



**International Franchise Association  
43<sup>rd</sup> Annual Legal Symposium  
May 16-18, 2010**

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**Basics Track:  
Disclosure Requirements Under Federal and State Laws**

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## **BASICS TRACK: DISCLOSURE REQUIREMENTS UNDER FEDERAL AND STATE LAWS**

In the United States, sales of franchises are regulated by the Federal Trade Commission (“FTC”) and various state agencies. Prior to offering or selling a franchise, the FTC requires franchisors to provide prospective franchisees with a disclosure document known as a Franchise Disclosure Document or “FDD,” for short. Fifteen states have laws and regulations regulating franchise sales. Fourteen of the fifteen states require franchisors to register with state agencies prior to offering franchises in the state and most of the states review the document to ensure that the disclosures are adequate. This paper will describe the basic disclosure requirements under both the federal and state regulatory regimes.

### **I. A BRIEF HISTORY OF FRANCHISE REGULATION**

Beginning in the early 1970s, a movement developed to regulate franchise sales in the wake of several high profile instances of deceptive franchise sales. News outlets reported multiple stories of franchisees making significant investments in nationally known chains, only to learn that the rights that they purchased were worthless. Some franchisors had taken advantage of the lack of regulation by misrepresenting the costs involved in the purchase and operation of franchises and vastly exaggerating expected gross income.

In response to these incidents, California enacted the first Franchise Investment Law in 1970 mandating certain disclosures, franchise sales practices, and registration requirements. In the next decade, 14 other states (Hawaii, Indiana, Illinois, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin) followed suit, adding their own versions of franchise investment laws.

After almost a decade of investigation, the Federal Trade Commission joined the regulatory fray in 1979 by enacting its "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (the "FTC Rule").<sup>1</sup> Like the state statutes, the FTC Rule mandated certain disclosures and added a waiting period before a franchise could be purchased. The FTC Rule, however, differed significantly from the state regulations in that it did not include a registration requirement or permit a private right of action for violations.

The FTC alleviated much of the complexity caused by dual levels of regulation by stating that its rule preempted state laws only to the extent that state laws provided less protection to prospective franchisees. Since most of the registration statutes required franchisors to comply with guidelines set forth by the North American Securities Administrators Association (“NASAA”), which required more comprehensive disclosures than those mandated by the FTC Rule, many of the problems created by dual federal and state regulation were eliminated. Thus, until 2007, disclosure documents were

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<sup>1</sup> 16 C.F.R. 436.1 *et seq.*

referred to as Uniform Franchise Offering Circulars or “UFOCs” and followed the guidelines set forth by NASAA.

In 2007, the FTC Rule was amended after a twelve year long review. The amended FTC Rule adopted in large part the disclosure requirements mandated by the NASAA Guidelines for UFOCs, but made substantial modifications to some sections. The UFOC name was abandoned in favor of the current Franchise Disclosure Document designation. In 2008, NASAA updated its own guidelines to largely conform with the revised FTC Rule’s requirements (with the exception of some state-specific additions), making the state and federal disclosure requirements substantially similar.

## **II. APPLICABILITY OF FRANCHISE STATUTES**

In order to determine whether federal or state franchise laws apply to a given business relationship, one must analyze whether the arrangement is covered by the jurisdictional scope of each statute, meets the definition of a “franchise” under the applicable statute, and qualifies for any exemptions or exclusions.

### **A. Jurisdictional Scope of Franchise Statutes**

Determining whether a business relationship is covered under a statute can be difficult under the state laws, but is easy under the FTC Rule. The FTC Rule applies to all offers and sales of franchises to be located in the United States and its territories. Thus, if the franchised outlet will be located internationally, the FTC Rule will not apply, regardless of where the franchisee is located.<sup>2</sup>

State statutes uniformly cover franchise sales activity taking place in each state. The states vary, however, as to what constitutes franchise sales activity within a state. The elements considered include where the offer to sell originated, where the offer was accepted, where the franchised business will be located, and where the prospective franchisee resides. Each state’s franchise sales law applies to franchised businesses that are located in the state. However, some state statutes, such as California’s, does not apply to franchisors located within the state that are making sales of franchises to franchisees that reside out of the state and intend to operate their business out of the state.<sup>3</sup> In contrast, other state statutes, such as New York’s, apply to franchise sales emanating from franchisors located in the state, regardless of whether the franchisee that purchases the business and the actual franchised business are located outside of the state.<sup>4</sup> As a consequence, each statute must be examined carefully, as it is quite possible for two state franchise statutes to apply in any given transaction.

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<sup>2</sup> Franchise Rule §Guide (“Compliance Guide”), available at <http://www.ftc.gov/bcp/edu/pubs/business/franchise/bus70.pdf>, p. 7. The Compliance Guide was issued by the FTC in May 2008.

<sup>3</sup> Cal. Corp. Code § 31105, BFG ¶ 3050.281.

<sup>4</sup> N.Y. Gen. Bus. Law § 681(12), BFG ¶ 3,320.02.

## **B. The Definition of Franchise**

While it is often an open and shut case when determining whether a relationship is a “franchise,” because federal and state laws vary on the definition of “franchise” and the lines of demarcation concerning certain variables are often gray, it can sometimes be a challenging analysis.

### **1. Under Federal Law**

Under the FTC Rule, there are three key elements for a commercial relationship to meet the definition of a franchise:

a. The franchisee must obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or must offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark.<sup>5</sup>

b. The franchisor must exert or have the authority to exert a significant degree of control over the franchisee’s method of operations or must provide significant assistance in the franchisee’s method of operation.<sup>6</sup>

c. The franchisee must make a required payment to the franchisor or its affiliates.<sup>7</sup>

When evaluating whether a business arrangement is a franchise, the trademark association element and required payment element are typically easily identifiable and are satisfied by most trademark license agreements. While the existence of a trademark license certainly satisfies the trademark element, substantial association with a trademark alone is sufficient. The required payment element may be satisfied by any payments made to the franchisor or its affiliates, such as initial franchise fees, training fees, rent, equipment rental expenses, security deposits, continuing royalties, and payments for required good, services, or equipment.<sup>8</sup> The purchase from the franchisor or its affiliates of “reasonable amounts of inventory at bona fide wholesale prices for resale or lease” however, does not constitute a required payment under the FTC Rule.<sup>9</sup>

A trademark licensing arrangement typically also includes some controls placed upon use of the mark. In fact, the Lanham Act virtually mandates that some control be imposed upon a licensee in order for the franchisor to retain the validity and ownership of the mark. These trademark controls alone, however, are not enough in themselves to create a franchise relationship.

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<sup>5</sup> 16 C.F.R. 436.1(h)(1).

<sup>6</sup> 16 C.F.R. 436.1(h)(2).

<sup>7</sup> 16 C.F.R. 436.1(h)(3).

<sup>8</sup> See Compliance Guide at 5.

<sup>9</sup> *Id.* at 6.

The difference between a trademark licensing relationship and a franchise relationship thus often turns on the amount of control or assistance that a franchisor exerts over a franchisee, which also happens to be the most difficult element to evaluate. The purpose of the control element is to measure a franchisee's reliance on the franchisor's business expertise. To be significant, the control or assistance must relate to the franchisee's overall method of operation, rather than controls aimed at the sale of a specific product with a marginal effect on the franchisee's entire business. Significant types of control include: site approval for unestablished businesses; site design or appearance requirements; hours of operation; production techniques; accounting practices; personnel policies; promotional campaigns requiring franchisee participation or financial contribution; restrictions on customers; and locale or area of operations. Significant types of assistance include formal sales, repair, or business training programs; establishing accounting systems; furnishing management, marketing, or personnel advice; selecting site locations; furnishing system-wide networks and website; and furnishing a detailed operating manual. Inventory controls, required displays of goods, requirements that a franchisee service or repair a product, and on-the-job assistance with sales or repairs will also be considered to a lesser extent when determining whether significant control or assistance is present. However, merely providing a distributor with point-of-sale advertising displays, sales kits, product samples and other promotional materials intended to assist the distributor in making sales is not sufficient alone to satisfy this element.<sup>10</sup>

In addition to trademark controls designed solely to protect the trademark owner's rights to a mark, the FTC has determined that several types of assistance and control do not satisfy the element, including, health or safety restrictions required by law; a bank credit interchange organization and retailers or member banks for the provision of credit cards or credit services; and assisting distributors in obtaining financing.<sup>11</sup>

## 2. Under State Laws

Substantively, the state registration laws describe the definitional aspects of franchises in a similar manner as under the FTC Rule, although the wording may appear quite different. All of the state statutes (with the exception of New York) require both the trademark association element and required payment element to be met.<sup>12</sup> However, rather than talking in terms of "substantial assistance" or "significant control," twelve states (California, Illinois, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin) require that the franchisee

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<sup>10</sup> *Id.* at 3-4.

<sup>11</sup> *Id.* at 4.

<sup>12</sup> New York requires the franchise fee element and either a marketing plan element or a trademark element to be satisfied, but not all three. See N.Y. Gen. Bus. Law §681(3), BFG ¶ 3,320.02.

also be required to follow a prescribed or suggested "marketing plan" or system prescribed in substantial part by the franchisor.<sup>13</sup>

What constitutes a marketing plan varies by state. The statutes of Illinois, Rhode Island, and Washington specify the following as relevant in determining whether a marketing plan exists: specification of price, special pricing systems, or discount plans; use of particular sales or display equipment or merchandising devices; use of specific sales techniques; use of advertising and promotional material or cooperation in advertising efforts; formal operations or management training; and operational, managerial, technical, or financial guidelines or assistance.<sup>14</sup>

The three remaining registration states (Hawaii, Minnesota, and South Dakota) replace the significant control or assistance prong with a requirement that the franchisor and franchisee share a "community of interest" in the marketing of goods and services.<sup>15</sup> These states determine whether a community of interest exists by examining the interdependence of the parties, the shared goals and cooperative efforts of the parties, and the existence of a continuing financial interest between the parties. While not dispositive, if a significant percentage of a franchisee's business is attributable to franchisor's products, it is strong evidence that there is a continuing financial interest between the parties.

