items to add subfranchisor information. The 2007 FTC Compliance Guides instruct: "Generally, Items 1-4 (information about the franchise system, prior business experience, litigation, and bankruptcy) call for both the franchisor and subfranchisor to supply information. In addition, a subfranchisor must provide Item 20 information (franchisee and company-owned outlet data). The franchisor must also provide Item 20 information if its statistics differ materially from the subfranchisor's statistics. Finally, both the franchisor and any subfranchisor must include their own financial statements in Item 21."[77]

The subfranchise agreement should stipulate that the subfranchisor may not register its FDD with any registration state unless it has been reviewed and approved by the franchisor. However, it should also make clear that the franchisor's approval does not render the franchisor liable for material misstatements or omissions by the subfranchisor that the franchisor did not know or have reason to know of.

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[77] A discussion of which party, the franchisor or the subfranchisor, may establish the fees payable by unit franchisees in the subfranchise territory and other practice tips for managing a subfranchise network and ensuring the subfranchisor's compliance with FDD disclosure and registration duties is beyond the scope of this paper.

C. Is a master franchisor jointly and severally liable to the subfranchisor's franchisees for the subfranchisor's franchise sales law violations?

Yes! Federal and state laws, however, provide a defense to fraud-based claims based on evidence proving that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he or she had exercised reasonable care, would not have known, of the untruth or omission.[78]

XII. REGISTRATION OF ADVERTISING AND PROMOTIONAL MATERIALS

A. When must a franchisor register its website content as franchisee advertising?

If the franchisor is using its website material to target prospects in an advertising registration state, it will have to comply with the state's advertising filing requirements.

Seven states require that advertising materials used to promote the sale of franchises within the state be filed with the state before they are published.[79] These states include: California, Maryland, Minnesota, New York, North Dakota, Rhode Island, and Washington. It is important to note that the advertisements that must be registered do not include the product or service that the franchise offers, just the sale of the franchise itself.

Nine states exempt internet-based franchise sales advertising from their registration requirements: California, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, and Washington.[80] In these states, a franchisor does not have to register its internet advertising so long as i) the offer says that it is not directed at residents of the state; ii) the offer is not in fact directed at residents of the state; and iii) the franchisor becomes properly registered in the state and complies with disclosure requirements. Rhode Island imposes additional procedural requirements that the franchisor avoid direct contact with a Rhode Island resident until a franchisor is registered or qualifies for an exemption or exclusion there.[81] California requires an advertising notice be filed there annually,[82] and Illinois limits contact to a franchisor keeping a list of prospects and requires a franchisor to notify prospects that it cannot engage in further discussion until it is registered there.[83] In New York, so long as a franchisor is registered there, and its website URL appears on the Cover Page of its FDD, and the advertising is not specifically directed to New York residents, the franchisor does not have to file its advertising.[84]

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[78] 15 U.S.C. § 45(m) (2012).; *see also* e.g., CAL. CORP. CODE §§ 31300, 31301 (West 2012).

[79] For a good summary of advertising requirements, see CAROL ANNE BEEN & SARAH J. YATCHAK, A BASIC OVERVIEW OF FRANCHISE AND CONSUMER ADVERTISING STANDARDS, ABA 31ST ANNUAL FORUM ON FRANCHISING 20 (2008). *See also* BRIMER *supra* note 5, at 91-92.

[80] CAROL ANNE BEEN & SARAH J. YATCHAK, A BASIC OVERVIEW OF FRANCHISE AND CONSUMER ADVERTISING STANDARDS, ABA 31ST ANNUAL FORUM ON FRANCHISING 20 (2008).

[81] R.I. GEN. LAWS § 19-28.1-6 (2010), Bus. Franchise Guide (CCH) ¶ 5390.01.

[82] CAL. CODE REGS. tit. 10, § 310.156.3(a) (2012).

[83] ILL. ADMIN. CODE tit. 14, § 200.306 (2012).

[84] N.Y. COMP. CODES R. & REGS. tit. 13 § 200.12(a) (2012).

B. Is a franchisor that is exempt from registration required to register its franchise advertising and marketing materials relating to the sale of franchises in the registration state?

Probably.

As previously discussed in Section IV, certain states provide for exemptions from registration. Typically the statutes that contain the exemptions from registration refer to the same franchise law that governs registration of advertising. See FAQ III E 3.

C. What best practice tips should a franchisor implement to ensure that it has registered all versions of its franchise advertising and marketing materials relating to the sale of franchises?

Maintaining accurate records is crucial in ensuring compliance with filing requirements. In much the same way that the prudent practitioner tracks filed versions of registration materials, franchisors should track versions of its advertising and where it is directed. Franchisors should verify that the relevant advertisements and marketing materials have been filed before sending any materials to any prospect. Further, in the event that a franchisor is relying on an exemption from filing based, for instance, on an advertisement in a general circulation publication, it should document that publication's circulation to ensure that no more than a required percentage of the subscriptions are sold in the target state.

D. As a practical matter, do franchise regulators monitor franchisor advertising practices?

Yes, some state regulators do. It is certainly easy for regulators to review a franchisor's website. This review could be prompted by something in the FDD (many errors or inconsistent statements), by a tip on the regulator-only listserv, or by public inquiries made about the system. It is important that a franchisor not include things on its website that contradict what appears in the FDD. For instance, if the FDD does not include Item 19 financial performance representations, yet there are glowing testimonials about how much money a franchisee will make on the website, a regulator will take keen notice.

XIII. RECORD KEEPING DUTIES

A. What franchise sales records must a franchisor retain to meet federal and state record retention requirements?

There is no federal record retention requirement that applies specifically to franchise sales records. The guidelines to the federal Paperwork Reduction Act of 1980 state that a federal agency cannot impose a records retention period of longer than three years (except for health, medical, or tax records, or a demonstrated substantial need for a longer time period).[85] Similarly, the Uniform Preservation of Private Business Records Act permits businesses to destroy records after three years.[86]

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[85] BRIMER, *supra* note 5, at 280.

[86] *Id.*

Several states do require franchisors to retain specific franchise sales documents for a minimum length of time after concluding a sale. For instance, Minnesota, North Dakota, and South Dakota each require franchisors to retain the FDD receipts for three years.[87]

Before a franchisor jumps to adopt a three year document retention policy, it must consider other factors. Franchisors should balance their legal obligations and strategies with practical business considerations when adopting a document retention policy. For instance, in Illinois, the statute of limitations for a written contact is 10 years. And franchise agreements frequently last 10 or more years, and may include renewal periods. A prudent policy is to keep records during the time that a franchise agreement is in effect plus a relatively few extra years (which should together be no less than the longest time period required by any state law).

Some business people err on the side of caution and want the confidence to know that they can access documents at any time. However, there may be a significant burden on company resources to catalog and retain voluminous franchise records (including the corresponding off-site charges for maintaining inactive records). Thus, there is some appeal to a shorter retention period. A franchisor should consult with counsel to weigh the potential risks in future litigation of having particular documents available with the costs associated with maintaining them. There are some useful guides to establishing a records retention policy.[88]

The most likely time for a franchise regulator to request a franchisor's sales records (or advertising or other business records) is when the regulator is investigating a system (e.g. for illegal sales activities or compliance concerns). These may be prompted by any of the following: a disgruntled franchisee; an overeager franchisee calling to see if a system is registered; an article appearing in the IFA SmartBrief; a local newspaper article featuring a new franchisor that is coming to town, or discussing a licensor's sales activities; suspensions, orders of denial, and advisories to cease sales activities in a state; and of course, the regulator-only listserv. A regulator may ask for copies of the FDD distributed, the franchise agreement executed, and the receipt. A regulator may also want to review the alleged promises made in the sales materials.

B. What best practice tips should a franchisor implement within its organization to discharge its record retention duties and ensure that all persons responsible for franchise selling activities retain appropriate records?