### **3. Business Opportunities**

Even if a relationship does not meet the definition of a franchise, it is possible that it could be considered a "business opportunity." Business opportunities, which include sales of vending machines and rack displays, are regulated by a federal rule.<sup>16</sup> Under the federal rule, a "business opportunity" is a continuing commercial relationship in which the seller arranges for the purchaser to obtain a supply of goods, commodities, or services and secures for the purchaser retail outlets or accounts for the goods, commodities, or services or secures for the purchaser locations or sites for vending machines, rack displays, or any other products displays used in the offer or distribution of goods, commodities, or services.

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<sup>13</sup> See Cal. Corp. Code § 31005, BFG ¶ 3,050.07; 815 Ill. Comp. Stat. § 705/3(1), BFG ¶ 3,130.03; Ind. Code § 23-2-2.5-1(a), BFG ¶ 3,140.01; Md. Code Ann., Bus Reg. § 14-201(e), BFG ¶ 3,200.01; Mich. Comp. Laws § 445.1502(3), BFG ¶ 3,220.02; N.Y. Gen. Bus. Law § 681.3, BFG ¶ 3,320.02; N.D. Cent. Code § 51-19-02.5, BFG ¶ 3,340.02; Or. Rev. Stat. § 650.005(4), BFG ¶ 3,370.01; R.I. Gen. Laws § 19-28.1-3(g), BFG ¶ 3,390.03; Va. Code Ann. § 13.1-559.A., BFG ¶ 3,460.03; Wash. Rev. Code § 19.100.010(4), BFG ¶ 3,470.01; Wis. Stat. § 553.03(4), BFG ¶ 3,490.02.

<sup>14</sup> See 815 Ill. Comp. Stat. § 705/3(18), BFG ¶ 3,130.03; R.I. Gen. Laws § 19-28.1-3(i), BFG ¶ 3,390.03; and Wash. Rev. Code § 19.100.010(5), BFG ¶ 3,470.01.

<sup>15</sup> See Haw. Rev. Stat. § 482E-2, BFG ¶ 3,110.02; Minn. Stat. § 80C.01, subd. 4, BFG ¶ 3,230.01; S.D. Codified Laws § 37-5B-1(11), BFG ¶ 3,411.01.

<sup>16</sup> See 16 C.F.R. 437.

Twenty-four states also have laws covering the sale of business opportunities, which are defined differently under each state statute. The state law definitions are often expansive enough to include traditional franchises or distributorships, as well as vending machines and rack displays. In particular, although Florida, Kentucky, Nebraska, Texas and Utah do not have franchise sales laws, their business opportunity laws may apply to franchises unless an exemption notice is filed (an annual filing is required in Florida and Utah and a one-time filing is required in Kentucky, Nebraska and Texas). Other state business opportunity laws, including those of Connecticut, North Carolina, and South Carolina, may apply to franchisors that have not registered the trademarks they license as part of the franchised business. Accordingly, these statutes must be taken into account in setting up any franchise or distributorship arrangement.

### **C. Exemptions and Exclusions**

Even if a business arrangement has all of the elements of a franchise, both the FTC and the states have exempted or excluded certain activities or persons from the scope of regulation. Under the FTC Rule, there are seven exemptions available that, if applicable, exempt franchisors from complying with the FTC Rule's disclosure requirements. Note that a franchisor should interpret the exemptions conservatively as they will ultimately bear the burden of proving that a certain transaction is exempt.

#### **1. Minimum Payment Exemption**

The FTC Rule exempts franchise sales where “the total required payments, or commitments to make a required payment, to the franchisor or any affiliate that are made any time from before to within six months after commencing operations of the franchisee’s business is less than \$500.” This exemption applies even if the franchisee makes a commitment to make a payment of over \$500 after the initial six months of operations, as might typically occur in a promissory note.<sup>17</sup>

#### **2. Fractional Franchise Exemption**

The sale of fractional franchises is also exempt. A fractional franchise exists when (i) the franchisee, any of its current directors or officers, or any of the directors or officers of a parent or affiliate have more than two years of experience in the same type of business as the franchise (a business selling competing goods or that would ordinarily be expected to sell the type of goods to be distributed under the franchise) and (ii) the parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee’s total dollar volume in sales during the first year of operation. A fractional franchise typically arises when a business expands its product offerings through the addition of a franchise.<sup>18</sup>

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<sup>17</sup> Compliance Guide, p. 7.

<sup>18</sup> *Id.*, at 8.

### **3. Leased Department Exemption**

The FTC Rule also exempts leased departments where an independent retailer sells its own goods and services from premises leased from a larger retailer in the larger retailer's store. The leased department exemption is only available if the independent retailer is not required to directly or indirectly to purchase its goods or services from the larger retailer or from a supplier required or approved by the larger retailer.<sup>19</sup>

### **4. Oral Agreements**

Oral relationships are exempt, on the grounds that it is difficult to enforce such agreements. However, if there is any writing regarding a material term of the relationship, such as a purchase order, the exemption will not apply.<sup>20</sup>

### **5. Petroleum Marketers and Resellers Exemption**

Petroleum marketers and resellers covered by the Petroleum Marketing Practices Act are exempt. Typically, this covers gasoline station franchises, but it is interpreted liberally to include other services and products such as a repair center, car wash, or convenience store, provided that the complementary business is sold under the same, unified franchise agreement as the gasoline station itself.<sup>21</sup>

### **6. Large Franchise Investment Exemption**

Franchises where the initial investment is at least \$1 million, excluding the cost of unimproved land and any franchisor or affiliate financing and any payments made to the franchisor, are also exempt. The initial investment includes expenses incurred prior to opening the franchise and in the first three months of operation. If an investor group is purchasing the franchise, to qualify for the exemption, at least one individual investor must invest at the \$1 million level.<sup>22</sup>

### **7. Large Franchisee Exemption**

The FTC Rule exempts franchise offers and sales made to large entities that have been in business for at least five years and have a net worth of at least \$5 million. The experience and net worth of a prospective franchisee's parents or affiliates may be considered.<sup>23</sup>

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<sup>19</sup> *Id.*, at 9.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*, at 10-12.

<sup>23</sup> *Id.*, at 12.



## 8. Insiders Exemption

Franchise sales to officers, directors, general partners, managers, and owners of the franchisor are also exempt. For an officer, director, general partner, or manager to qualify for the exemption, they must (i) purchase at least a 50% ownership interest in the franchise and (ii) have had at least two years of experience in such position with the franchisor within 60 days of the proposed franchise sale. For an owner of the franchisor to qualify, they must (i) purchase at least a 50% ownership interest in the franchise and (ii) have owned at least a 25% interest in the franchisor for at least two years within 60 days of the propose franchise sale.<sup>24</sup>

## 9. Federal Exclusions

In addition to exemptions, the FTC Rule specifically identifies five relationships which are excluded from the scope of the rule. These include (i) bona fide employer-employee relationships, (ii) general partnerships, (iii) agricultural cooperatives and retailer-owned cooperative chains, (iv) certification or testing services (such as Underwriters Laboratories), and (v) single trademark licenses where a single licensee is granted the right to use a trademark.<sup>25</sup>

## 10. State Exemptions

Even if a franchise sale qualifies for an exemption from the federal disclosure requirements of the FTC Rule, it is possible that the transaction would not be exempt under applicable state laws. There are a variety of exemptions available under each state's franchise statute that may exempt a franchisor from registration requirements and a number of exemptions that may exempt a franchisor from both registration and disclosure requirements.

The exemptions that are available vary by state and may differ in substance too. For example, nine state statutes exempt large franchisors whose net worth exceeds a specified amount (typically \$5 million) and who have experience operating large franchise systems.<sup>26</sup> Eight states exempt fractional franchises.<sup>27</sup> Six states exempt sales to sophisticated franchisees with certain levels of experience and net worth.<sup>28</sup> Most state statutes exempt isolated sales where a franchisor is selling only one franchise in the state. Some states permit franchisors to apply for a discretionary exemption, which may be granted by the state's regulators if a proposed sale does not pose a risk of deception. Thus, when considering state exemptions, it is imperative to carefully review each state's statute and regulations to determine whether an exemption

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<sup>24</sup> *Id.*, at 13.

<sup>25</sup> *Id.*, at 15-16.

<sup>26</sup> California, Illinois, Indiana, Maryland, North Dakota, Rhode Island, South Dakota, Virginia, and Washington. Notably, New York has an exemption that has a net wroth requirement but no experience requirement.

<sup>27</sup> California, Illinois, Indiana, Michigan, Minnesota, New York, Virginia, and Wisconsin.

<sup>28</sup> California, Illinois, Maryland, Rhode Island, Washington, and Wisconsin.

is available and whether it exempts the franchisor from disclosure and registration or only registration requirements.

### **III. THE DISCLOSURE DOCUMENT**

If a relationship meets the applicable state or federal definition of a franchise and does not qualify for exemptions, the franchisor or its counsel must prepare an FDD that includes certain disclosures mandated by the FTC Rule and state statutes. While the form of FDD is very similar among the various states, each state has its own peculiarities, which means that the document used to sell franchises in each registration state may be different in certain respects from that used in other jurisdictions. Typically, these state peculiarities are addressed in the form of addenda to the FDD and to related agreements so that a single FDD may be used in all fifty states.

A FDD includes 23 Items and numerous exhibits. The body of a typical FDD ranges from 30 to 50 pages. The entire FDD, including exhibits, often will be over 200 pages and can even balloon to over 700 pages for some of the largest franchisors. While the size of the FDDs may vary depending on the complexity of the offering or the size of the system, the content included may not vary, as the FTC Rule prohibits franchisors from including in a FDD any information beyond what is required or expressly permitted, such as testimonials or promotional literature, for example.

#### **A. General Information Required**

The following are the highlights of the key requirements for each disclosure Item as set forth in Sections 436.3 – 436.5 of the FTC Rule and the NASAA Guidelines<sup>29</sup>:

##### FTC Cover Page

- Franchisor's full legal name, state of formation, address, telephone number, and website address
- Sample of primary trademark used in the franchise system
- Brief description of franchised business and total estimated initial investment, including all initial fees payable to the franchisor or its affiliate
- Required legends, including use of electronic disclosure and alternatives
- Issuance date

State Cover Page (required by the NASAA Guidelines if franchisor will be doing business in one or more registration states)

- Legend regarding franchisee renewal rights
- Risk factors

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<sup>29</sup> The disclosure highlights in this paper are not intended as an exhaustive list of disclosure requirements, but merely as a summary of the key topics and requirements. See the FTC Rule and the NASAA Guidelines for complete lists of all required disclosure items.

- Statement regarding use of franchise broker or referral sources (if applicable)
- State effective dates

### Table of Contents

- Correct Item headings and pagination
- List of all exhibits, including state addenda

### Item 1 – The Franchisor and any Parents, Predecessors, and Affiliates

- Background and business experience of franchisor, parents, predecessors and certain affiliates
- Description of the franchise offering and general market for products or services
- General conditions of competition
- Laws and regulations related to the franchised business

### Item 2 – Business Experience

- 5-year employment history for directors, principal officers, general partners, trustees and any other individuals with management responsibility in connection with the sale and operation of the franchise
- List employer, location (city and state), and the starting and end dates (month and year) for each position

### Item 3 – Litigation

- Pending litigation in specified categories against the franchisor, any predecessor, any parent or affiliate that guarantees the franchisor's performance, any affiliate that offers franchises under the franchisor's principal trademark or any person identified in Item 2
- Currently effective orders or decrees from pending or concluded agency actions against the franchisor, any predecessor, any parent or affiliate that guarantees the franchisor's performance, any affiliate that has offered franchises in any line of business within the last 10 years, or any person identified in Item 2
- Franchisor-initiated litigation involving the franchise relationship during the past year
- Certain litigation during the past 10 years against the franchisor, any predecessor, any parent or affiliate that guarantees the franchisor's performance, any affiliate that offers franchises under the franchisor's principal trademark or any person identified in Item 2

- If no litigation to disclose, state: “No litigation is required to be disclosed in this Item.”

#### Item 4 – Bankruptcy

- Bankruptcy filings during the last 10 years involving the franchisor, any parent, any predecessor, any affiliate, or any officer, general partner, or any other person who will have management responsibility relating to the sale or operation of the franchise, including bankruptcy filings by other company’s for which those persons were either principal officers or general partners
- If no bankruptcy to disclose, state: “No bankruptcy is required to be disclosed in this Item.”

#### Item 5 – Initial Fees

- All fees and payments or commitments to pay for services or goods received from the franchisor or its affiliates before the franchisee’s business opens and whether and under what circumstances the fees are refundable
- Examples: initial franchise fee, initial training fee, computer system fees, initial supply packages

#### Item 6 – Other Fees

- All recurring fees that the franchisor or an affiliate collects or that the franchisor or its affiliates impose or collect on behalf of a third party
- Description of refundability and uniformity of fees

#### Item 7 – Estimated Initial Investment

- Estimated initial investment costs (typically for the time from the signing of the franchise agreement until the time the franchise has operated for three months), along with method of payment, due date, and party to whom payment made in tabular form, along with notes describing the costs. Categories should include initial franchise fee; training expenses; real property, equipment, other fixed assets, construction, remodeling; opening inventory; deposits and license fees; “additional funds” for initial period (typically 3 months), along with factors, basis and experience that franchisor considered in formulating the estimate; and any other required expenses
- Must include the following title directly above the table: “YOUR ESTIMATED INITIAL INVESTMENT”

#### Item 8 – Restrictions on Sources of Products and Services

- Identification of products and services that franchisees must purchase from the franchisor, its affiliates, third-party approved sources, or according to the franchisor's specifications
- Description of vendor approval process
- Identification of any supplier in which an officer of the franchisor has an ownership interest
- Statement on whether the franchisor or its affiliates derive income based on franchisee purchases, and, if so, the total amount received during the previous fiscal year, and the percentage of total revenue for that year represented by that amount
- Disclosure of payments made to franchisor by designated supplier based on franchisee purchases (e.g., rebates, commissions, sale of similar goods or services at lower price), along with basis of payment (flat rate or percentage)

#### Item 9 – Franchisee's Obligations

- Table listing the franchisee's principal obligations under the franchise agreement and other related agreements with cross-references to the agreement section numbers
- Description and order of obligations listed in the table are prescribed by the FTC and cannot be changed
- Must include the following statement (in bold) before the table: **“This table lists your principal obligations under the franchise and other agreements. It will help you find more detailed information about your obligations in these agreements and in other items of this disclosure document.”**

#### Item 10 – Financing

- Description of terms of any financing offered directly or indirectly to the franchisee by the franchisor or its affiliates or agents or any payments received by the franchisor or its affiliates from a lender based on franchisee financing with that lender
- Forms of financing documents must be attached to the FDD as an exhibit

#### Item 11 – Franchisor's Assistance, Advertising, Computer Systems, and Training

- Description of principal assistance and obligations provided by franchisor, including
  - Site selection and typical length of time between contract signing and opening

- Pre-opening obligations, such as training, provision of operations manual, construction design and plan approval, provision of proprietary goods or assistance in placing orders with approved suppliers, approval of grand opening advertising
- Initial training program in tabular form, along with identification of principal trainers and their experience in both the subject matter taught and the franchisor's operations
- Advertising program
- Any required electronic cash register or computer systems

#### Item 12 – Territory

- Description of any exclusive territory or inclusion of the following required language if the franchisor does not offer exclusive territories: “You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.”
- Disclosure regarding franchisor use of alternative channels of distribution to make sales in franchisee's territory, such as Internet and catalogue sales and whether franchisee has any rights to use alternative channels
- Franchisor or affiliate current or planned operation or franchising of a business under different trademarks that sells or will sell similar goods and services

#### Item 13 – Trademarks

- Registration or application information for principal trademarks, along with a brief description of any limitations on the franchisee's ability to use those marks
- Include the following language if a principal trademark is not registered on the Principal Register of the US Patent and Trademark Office: “We do not have a federal registration for our principal trademark. Therefore, our trademark does not have many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.”

#### Item 14 – Patents, Copyrights, and Proprietary Information

- Information regarding any patents, copyrights or other confidential information or trade secrets used in connection with the franchise

#### Item 15 – Obligation to Participate in the Actual Operation of the Franchised Business

- Description of any requirement that franchisee personally participate in the day-to-day operations of the franchised business

### Item 16 – Restrictions on What the Franchisee May Sell

- Description of any restrictions on goods or services offered or customers served, as well as whether the franchisor has the right to change the type of goods and services authorized for sale

### Item 17 – Renewal, Termination, Transfer, and Dispute Resolution

- Tabular disclosure of contractual terms affecting the franchise relationship, such as termination, renewal, transfer, modification, and dispute resolution
- Required legend in bold-faced type precedes table

### Item 18 – Public Figures

- Description of any compensation and management control of a public figure who endorses or recommends the purchase of the franchise or who is used in the franchise name or logo

### Item 19 – Financial Performance Representations

- Not required, but a franchisor may not make a Financial Performance Representation (“FPR”) to prospective franchisees if one is not included in Item 19, or if the FPR is inconsistent with the information in Item 19
- Definition of Financial Performance Representation: “any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits.”<sup>30</sup>
  - Charts, tables, mathematical calculations or formulas may qualify as an FPR if they represent the specific level or range of sales, income or profits that a prospective franchisee might attain
- Types of information that are considered to be FPRs:
  - Actual data on past sales or other performance measures achieved by company-operated or franchised units
    - Annual sales
    - Return on investment
    - Income or profits
    - Industry-specific measures (e.g., reservations, occupancy rates, revenue per available room for hotels)
    - Costs represented as percentage of revenue

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<sup>30</sup> 16 C.F.R. § 436.1(e).

- Statements that expressly or implicitly suggest a level of income, sales or profits
  - “Earn up to \$25,000 per year income”
  - “5 Customers per month; \$5,000 per customer”
  - “Earn enough money to buy a new Porsche”
- Forecasts of future performance
- Types of information that are not generally considered FPRs:
  - Financial information provided to lender directly in connection with arranging of financing is not an FPR
  - Actual operating results of a particular outlet in connection with the sale of that outlet to a particular franchisee
  - Blank pro-forma
    - CAVEAT: Filling in even some of the blanks likely will transform the pro-forma into an FPR
  - Cost data only as in Items 5 and 7
    - CAVEAT: If the cost data is presented with sales or earning information or represented as a percentage of revenues, the information likely will be considered an FPR<sup>31</sup>
  - Puffery
    - E.g., “Make big money,” “this business is a real cash cow,” or “Opportunity of a lifetime”<sup>32</sup>
- General Media Claims include radio, television, magazine, newspaper, billboard and electronic advertisements
  - FPRs included in general media must state:
    - The number and percentage of outlets that met or surpassed the represented level
    - The time period when the performance levels were achieved
    - Clear and conspicuous admonition that a new franchisee’s results may differ
  - The following are not considered general media claims, unless the franchisor uses them to directly target prospective franchisees:
    - SEC filings
    - Statements made in financial press or trade journals in connection with bona fide news article
    - Company press release or corporate speech
    - CAVEAT: If the franchisor provides reprints or otherwise directs prospective franchisees to these materials, they become FPRs
- Must include required preambles even if franchisor does not make an FPR
- If the franchisor includes an FPR in Item 19, it must meet certain requirements:
  - Identification of whether the FPR is based on historical or projected performance

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<sup>31</sup> Compliance Guide at 131.