The first step is to establish a policy. This should be done with counsel to be sure that it conforms with a franchisor's legal obligations and with company executives so that it is practical. Next, the policy should be carefully articulated in writing. Once the policy is adopted, the appropriate members of the franchisor's management who will be responsible for its implementation must be trained in what documents to retain and where and how to retain them. Finally, the company should monitor the process to be sure that records are in fact being

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[87] MINN. STAT. § 80C.05, subdiv. 5, Bus. Franchise Guide (CCH) ¶ 3340.08 (2012); N.D. CENT. CODE § 51-19-08.6, Bus. Franchise Guide (CCH) ¶ 3340.08 (2012); S.D. CODIFIED LAWS § 37-5A-48, Bus. Franchise Guide (CCH) ¶ 3410.48 (2012).

[88] See BRIMER, *supra* note 5; Lyn Brown, Guide to Record Retention Requirements: In the Code of Federal Regulations as of January 2006 (CCH 2007); D. Skupsky, *Legal Requirements for Business Retention: The Three-Year Presumption!* in LEGAL REQUIREMENTS FOR BUSINESS RECORDS ¶ 020-050-00, BRIMER, *supra* note 5 at 280.

retained or destroyed consistent with the policy. Part of this monitoring is implementing periodic reviews to confirm that the policy is appropriate and compliant.

XIV. CURING STATUTORY VIOLATIONS

A. When a franchisor is filing an initial registration application, must the franchisor notify the franchise regulator about previous licensing arrangements entered into by the franchisor with state residents or for locations in the state that the franchisor knows or should reasonably believe are franchises under state law?

Yes. And there are practical reasons for self-reporting previous violations to state regulators.

Item 1 requires the franchisor to make disclosures about the franchisor's previous business activities. If a franchisor previously awarded licenses and is now registering the same or similar program as a franchise, this information needs to be disclosed and identification of the licensees should be disclosed. If the franchisor knows or reasonably believes that the previous licensing arrangement was a franchise under state law, it should notify the state regulator and explain its steps for becoming compliant.

Under this voluntary self-reporting process, a franchisor prepares a Notice of Violation subject to the direction of the regulator and sends the state-approved correspondence to the franchisee to cure the unregistered sale. (Of course, the alternative of electing not to self-report is that the franchise registration may be denied if the franchisor does not go through this process or the company may be subject to enforcement action.) In California, this notice alerts the franchisee to the unregistered sale and shortens the statute of limitations.[89] In New York, in addition to the shorter statute of limitations, damages are limited by self-reporting and issuing a voluntary notice to franchisees.[90] Whether via a Notice of Violation or another notification format, in Illinois, the franchisee is notified of the reduced statute of limitations.[91]

Importantly, state franchise regulators are less likely to impose fines or penalties on franchisors trying to do the right thing - especially if there has been no corresponding harm to franchisees.

B. Will a franchisor's voluntary disclosure of previous unregistered franchise sales automatically result in denial of a franchise registration application or imposition of administrative penalties?

No. In fact, depending upon the circumstances, the franchisor may receive a more lenient decision or no penalty based upon its self-reporting. The regulators are primarily concerned with whether franchisees have been harmed by the unregistered sale. If a franchisor can demonstrate factors that led to its inadvertent failure to register, regulators will have less incentive to punish the franchisor. For instance, regulators have considered whether a

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[89] CAL. CORP. CODE § 31303 (West 2012).

[90] NEW YORK GEN. BUS LAW, § 691(2) (McKinney 2012).

[91] 815 ILL. COMP. STAT. 705/27 (2012).

franchise system's decision not to register was based upon incorrect legal advice. If the franchisees bought the franchisor system, and as owners incorrectly believed that such an arrangement did not qualify as a franchise, or they otherwise misinterpreted their eligibility for an exemption, these factors will be seriously considered by regulators.

Consideration of franchise registration and administrative orders and penalties are reviewed on a case by case basis. Franchisors should be upfront about the circumstances, have a plan to become compliant, be responsive to state inquiries, and, above all, be cooperative with regulators.

C. <u>What kind of statutory infractions are most likely to result in an administrative penalty or sanction (whether monetary or a cease and desist order requiring FDD disclosure)?</u>

A state franchise regulator's primary concern is to protect (i) the integrity of the fully disclosed sales process, and (ii) state citizens who may have bought a franchise during a period when the franchisor was not registered to sell franchises. So, when a state regulator finds evidence that a franchisor has engaged or is engaging in purposeful non-compliance, or evidence that demonstrates a careless or reckless failure to know and comply with federal and state laws or a pattern of noncompliance in other jurisdictions, regulators will exercise their discretion to impose penalties and sanctions. These may include commencing an informal or formal investigation, issuing an order of denial of a registration application, issuing a cease and desist order prohibiting franchise sales, suspension of an existing franchise registration, imposing fines, ordering restitution of money or rescission of existing agreements, freezing bank accounts, or imposing other penalties.[92] These sanctions may be directed not just to the franchisor-entity, but also to affiliated entities and their management. The franchisor's behavior is a large contributing factor in a regulator's reaction.

XV. RESPONDING TO AGENCY INVESTIGATIONS

A. <u>How frequently do franchise regulators receive complaints from unhappy franchisees and how do franchise regulators most commonly handle these complaints?</u>

Regulators receive complaints regularly from a variety of sources. Most registration states provide the public access to complaint forms on their websites. This allows complaints to be submitted in writing and routed to the regulator assigned to the franchise system. Regulators typically speak to the complainants to determine if they have jurisdiction over the complaint and, if so, to verify the facts. At that point, the complaint is reviewed on a case by case basis to determine what, if any, state action will be pursued.

B. <u>How frequently do franchise regulators receive complaints from a franchisor's competitors and, if so, how do franchise regulators most commonly handle these complaints?</u>

Complaints from the competition or other disgruntled individuals are common. The nature of the complaint and the evidence provided is the focus of case by case consideration.

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[92] *See* MARTIN CORDELL, MARK B. FORSETH & BRIAN SCHNELL, THE ULTIMATE REMEDY: MANAGING REGULATORY ENFORCEMENT ACTIONS, ABA 34TH ANNUAL FORUM ON FRANCHISING (2011).

Therefore, the quality of the complaint and not the source of the information is the determining factor in whether or not the state takes action.

C. Do franchise regulators as a matter of practice always notify a franchisor about complaints received about the franchisor or its franchise salespersons or brokers?

No. Regulators do not typically notify franchisors about complaints especially since complainants can often elect to be anonymous. Franchise regulators are careful not to identify a complainant inadvertently. A franchisor may be able to identify a complainant from the fact that a complaint was filed (or when it was filed) or from the nature of the complaint.

D. After a state regulator receives a complaint about a franchisor's alleged unfair or unlawful franchise sales practices in the state, will the state regulator typically alert his or her counterparts in other franchise registration states and the FTC about the complaint?

It depends. It is common practice for franchise regulators to discuss unusual franchisor issues on the regulator-only listserv. If there are certain facts about a franchisor's sales practices (widespread complaints, illegal "licensing" activities in multiple states) or reactions to inquiries from the regulator ("no other state had a problem with this," or flagrant disregard or indifference), then a regulator will likely post an inquiry or otherwise notify other state franchise regulators. The regulator-only listserv is a valuable tool for the regulators.

E. What factors influence when an informal investigation will be reconstituted as a formal agency proceeding?

The number one factor that influences whether the state will take action is evidence that demonstrates a purposeful disregard in understanding and complying with state and federal law. And, candidly, if a franchisor is dismissive, evasive, argumentative, or refuses to provide requested information, a regulator may elevate the investigation to a formal agency proceeding.

F. What factors influence when a state franchise agency will expand a formal or informal investigation to name the franchisor's parent company and their respective officers, directors or key members of management (i.e., "control persons")?

The number one issue that will expand an investigation is documented fraud. For instance, one state regulator was presented with multiple affiliated franchisors selling different franchises under separate filings. The regulator keyed in on the financials. What appeared to be solid, profitable franchisors in fact turned out to be companies with sizeable account receivables, liabilities, and revenues that were being shuffled among the various affiliated entities. Registration was interrupted, corrected financials were required, and the franchisor was obliged to provide financial assurances.