<sup>32</sup> Compliance Guide at 131.



- Clear and conspicuous admonition that a new franchisee's results may differ
- The FPR must have a reasonable basis at the time it is made, and the franchisor must have supporting substantiation
  - The following can provide substantiation: "market studies, statistical analyses, franchisee profit and loss statements, as well as other types of information that are customarily relied upon by prudent persons in making business decisions"<sup>33</sup>
  - If the FPR is based on past performance of existing outlets, the FPR must include the dates when the financial performance achieved, total number of outlets at time of financial performance, any characteristics used to narrow number of outlets included in sample, number of outlets that had the characteristics, and the number and percentage of outlets in sample that achieved or surpassed the stated results

#### Item 20 – Outlets and Franchisee Information

- Tabular disclosure of total franchised and company-owned outlets, as well as state-by-state information on openings, terminations, non-renewals, reacquisitions by franchisor or cessation of operations for other reasons during the past 3 years
- Projected number of franchises to be sold in the next year (by state)
- Name of all current franchisees and addresses and phone numbers (may be attached as an exhibit)
- Name, city and state, and phone number of each franchisee who ceased operations in the past year, or who failed to communicate with the franchisor within 10 weeks of the application date (may be attached as an exhibit with required legend)
- Names and addresses of trademark-specific franchisee organizations formed, sponsored or endorsed by franchisor, along with names of independent franchisee associations that request inclusion
- Whether franchisor has entered into confidentiality agreements with current or former franchisees during the past 3 fiscal years

#### Item 21 – Financial Statements

- Audited balance sheets for the franchisor or an affiliate who absolutely and unconditionally guarantees the franchisee's performance as of the end of the last 2 fiscal years and their statements of operations, stockholders' equity and cash flows for the last 3 years

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<sup>33</sup> Compliance Guide at 137.

- If date of balance sheet and statement of operations more than 90 days before effective date, most states require unaudited financial statements
- Start-up franchisors may phase-in use of audited financial statements

### Item 22 – Contracts

- Samples of all proposed agreements that franchisee will be required to sign, such as the franchise agreement, guarantees, releases, license agreements for proprietary software, promissory notes, leases or lease addenda should be attached as exhibits

### Item 23 -- Receipts

- Attachment of 2 copies of acknowledgment of receipt in prescribed form – one for franchisee, one for franchisor to retain (for at least 3 years for each complete sale)
- Receipt includes name and address of “franchise seller”

## **B. Interpretation of Requirements**

At first glance, the disclosure requirements for each Item appear detailed and straightforward. Upon closer examination, however, practitioners may discover gaps or ambiguities in the text of the FTC Rule or NASAA Guidelines. Fortunately, both the FTC and the states provide a variety of sources that explain, interpret, and illustrate the statutory requirements, including the FTC Rule’s Statement of Basis and Purpose<sup>34</sup>, the Compliance Guide, the FTC’s Frequently Asked Questions (“FAQ”),<sup>35</sup> the FTC’s staff advisory opinions, the Commentary on the NASAA Guidelines,<sup>36</sup> as well as state regulations, interpretive opinions, policy statements, and commentaries.

### **1. FTC Guidance**

#### **a. The Statement of Basis and Purpose**

The Statement of Basis and Purpose contains the FTC’s section-by-section analysis of the final Rule, along with a review of comments received during the rulemaking process, is binding authority, and generally should be the first place that a franchise practitioner looks for clarification on a disclosure issue. For example, in-house counsel may be asked by the corporate communications or investor relations department whether it is permissible to post 10-Qs and 10-Ks on the company’s website. To respond to that inquiry, the franchise counsel might turn to the FTC’s

<sup>34</sup> 72 Fed. Reg. 15444 (March 30, 2007) available at <http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf> (“Statement of Basis and Purpose”).

<sup>35</sup> Available at <http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml> (“FAQs”).

<sup>36</sup> Available at [http://www.nasaa.org/content/Files/FranchiseCommentary\\_final.pdf](http://www.nasaa.org/content/Files/FranchiseCommentary_final.pdf).

analysis of the definition of “Financial Performance Representation” in the Statement of Basis and Purpose, and discover that the Commission concluded that treating such postings as “Financial Performance Representations” subject to disclosure requirements of the FTC Rule would be “pointless, unworkable, and unduly burdensome.”<sup>37</sup>

## **b. Compliance Guide**

The Compliance Guide is another useful source in preparing the FDD and answering general questions about disclosure obligations. While the Statement of Basis and Purpose provides the detailed legal and policy analysis behind each section of the rule, the Compliance Guide is a more practical, user-friendly, section-by-section guide to the required content and format for each Item with sample disclosures to illustrate the Rule. Unlike the Statement of Basis and Purpose, however, the Compliance Guide represents the FTC staff’s view only and has not been reviewed and adopted as binding authority by the Federal Trade Commission.

A practitioner may turn to the Compliance Guide to determine how best to disclose a particular item. For example, franchise counsel may question whether the Item 11 requirement to disclose a trainer’s experience can be met by a cross-reference to a manager’s biography in Item 2. Excerpts from the Compliance Guide’s commentary and sample disclosure for Item 11 attached as Exhibit B show that proper disclosure of a trainer’s experience for Item 11 purposes is somewhat different than that of Item 2 and requires only a statement regarding the length of experience with the franchisor’s operations and in the subject matter taught.

## **c. Frequently Asked Questions (“FAQ”)**

If franchise counsel is unable to resolve a disclosure issue after reviewing both the Statement of Basis and Purpose and the Compliance Guide, the FAQs may provide clarity. The FAQs treat all aspects of disclosure compliance and may provide additional insight into the FTC staff’s view on some of the details in the FTC Rule. For example, in responding to a questionnaire on Item 8, a franchisor may inquire whether there is a threshold level of ownership in a supplier by an officer that requires disclosure. FAQ #18 clarifies that the requirement to disclose officer ownership interest in a supplier depends upon whether the interest is “material,” which is a fact-specific inquiry.<sup>38</sup> Consequently, there is no minimum threshold of ownership interest in a supplier that would provide officers with a safe harbor from disclosure. Although the FAQs provide clear interpretive guidance on a number of issues, it is important to remember that similar to the Compliance Guide, the FAQs represent the staff’s views, are unreviewed by Commission and are therefore not binding.

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<sup>37</sup> Statement of Basis and Purpose at 15457-58.

<sup>38</sup> FAQ #18 at 12-13.

## **2. State Issues**

### **a. NASAA Guidelines and Commentary**

In addition to providing detailed guidelines on each disclosure item, the NASAA Guidelines<sup>39</sup> also include samples of the filing forms that are acceptable to most registration states, including the Uniform Franchise Registration Application, Franchisor's Costs and Source of Funds, Uniform Consent to Service of Process, Franchise Seller Disclosure Form, Guarantee of Performance, and Auditor's Consent. Similar to the FTC FAQs, the NASAA Commentary<sup>40</sup> provides additional explanation, analysis and guidance on interpreting the NASAA Guidelines and determining a franchisor's disclosure obligations.

### **b. State-specific disclosures**

Either by legislation or through policy, many registration states require additional disclosures or prohibit the use of certain contractual provisions, such as dispute resolution provisions, requirements that franchisees release claims against the franchisor as a condition of renewal, non-competition provisions, and waivers. Exhibit C contains a chart showing the additional and prohibited provisions in each registration state. Both the FTC and NASAA permit franchisors to disclose these additional/prohibited provisions through state-specific addenda to the FDD, the Franchise Agreement or both. In addition, certain states, such as Michigan and Washington, prescribe the form and content of the state-specific addenda that franchisors should use.

### **c. Frequently arising comments by state examiners**

If a state franchise examiner's review of the FDD indicates deficiencies in form or content, the state generally will refuse to register the offering until the deficiencies are cured, which can lead to delays or stoppages in the sales process. Fortunately, state franchise examiners have provided guidance to franchisors and their counsel over the years through informal conversations; deficiency letters and other correspondence; educational sessions; and general updates addressed to the franchise community. Some of the more common FDD deficiencies cited by state examiners include:

- Changing Item or table headings – Both the FTC Rule and the NASAA Guidelines clearly indicate the order and titles for each disclosure Item, and franchisors may not deviate from those requirements for any reason.
- Failure to include specific language or type style – Similar to Item titles and order, the FTC Rule and NASAA Guidelines clearly indicate that the

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<sup>39</sup> Available at <http://www.nasaa.org/content/Files/2008UFOC.pdf>.

<sup>40</sup> Available at [http://www.nasaa.org/content/Files/FranchiseCommentary\\_final.pdf](http://www.nasaa.org/content/Files/FranchiseCommentary_final.pdf).

FDD contain certain legends in bold-faced type, such as before the tables in Items 9 and 17.

- Failure of franchisors to include negative disclosures – If an item requires disclosure about a particular issue, the franchisor must address that point if only to state that it does not apply. Some items require the use of specific language to make a negative disclosure, such as in Item 3 (litigation), Item 4 (bankruptcy), Item 12 (non-exclusive territories), Item 13 (unregistered trademarks), and Item 19 (no financial performance representation).
- Inclusion of extraneous additional information – If information is not required under the FTC Rule, the NASAA Guidelines, or state law, most franchise examiners will require a franchisor to remove such additional information, unless it is otherwise material or necessary to prevent the required disclosure from being misleading. For example, franchisors often wish to include complete biographical information for officers and managers to highlight educational and professional accomplishments. If that experience covers more than the 5-year history required in the FDD or more than the individual's employment experience, most franchise examiners will require its removal. On the other hand, it is appropriate to disclose additional information as necessary to clarify a material disclosure issue, such as the definition of “gross revenues” or similar terms to fully explain the fees in Item 6. Such additional disclosures typically appear in footnotes or remarks.
- Use of legalese rather than Plain English – The FDD is not the place to showcase counsel’s command of Latin or other archaic legal terms. See Exhibit C for additional guidance on using Plain English.
- Failure to disclose state-specific information in the FDD, the Franchise Agreement or in an addendum.
- Excessive internal cross-references – If the same or similar information is required in two items (e.g., initial fees in Items 5 and 7), the franchisor generally should disclose that information in both Items rather than disclosing in one Item and cross-referencing in the other.
- Internal inconsistencies – For example, many franchisors indicated in Item 1 that they do not have a parent or affiliate, and then list an affiliate as a required source for franchisee purchases in Item 8. Inconsistencies also often occur between the total investment amount indicated on the Cover Page and the disclosure of fees in Items 5 and 7.
- Financial assurances – If a state franchise examiner’s review of the franchisors audited financial statements indicates that the franchisor may

be unable to meet its obligations to franchisees (typically because of negative net worth or inadequate financial ratios), the examiner may request that the franchisor provide “financial assurances” by deferring initial fees or placing them in an escrow account until the franchisor meets all pre-opening obligations and the franchised business opens, or posting a surety bond.

A more detailed, item-by-item listing of “Common Deficiencies Seen by Examiners in the Review of the FDD” provided in the “Ask the Regulators” session at the 2009 IFA Legal Symposium is attached as Exhibit D.

#### **IV. GATHERING INFORMATION FOR DISCLOSURE DOCUMENTS**

The preparation of an FDD does not stop with franchise counsel’s mastery of the FTC Rule and state disclosure rules. The key to producing a reliable FDD is obtaining complete and accurate information from the franchisor. Accordingly, before preparing the FDD, franchise counsel must develop a plan for gathering relevant information from the franchisor. Franchise counsel also needs to ensure that the information-gathering process is not limited just to the annual update period, but also that it will continue on an ongoing basis to capture any material changes in the franchise system or the franchise company during the year. In so doing, franchise counsel must educate the franchisor on the types of events that will trigger amendments to the FDD (see Section V.B below) and encourage constant communication throughout the year.

The method of information-gathering will vary based on the size and experience of the franchisor, whether franchise counsel is in-house or outside counsel, and the business practice and processes of the franchisor. All franchisors should designate a “point person” to shepherd the information-gathering, and large companies should provide counsel with access to the business departments responsible for the substantive areas covered by the FDD.

Franchise counsel must adapt the information-gathering process to the needs and strengths of the franchisor and typically use some combination of the following methods: questionnaires; face-to-face meetings and conference calls; review of franchisor’s website; state corporate records; corporate secretary, corporate minute books and records; and e-mail communications. Regardless of the method used, the franchise counsel should conduct her own due diligence to verify the accuracy of all material facts by requesting supporting documentation, reviewing corporate records and websites, or through cross-department verification. For example, financial data used in making disclosures in Item 8 and an Item 19 financial performance representation should be verified with the Accounting Department or the auditor. In addition, franchise counsel should thoroughly review the audited financial statement to ensure that the audited financial statement and all of the notes are consistent with the FDD since many financial statements include descriptions of the business and corporate structure. In addition, counsel should understand the financial health of the company so that she can identify whether large franchisor exemptions apply or conversely whether states are likely to

request financial assurances. Finally, the franchise attorney should obtain officer or department head sign-off on each revision to the FDD.

#### **a. Questionnaires**

Many franchise counsel begin with an item-by-item questionnaire to elicit the necessary information from their clients. Questionnaires may be used for initial FDDs, annual updates, or amendments and will need to be modified based on the nature of the filing. Questionnaires are also effective tools for obtaining the information needed from individual officers, directors, managers, and salespersons. See Exhibit E for a sample of an officer/director questionnaire.

The key to developing a questionnaire is to determine the identity of the personnel who will be completing it. For example, a questionnaire for a new franchisor making an initial offering likely will be more detailed and include more definitions than an annual update questionnaire for an established franchisor. Even if the franchisor assigns a “point person” as recommended, counsel should know whether the questionnaire will be delegated to various departments for completion so that each Item or section can be read as a stand-alone document.

After identifying who will complete the questionnaire, counsel can focus on preparation of the actual questionnaire. In drafting the questionnaire, counsel must define terms, such as “parent,” “affiliate” and “predecessor,” so that the franchisor understands which entities are subject to disclosure requirements. The questionnaire also should highlight any changes in the FTC Rule or state requirements from a previous year so that the franchisor will understand any new disclosure obligations. In addition, an amendment or update questionnaire should be drafted to ensure that the respondents read, review, and modify (if necessary) existing language rather than simply checking a “no change” box and moving to the next question. One technique for doing this is to request any internal memoranda, brochures, or other communications that describe various programs and fees so that counsel can tailor questions to current programs, rather than relying solely on previous descriptions of the franchise system. Finally, counsel should indicate on the questionnaire that additional questions may be necessary depending upon the answers so that the respondents will be prepared for follow-up discussions.

#### **b. Face-to-face Meetings and Conference Calls**

At some point in the information-gathering process, a face-to-face meeting or conference call likely will be necessary and should be encouraged. Some franchise counsel schedule meetings with questionnaire respondents after the questionnaire is complete to review the responses, answer questions, or clarify any outstanding issues of confusion. Some counsel and franchisors will even dispense with the questionnaire and schedule a day-long meeting to review the FDD line-by-line and update it together. If the face-to-face only approach is used, counsel still should prepare a questionnaire or

checklist to use in the meeting to ensure that any changes in the franchise system or disclosure requirements are captured.

**c. Franchisor's Website**

The franchisor's website is a good starting point for drafting an initial FDD and obtaining background information about the franchisor and the franchise system. In addition, the website review is another aspect of franchise counsel's due diligence and verification of questionnaire responses. Indeed, franchise counsel should review the franchisor's website throughout the year and request that the franchisor notify her when it will be making updates to that website so that she can confirm that the website remains consistent with the FDD. Franchise counsel also should be aware that many state franchise examiners will review franchisor websites when reviewing the FDD and failure by counsel to review the website to ensure consistency with the FDD could lead to delays in the registration process.

**d. State Corporate Records**

Another source of due diligence and verification of questionnaire responses is through state corporate record databases that show names of business organizations, dates of formation, and names of officers. Similar to the franchisor websites, some state franchise examiners will check these sites when reviewing a franchisor's registration application. Accordingly, franchise counsel should be aware of and correct any discrepancies between the information provided by the client and the official state records.

**e. Corporate Secretary, Corporate Minute Books, Records and SEC Filings**

The corporate secretary who manages the corporate organization of the franchisor and any affiliates and subsidiaries should have access to corporate information necessary to complete Items 1 and 2. Review of these corporate records should be another part of the franchise counsel's due diligence and questionnaire response verification. In addition, it is often useful to work with the department responsible for completing any SEC filings, such as 10-Ks, to ensure that any information included in both the FDD and the SEC filings is consistent. Since the FTC Rule has slightly different requirements than SEC regulations, franchise counsel should be prepared to explain to the franchisor's auditors why various disclosures may be slightly different in the FDD.

**f. E-mail Communications**

E-mail communications often will be the most efficient method of communicating with the franchisor and certainly are an effective way to quickly distribute drafts and request clarification on simpler points. For more complicated issues that may require



significant discussion or presentation of supporting materials, however, a face-to-face meeting or conference call probably remains the best method of communication.

#### **g. Timing**

In addition to determining the best methods for obtaining information, counsel needs to consider the timing for information-gathering. For a start-up franchisor, the information-gathering process should begin as far in advance of the targeted launch date as possible, as new franchisors often are unaware of the level of detail required in an FDD and may not have fully considered or completed all aspects of the franchise system, such as computer requirements, operations manual drafting, fees, contractual provisions, as well as the necessity of audited financial statements. Although the timing will vary based on the circumstances, it is not unusual to spend 6-12 months gathering information to prepare an FDD for a start-up franchisor.

After an initial registration, counsel should keep the franchisor informed of FTC and state registration deadlines, and as noted above, counsel should encourage open and ongoing communications throughout the year. Even with constant communication, counsel will need to conduct a more formal information-gathering process during the annual renewal process, as well as for each quarterly update. Typically, counsel should remind the franchisor by the end of the fiscal year (or 3-4 months in advance for any calendar-year state registration date that is not aligned with the fiscal year) that the FDD renewal date is approaching and propose a schedule for updating the FDD. The schedule should build in adequate time for client gathering of the necessary information; counsel verification of that information; incorporation of the updates into the FDD by counsel, franchisor review of drafts; revisions and additional due diligence by counsel; meetings or conference calls to clarify responses; and any unanticipated last-minute issues of concern. The schedule will vary depending upon the size and experience of the franchisor and its personnel, as well as counsel's experience; however, it generally is a good idea to begin the information-gathering process in earnest within 1-2 weeks after the end of the fiscal year.

After the update is complete, counsel should provide the franchisor with instructions on the types of changes that will constitute a "material change" that could require immediate amendment in some states. In addition, since the new FTC Rule requires quarterly amendments for material changes, counsel should issue a mini-questionnaire to identify whether there have been any material changes as described in Section V.B below before the end of the relevant quarter. Similar to the initial and renewal questionnaires, the exact timing will depend upon the size and experience of the franchisor and the relation to counsel; however, counsel's initial contact with the franchisor probably should occur around 30 days before the end of the relevant calendar quarter. Although certain information, such as franchisor-initiated litigation and outlet summaries generally are required to be updated only once per year, many franchisors (particularly large systems) should consider updating this information on an ongoing basis to facilitate verification and avoid the need for last-minute gathering of voluminous data.

Finally, as noted above, the most detailed questionnaires and due diligence schedule do not substitute for open and ongoing communications with the franchisor. If counsel is in-house, it is important to develop a good rapport with the various department heads and request copies of communications for review before they are distributed to determine whether a department's new initiatives might raise disclosure issues. Outside counsel must educate the client on disclosure requirements and materiality and check in periodically with the franchisor outside of the formal questionnaire process. Outside counsel also should review newsletters and other materials produced by the franchisor and monitor the trade press to determine if the franchisor is contemplating changes that will affect the FDD.