G. What recourse does a franchisor have to appeal an administrative order?

A franchisor has very little practical recourse with respect to appealing an administrative order. Although state statutes provide a right to appeal a franchise regulator's decision and include a formal hearing process, as a practical matter, the regulator who issued the administrative order will likely be part of the process.[93]

XVI. CONCLUSION

The same principles that guide franchise practitioners in managing a successful multi-state franchise registration practice apply to creating effective relationships with state franchise regulators. One must be organized and prepared, have researched the mosaic of applicable regulatory details, and, above all recognize that the job of franchise regulators is to protect consumers (franchisees).

This paper has identified some common registration practice issues and misconceptions about the registration process, offered best practice tips for operational and sales practices, and highlighted enforcement concerns from state regulators.

A successful state registration practice involves more than simply getting a compliant FDD registered. It includes adopting strategies for efficient state registration and management. Determining what laws apply and where a franchisor must register is a key first step. Recognizing that more than one state may assert jurisdiction over any single sale is crucial. If a franchisor sells in multiple states, franchise practitioner must orchestrate a variety of state franchise registrations and exemptions, and advertising registrations or exemptions. This requires keen attention to due dates, document versions, and document management. It is efficient and economical to manage registration and expiration periods so that renewals will occur at the same time each year. When preparing the FDD note that the financials are likely a threshold issue in some jurisdictions. It is important to become familiar with these and anticipate if a financial assurance will be required. These are very state specific, so a franchisor need not provide a financial assurance unless requested by a regulator. Understanding the "automatic effectiveness" rules in states and timely filing renewals will avoid blackout periods.

Franchise practitioners should work with their franchisors to adopt best practices for their company operations and policies that will assist in the registration process. These operational practices often yield valuable evidence that can be used to defend or support any enforcement actions.

The sales process is where many practitioners focus their attention. Again, it is crucial that everyone involved in the sales process identify that frequently more than one state's law may apply to a single sale. Proper training and document management will help sales people identify and navigate the key events triggering different states' jurisdiction during the sales process. Establishing a process to send notices to sales people regarding where and when they can sell will help avoid improper sales. Sales people need to learn the nuances of the negotiated sales process (especially filings and disclosures).

Sometimes, things go wrong. A prudent franchisor will confirm representations made during the sales process and review essential matters with the franchisee before the franchisee

[93] In California, failure to request a hearing within 60 days results in the order becoming final. The section specifically states the order "shall not be subject to review by any court or agency." CAL CORP. CODE §§ 31402 & 31403 (West 2012). In Illinois a hearing may be requested within 15 days of the order being issued. If a timely request is received the hearing will be set within 10 days of receipt, unless the consenting party agrees to a later date. If a timely hearing request is not made then the order will remain in effect until it is modified or vacated by the Administrator. ILL. ADMIN. CODE tit. 14, § 200.404 (1988).

signs the franchise agreement. If there has been an improper representation, the franchisor should “rewind” the process, document the situation (take appropriate action with the errant salesperson), and redisclose. If the franchisor fails to properly register, the best strategy to minimize or avoid sanctions and penalties is to self-report the circumstances to the applicable regulator. In some jurisdictions, complying with a Notice of Violation process has significant added legal benefits to the franchisor.

Filing compliant registration applications will likely result in a practitioner having little interaction with state regulators. However, when those unusual situations arise, it is best to be prepared, be forthcoming, and engage the appropriate regulators in the solution. Understanding the regulators’ concerns of ensuring the integrity of the sales process and protecting state citizens will help practitioners anticipate what a regulator may require.

And above all, be nice.

APPENDIX A

Additional Resources

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Amended Franchise Rule FAQ's, Federal Trade Commission (March 28, 2011).

N. Am. Securities Adm'rs Ass'n, Franchise Registration and Disclosure Guidelines (2008).

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State franchise sales laws can be found in Commerce Clearing House (CCH), Business Franchise Guide, and on the website of each state agency that is responsible for regulating franchise sales. The CCH Business Franchise Guide is a handy resource since it compiles all state laws and regulations in one place. However, states often post additional filing instructions on their website that are not always picked up by the Business Franchise Guide.

SECONDARY MATERIALS

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