## **V. MANAGING THE DISCLOSURE UPDATING AND RENEWAL PROCESS**

Managing the process of updating the FDD is critical to franchisors since they will want to minimize the period of time in which they are prohibited from engaging in any, or limited, sales activity. In many registration states, a franchisor must suspend all sales activity while renewal applications and amendments are pending, thus making the issue of timing even more critical, as it can ultimately effect the franchisor's revenue stream.

Throughout any given year, a franchisor (particularly newer franchisors) may have various issues arise which prompt the franchisor to note that it wants to change a portion of the FDD or franchise agreement. For example, the franchisor's sales staff may note that prospective franchisees are consistently inquiring about a particular aspect of the FDD or franchise agreement, and, as a result, the franchisor may want to refocus its business or offer certain incentives to prospective franchisees in order to attempt to gain a competitive advantage. In addition, during the course of a year, franchisors will experience changes in key management, become involved in litigation, enter into new franchise relationships and terminate existing franchise relationships, and obtain new trademark registrations for marks to be used in connection with the franchise. While some of these experiences will require the franchisor to amend its FDD prior to the end of its fiscal year or expiration of state registrations, all of the changes should be integrated into the FDD when it is updated annually.

Maintaining a file with a list of changes as they occur or are suggested will help streamline the process of updating the FDD during the annual renewal period. In the event changes are "material", as discussed below, the change may require the franchisor to file an amendment prior to annual renewal and suspend sales activity during the pendency of the amendment application.

### **A. Required Renewals**

#### **1. The FTC Rule**

A franchise registration is typically valid for one (1) year from the date of registration. The FTC Rule, which exclusively governs in all non-registration states and

applies in all registration states except to the extent the state laws are inconsistent with the FTC Rule, requires a franchisor to update its FDD within one hundred twenty (120) days after the end of its fiscal year.<sup>41</sup> At that time, the franchisor should cease using its prior FDD. Although not required by the FTC Rule, as a best practice, a franchisor should provide an updated FDD that includes information concerning the latest fiscal year to prospective franchisees to whom it has disclosed, but who have not yet executed the franchise agreement.

## **2. Registration States**

All registration states require that franchisors maintain their registration if they want to continue to offer and sell franchises in that state. Franchisors are required to file renewal applications to provide updated information and financial statements in order to maintain their registration. The registration states generally fall into two categories with respect to renewals: (i) those states requiring a franchisor to renew its registration within a period of time prescribed by statute after the end of the franchisor's fiscal year end,<sup>42</sup> or (ii) those states requiring a franchisor to renew its registration prior to the anniversary date of the effective date of its registration.<sup>43</sup> It is important to know which states use the effective date where the renewal process will be triggered from the date of registration of the FDD, and which states use the franchisor's fiscal year end where the registration process will be triggered within a certain period of time after the end of the franchisor's fiscal year.<sup>44</sup>

## **3. Information Required to be Updated**

The renewal application must provide the franchisor's current information, clearly marked so that each change is noticeable. The franchisor must update its FDD and franchise agreement to reflect the current terms of its offering. In addition to any substantive changes to the franchise offering, the following information must also be updated:

Item 2 – changes to officers, directors and key management personnel. Changes to this item may also warrant changes to Item 3 (litigation), Item 4 (bankruptcy) and Item 11 (training).

Item 5 – changes in the initial franchise fees.

Item 6 – changes in the fees that a franchisor may incur in establishing the franchise.

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<sup>41</sup> 16 C.F.R. § 436.7(a).

<sup>42</sup> Minnesota, New York, Rhode Island and South Dakota.

<sup>43</sup> California, Hawaii, Illinois, Indiana, Maryland, Michigan, North Dakota, Washington, Wisconsin; and with respect to exemption states, Utah and Florida.

<sup>44</sup> See Exhibit F.

Item 7 – changes in the franchisee’s initial investment and related explanatory notes.

Item 8 – total revenue derived by the franchisor and its affiliates from franchisees’ purchases from required sources and the percentage such amount bears to total revenue from all sources.

Item 11 – information on how advertising funds were used during the most recent fiscal year.

Item 20 – all of the charts in this Item must be updated. In addition, the franchisor must updated the list of existing franchisees, the list of franchisees whose franchise agreements were terminated, cancelled or not renewed, and the list of franchisees who did not communicate with the franchisee during the 10 weeks prior to renewal.

Item 21 – audited financial statements for the most recent fiscal year end.

Each of these changes may require corresponding changes in other FDD items and in the franchise agreement or other agreements that are required to be included with the FDD and provided to a prospective franchisee.

#### **4. Timing**

In the event a franchisor does timely not make the appropriate renewal filing and renew its registration in a registration state, the franchisor will be prohibited from offering or granting franchises in that state. Some registration states permit limited sales activity once the renewal application is filed, however most registration states require that all sales activity be suspended once the renewal application is filed.<sup>45</sup> In addition, some states, such as Maryland, may require the franchisor to execute an affidavit affirmatively stating that it has not offered or granted any franchises in that state since the date the registration expired.

Since many franchisors use December 31 as the end of their fiscal year, most registration states process a large volume of renewals from February through May. In addition, accountants who are required to prepare the franchisor’s audited financial statements are in the midst of tax season during the first 120 days of each year. Therefore, the timing for gathering updated information, engaging the accountant to prepare the audited financial statements and filing a renewal application are critical to ensure the franchisor’s registration does not lapse.

Franchisors, particularly start-up franchisors, may have registration dates throughout the year in various registration states. In order to coordinate the renewal process in registration states and streamline the process of updating the FDD for the

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<sup>45</sup> See Exhibit F.

franchisor, it may be necessary to file renewal applications earlier than otherwise required or request that state examiners modify the effective date of registration.

If a franchisor has any sales pending during the renewal period, the franchisor should redisclose to such prospective franchisees the updated FDD once approved by the applicable registration state(s).

## **B. Required Amendments**

In addition to renewal filings, a franchisor must timely amend its FDD and file an amendment in registration states in the event a “material change” occurs. The FTC Rules does not define “material change”, but indicates in the Statement of Basis and Purpose that accompanied the new FTC Rule that (i) it would not treat “materiality” different under the new FTC Rule, and (ii) materiality is determined from the prospective franchisee’s point of view. Based on the FTC’s position, the definition of “material change” under the original FTC Rule is still of importance. The original FTC Rule defined “materiality” as follows:

“Any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to the named franchise business or which has a significant financial impact on a franchisee or prospective franchisee.”

Some of the registration states have defined a “material change” by way of example. These definitions are not uniform, but are instructive when determining whether an event is a “material change”. Examples of material changes include the following:

- Changes in the franchisor’s franchised business, such as changes in the services the franchisor will provide to its franchisees, the fee structure, or the introduction of a new program which affects the franchisee’s investment.

- Changes in the franchisor’s financial condition which could adversely impact the ability of the franchisor to meet its obligations to its franchisees.

- Changes in the franchisor’s key management personnel who are responsible for oversight or administering services to franchisees.

- A change of control or reorganization of the franchisor.

- Significant changes in the number of franchisees, such as the termination, closing or purchase of a large number of franchisees.

## **1. FTC Rule – Revisions to the FDD**

Within a reasonable period of time after the end of each quarter of the franchisor's fiscal year, the franchisor must prepare an attachment to its FDD to reflect any material changes that occurred within such quarter.<sup>46</sup> The quarterly update does not need to include franchisor-initiated litigation, statistical information about the franchised outlets in Item 20 or audited financial statements, which only needs to be updated annually. A franchisor is, however, free to update its FDD on a more frequent basis. Each quarterly update during a fiscal year should be provided to a prospective franchisee with the FDD.

## **2. Registration States – Amendment Filings**

Registration states require a franchisor to file the modified pages of the FDD, along with a clean copy of the FDD and the appropriate filing fees. Registration states vary, however, on the timing of filing an amendment. The standards range from "promptly," "upon," or "as soon as reasonably possible after" a material change.<sup>47</sup> Some states require that the amendment be filed a set number of days after which the material change has occurred that the amendment must be filed. The occurrence of a material change, the corresponding amendment and the timing of filing can have significant practical implications on a franchisor's sales activity. A franchisor must suspend its sales activity until the amendment application is effective and the updated FDD is delivered to prospective franchisees. Furnishing the updated FDD to a prospective franchisee before the amendment application is effective would constitute an offer of an unregistered franchise.

Several states, including Illinois, South Dakota, Virginia and Wisconsin, provide for automatic effectiveness of an amendment upon filing. In these states and in non-registration states, the franchisor can resume its sales activity relatively quickly after the occurrence of a material change and the preparation and filing of the necessary amendments. Since material changes can occur at any time, and are often beyond the franchisor's control (such as the departure of key management personnel), most registration states recognize the impact of an amendment and the suspension of sales activity on franchisors and will promptly review the amendment filing upon receipt.

Once the amendment has been prepared in non-registration states and filed and approved in registration states, the franchisor must re-disclose the amended FDD to its prospective franchisees and wait the appropriate period of time before the prospective franchisee executes the franchise agreement or pays any consideration.

## **VI. REGISTERING IN STATES**

As stated above, there is no federal registration of franchise offerings. In the fourteen states which require registration of franchise offerings, before offering or selling

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<sup>46</sup> 16 C.F.R. § 436.7(b).

<sup>47</sup> See Exhibit F.

franchises in the state, the franchisor must register the franchise offering with the state.<sup>48</sup> To obtain registration, the franchisor or his counsel must submit the FDD and various other forms (which may include a cover page, consents to service of process, copies of advertising and promotional literature, and sales agent disclosure forms, all collectively referred to as the registration application) to the appropriate state officials, typically the state's Department of Corporations or Attorney General's office. Except in Indiana, Michigan, South Dakota, and Wisconsin (where the review process has been eliminated), the state officials are given a period of time—usually about 30 calendar days—to review the registration application and furnish comments to the franchisor. Once a franchisor receives the comments, it must respond, either by making the suggested changes or by convincing the officials that their concerns are unwarranted and that no changes are necessary. When the registration process is successfully completed, an order declaring the registration effective is issued by the state. Another paper presented at the IFA Symposium specifically addresses registration issues and provides further details on the registration process.

## **VII. MAKING DISCLOSURES TO PROSPECTS**

### **A. Disclosure of the FDD**

#### **1. Disclosure to Prospective Franchisees**

Assuming there is no applicable disclosure exemption, the FTC Rule and all registration states require pre-sale disclosure to prospective franchisees. A “prospective franchisee” that must be provided a FDD includes “any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.”<sup>49</sup> If a franchisor has taken steps to begin the sales process, such as responding positively to a franchise application, the franchisor must supply the FDD to the prospective franchisee upon its reasonable request, even if it is not contemplated that the transaction will soon be completed. Franchisors are not required to provide FDDs to (i) individuals lacking a bona fide interest in acquiring a franchise from franchisor, (ii) individuals acquiring a franchise from an existing franchisee, unless the franchisor plays a significant role in the sale, and (iii) existing franchisees who are purchasing an additional outlet or extending an existing franchise agreement, unless the new relationship is under materially different conditions than the existing arrangement.

#### **2. Timing of Disclosure**

Under the FTC Rule and the laws of most states<sup>50</sup>, a franchisor must provide its FDD, including all franchise and related agreements and financial statements, to any

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<sup>48</sup> All of the states with franchise sales laws, except Oregon, require registration.

<sup>49</sup> See 16 C.F.R. §436.1(r).

<sup>50</sup> California, Hawaii, Illinois, Indiana, Minnesota, North Dakota, South Dakota, Virginia and Wisconsin.

prospective franchisee at least 14 calendar days before the franchisor or its affiliate enter into any binding agreement with, or receive any payment from, the franchisee.<sup>51</sup>

Some registration states require disclosure earlier than the FTC Rule. Maryland, New York and Rhode Island have retained the original FTC Rule requirement of disclosure of the FDD on the earlier of the first personal meeting or 10 business days prior to the execution of the franchise agreement or the payment of any consideration to the franchisor. Michigan and Washington require the franchisor to provide the FDD to prospective franchisees at least 10 business days prior to the execution of any binding agreement or the payment of any consideration to the franchisor or its affiliates.

In the event the franchisor unilaterally makes any material changes to the terms of the franchise agreement or any of the related agreements, the franchisor must provide a copy of the revised franchise agreement to the prospective franchisee 7 calendar days before the prospective franchisee executes the franchise agreement.<sup>52</sup> The 7-day rule is not triggered by changes requested by the franchisee or completing blanks in the franchise agreement, such as the name and address of the franchisee or the date on which the agreement is signed.<sup>53</sup>

### **3. Method of Disclosure**

To make a disclosure, franchisors may furnish their FDD in either paper or electronic form, which may be a file distributed via disk, email, or a web page. If a franchisor provides a FDD electronically, the document may not contain additional electronic features (other than basic navigation features) such as pop-up windows, audio, video, and links to external documents. Moreover, all of the required information must be in a single document so that downloading or printing the document incorporates all required information.<sup>54</sup>

#### **B. Redisclosure After An Amendment or Material Change**

An amendment to the FDD will require redisclosure to prospective franchisees who received the FDD and franchise agreement prior to the occurrence of the material change but did not execute the franchise agreement prior to the material change. After the effectiveness of the amendment, as discussed above, the franchisor must provide the prospective franchisee with the FDD, as amended, and wait the appropriate period of time prior to when the prospective franchisee can execute the franchise agreement or make any payment to the franchisor or its affiliates. If a franchisor makes changes to the FDD that are not material enough to necessitate an amendment, the franchisor must supply its most recent annual update of the FDD and any quarterly updates upon a franchisee's request. Moreover, if at the time of furnishing the FDD the franchisor is aware of any material changes relating to its financial performance representations, the

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<sup>51</sup> See 16 C.F.R. § 436.2(a).

<sup>52</sup> 16 C.F.R. § 436.2(b).

<sup>53</sup> Compliance Guide, p. 22-23.

<sup>54</sup> Compliance Guide, p. 19-20.



franchisor or franchise seller must notify the prospective franchisee of the material change in any reasonable manner.<sup>55</sup>

### **C. Obtaining Receipts**

Upon providing the FDD to a prospective franchisee, the franchisor should specifically request that the prospective franchisee sign and return one of the two receipts. If the franchisor discloses to the prospective franchisee in person, the franchisor's representative should obtain the signed receipt at that time; if by mail or courier, request that the prospective franchisee return the receipt by mail, fax or e-mail; if by electronic delivery, the franchisor should have a method for acknowledging receipt when the prospective franchisee downloads the FDD. As a best practice, a franchisor should always request that the prospective franchisee return a signed receipt by mail, fax, or as a scanned e-mail attachment.

The FTC Rule now requires that the receipt include the name, principal business address and telephone number of each franchise seller offering the franchise.<sup>56</sup> The franchisor should ensure that the seller – whether that be an in-house sales representative or a franchise broker – complete this information prior to disclosure of the FDD to the prospective franchisee. All brokers or sales representatives that have significant involvement in the sales process with the prospective franchisee should be listed as a franchise seller.

### **D. Financial Performance Representations**

If a franchisor makes a financial performance representation it must be contained in Item 19 of the FDD. A franchisor cannot make a financial performance representation that is inconsistent with Item 19. Likewise, if the franchisor states in Item 19 that it does not make or authorize the making of financial performance representations, it cannot provide or authorize others to provide financial performance information to prospective franchisees. When providing the FDD to a prospective franchisee, the franchisor must also disclose any material changes that the franchisor knows or should have known occurred in the information contained in the financial performance representation made in Item 19.<sup>57</sup>

## **VIII. PENALTIES FOR NON-COMPLIANCE**

### **A. Under the FTC Rule**

Failure to comply with the FTC Rule can have severe results. An FTC Rule violation may result in fines of up to \$11,000 per violation per day. Other remedies include equitable remedies, assessment of damages incurred by the public, and criminal sanctions.

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<sup>55</sup> Compliance Guide, p. 128-129.

<sup>56</sup> 16 C.F.R. § 436.7(w)(2).

<sup>57</sup> 16 C.F.R. § 436.7(d).

In practice, the FTC typically seriously investigates situations only when there is evidence of pervasive non-compliance by a franchisor, when the FTC Rule has been flouted flagrantly, or when widespread harm has been inflicted on the public. Isolated FTC Rule violations are generally not pursued, as are technical violations such as violation of the FTC Rule's waiting period before consummation of the franchise sale. The FTC has been more aggressive in prosecuting business opportunities sellers who do not comply with the FTC Rule.

When the FTC has taken on franchisors, it has been very aggressive in seeking relief. It has imposed pre-judgment freezes on the assets of the franchisor and its principal officers. It has also imposed hefty fines on some FTC Rule violators. As for minor or technical violations, the FTC has addressed this problem by implementing a program under which offenders may agree to participate in a remedial program rather than face prosecution. Under this program, the franchisor's management must participate in programs designed to assure that the franchisor is aware of its responsibilities under the FTC Rule, and the FTC will indirectly monitor the franchisor's sales activities for a limited time, typically three years.

The absence of a right in an aggrieved franchisee to pursue a claim considerably reduces the risks of lawsuits resulting from FTC Rule violations. However, many states have adopted so-called "Baby FTC Acts" which, in essence, give franchisees causes of action for FTC Rule violations. Franchisees may also have state actions available for fraud or unfair or deceptive practices if the FTC Rule has been violated.

## **B. Under State Laws**

The consequences for violations of state registration laws can also be dire. The remedies generally include civil penalties, including fines, provable damages, and injunctive relief. Criminal penalties, which may include fines or imprisonment, are also possible. State statutes grant franchisees the right to pursue their remedies by themselves, and in most states, grant franchisees the right to rescind their franchise purchases, even if they have suffered no provable damages.

State enforcement is viewed with a higher level of fear than FTC enforcement. Relatively speaking, most states have devoted more resources than the FTC to enforcing their acts, especially when the violation is the failure of the franchisor to register. However, when a franchisee claims that the franchisor has misrepresented what is being sold, the state may be more reluctant to bring its enforcement powers to bear, absent compelling evidence verifying the aggrieved franchisee's position. Also, isolated technical violations of state law, if handled properly, generally do not bring about the state's full wrath, absent clearly demonstrable damages resulting from the violation.

Exhibit A – FTC Compliance Guide: Sample Item 11 Disclosure Excerpts

Exhibit B – Additional Disclosures Required by the States

Exhibit C – Plain English Guidelines

Exhibit D – Common Deficiencies Seen by Examiners in the Review of an FDD (Ask the Regulators, IFA Legal Symposium, May 2009)

Exhibit E – Sample Officer/Director Questionnaire

Exhibit F – State Renewal and Amendment Chart

## EXHIBIT A

### FTC COMPLIANCE GUIDE ITEM 11 SAMPLE DISCLOSURE EXCERPTS

#### Training

The amended Rule's Item 11 also calls for disclosure of information about the staff who provide the training. If the franchisor's training staff is large or changes frequently, the franchisor can use a general description of the background and experience of the staff providing the training. Also, franchisors should disclose here (if not disclosed in Item 2), the corporate officer in charge of training, if any, along with information about his or her experience. . . .

#### **Sample Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training**

##### TRAINING PROGRAM

(Column 1) Subject	(Column 2) Hours of Classroom Training	(Column 3) Hours of Training On- the-Job	(Column 4) Location
Real Estate and Development	8	20-30	Franchise Market Area
Administration	24	24	Jackson, Minnesota
Operations Training	40	160	Jackson, Minnesota
Store Opening Assistance	0	80	Franchised Location
Follow-up Training	0	24-40	Franchised Location

Belmont conducts training programs for both you and some of your employees. The training program will include four segments, which are conducted as needed. Belmont does not charge for this training or service, but you must pay the travel and living expenses for you and your employees. All training occurs at Belmont's Jackson, Minnesota, headquarters, the first weekend of each month. Training is conducted by Mark Smith, who has 20 years' experience in operating a muffler shop, 12 years of that with Belmont.

## EXHIBIT B

### ADDITIONAL DISCLOSURES REQUIRED BY THE STATES<sup>58</sup>

STATE	ADDITIONAL DISCLOSURES
<b>California</b> (Cal Code Regs. Tit. 10 §310.114.1)	Specific, all-cap preamble required; General releases upon renewal or transfer are void; choice of law or forum outside of California may not be enforceable; California law on termination or non-renewal will apply; post-termination non-competition clauses may not be enforceable; binding arbitration outside California may not be enforceable; termination upon bankruptcy not enforceable based upon federal law; Internet advertising exemption; financial disclosure form; legend for Item 19 if cost data not provided
<b>Hawaii</b> (HI. Admin. Rules §16-37-4)	Specific language to state that filing of FDD by state does not constitute approval; disclosure delivery requirements; and a reminder that the FDD is only a summary of material provisions
<b>Illinois</b>	Choice of law other than Illinois law is void; choice of forum outside Illinois is void; statutes of limitations are void; integration clauses are void
<b>Maryland</b> (Md. Reg. Code tit. 2 §02.02.16)	Termination upon bankruptcy is not enforceable under federal law; release as a condition of renewal or transfer will not apply to liability under Maryland Franchise Registration and Disclosure Law; choice of forum outside of Maryland is void; filing of quarterly sales reports
<b>Michigan</b> (Mich. Comp. Laws §445.1508)	Must include a Michigan-specific addendum at the beginning of the FDD that addresses provisions in the franchise agreement that are void or unenforceable under Michigan law, including prohibitions on a franchisee's right to associate, a franchisor's ability to refuse a transfer except for good cause, and a requirement that the franchisee arbitrate or litigate outside of Michigan.
<b>Minnesota</b> (Minn. Stat. §80C.06 and §80C.14)	Additional trademark disclosures; choice of forum outside Minnesota is void; nothing in FDD can limit franchisee's rights under Chapter 80C or franchisee's rights to any procedure, forum, or remedies provided by Minnesota law; franchisors must agree to comply with the termination and nonrenewal provisions of the Minnesota statute; franchisee cannot consent to franchisor obtaining injunctive relief; releases on renewal and transfer are void; jury trial waivers are void; and franchisor cannot require franchisee to consent to liquidated damages
<b>New York</b> (N.Y. Comp. Codes R. & Regs, tit. 13 §200.2)	State-specific negative disclosure for litigation and bankruptcy actions; franchisor cannot assign rights under the franchise agreements except to an assignee, who, in franchisor's good faith and judgment, is willing and able to assume the franchisor's obligations; choice of law will not be considered a

<sup>58</sup> See Joseph J. Fittante, Jr., Susan Meyer, Craig Tregillus, "Fundamentals 201: Drafting a Disclosure Document," ABA 32<sup>nd</sup> Annual Forum on Franchising (2009) at 19-25; Joe Nugent, Maureen O'Brien, Bob Sawyer, "Basic Tracks: Disclosure Under the Amended FTC Rule and State Franchise Disclosure Laws," IFA 42<sup>nd</sup> Annual Legal Symposium (2009) at Exhibit B.

STATE	ADDITIONAL DISCLOSURES
	waiver of any right conferred by New York Franchise Law; franchisor can only obtain injunctive relief after making proper proofs and appropriate authority has granted such relief
<b>North Dakota</b> (N.D.C.C. §51-19-09 and Securities Commissioner Statement of Policy)	Post-term non-compete provisions are not enforceable; release on renewal is void; waiver of exemplary or punitive damages is void; jury waiver is void; choice of forum outside North Dakota is void; choice of law other than North Dakota law is void
<b>Rhode Island</b> (R.I. Gen. Law §19-28.1-14)	Any provisions restricting jurisdiction or venue to a forum outside of Rhode Island is void
<b>Virginia</b> (Va. Code Ann. §13.1-564)	Unlawful for a franchisor to cancel a franchise without reasonable cause or use undue influence to induce a franchisee to surrender any right given to him by any provision in the franchise
<b>Washington</b> (Wash. Admin. Code §19.100.180 and Statement of Policy)	Required language regarding Washington law on termination and renewal, arbitration, conflict of law, releases, statutes of limitations under Washington Franchise Investment Law and jury trials. Note: Washington also contains a provision limiting transfer fees to the franchisor's cost to complete the transfer.
<b>Wisconsin</b> (Wis. Stat. §135.01 <i>et seq.</i> )	Addendum to disclose restrictions on termination in the Wisconsin Fair Dealership Law

## EXHIBIT C

### PLAIN ENGLISH GUIDELINES

(Source: Uniform Offering Circular – 1993 Guidelines  
adopted by NASAA on April 25, 1993, available at

<http://www.nasaa.org/content/Files/UniformFranchiseOfferingCircular.doc>)

Archaic Term	Preferred Substitute
Arising from	From
As set forth in	In
Commence	Begin
Condition precedent	Before
Condition subsequent	After
Consist of	Are
Engaged in the business of offering	Offers
For a period of	For
In the event	If
Including but not limited to	Including
Including without limitation	Including
Not later than	Within, by
Not less than	At least
Offers to an individual, corporation or partnership	Offer
On behalf of	For
Precedent	Before
Prescribed	Required
Prior to	Before
Provided however	But, unless
Provided that	If, unless
Relating to	Under
Subsequent	After
Such	This
So as to	To
So long as	While
Related to or growing out of	Because
Certified as true and correct	Certified
Consultation, assistance and guidance	Guidance
Twenty-three (or any number)	23
As the franchisor prescribes	You must
Being offered	Offers
Consist of	Is
If it becomes necessary for	If
Inure to the benefit of	Benefits
Is granted the right to	Can
Is required to	Must
Shall be no less than	A minimum of
Shall continue in effect	Continues
With the exception of	Except

**In addition, avoid using the following terms:**

Aforesaid  
As between  
As an inducement for  
As part of the consideration  
As the case may be  
At a later point in time  
Binding upon and inure  
For and in consideration of the grant of the franchise  
Foregoing  
Forthwith  
From time to time  
Further  
Hereby  
Herein  
Hereinafter  
Hereto  
Heretofore  
If necessary  
In any manner whatsoever  
In conjunction with  
In connection with  
In no event  
In whole or in part  
It will be specifically understood that  
Manner in which  
Notwithstanding  
Purporting to  
Thereafter  
Therefrom  
Thereof  
Thereunder  
Without limiting the foregoing  
Whatsoever  
With respect to  
Agrees, Acknowledges and Recognizes  
Any and All  
Are and remain  
Based upon  
Each and every  
Necessary and appropriate



## EXHIBIT D

### COMMON DEFICIENCIES SEEN BY EXAMINERS IN THE REVIEW OF AN FDD

(Source: "Ask the Regulators," IFA Legal Symposium May 2009)

#### **FDD Cover Page**

1. Failure to disclose information in the required format and to use the required language
2. The paragraph relating to the initial investment disclosure must disclose the initial investment first and the initial fees and the payments to the franchisor and/or its affiliate

#### **State Cover Page**

1. Failure to include this page

#### **Item 1**

1. Failure to disclose whether or not there is a parent, predecessor and/or affiliate. And, when any or all of these are present, failure to disclose all required information regarding them.
2. The inclusion of a list of definitions of terms used in the disclosure document.

#### **Item 2**

1. Inclusion of an introduction
2. "Puffery" disclosure

#### **Item 3**

1. Failure to disclose summary or relief sought in either the original claim or in a counterclaim
2. Confidential settlements
3. Disclosure of the franchisor's opinion on the merits of the claim

#### **Item 5**

1. Failure to include payments for goods and/or services made to the franchisor and/or an affiliate prior to commencement of the business
2. Failure to disclose whether the initial fee and/or the initial payments are refundable

## **Item 6**

1. Inclusion of an introduction. Usually these introductions include information required by the Rule which should be included in the remarks column of the table or in footnotes to the table.
2. Failure to disclose the range or formula for determining the amount of fees for which there is no set amount.
3. Inclusion of fees/payments which are imposed only once and usually prior to the commencement of operations of the franchise business (These should be disclosed in Item 7)
4. Inclusion of fees which are not imposed.

## **Item 7**

1. Failure to disclose both the Item title and the table heading.
2. Inclusion of an introduction. As in Item 6, these introductions disclose information required by the Rule, but which should be disclosed in the table or in footnotes.
3. Failure to provide for real estate and leasehold improvement costs for franchisees who either cannot or choose not to work out of their homes.
4. Travel and living expenses for training are often underestimated.
5. Failure to disclose the factors, basis and experience the franchisor considered or relied upon in determining the amount disclosed for additional funds.

## **Item 8**

1. Failure to disclose whether or not an officer of the franchisor owns an interest in any supplier.
2. Failure to disclose all of the information regarding the franchisor's revenues from required purchases.
3. References to affiliates as approved suppliers when no such affiliates are disclosed in Item 1.
4. Disclosure of detailed descriptions of computer hardware/software specifications.

## **Item 9**

1. Failure to include all required categories.
2. Inclusion of categories not required by the Rule prior to the end of the table.
3. Incorrect cross-references to the disclosure document.

### **Item 11**

1. Disclosure of required site location information under the subheading of "Time of Opening."
2. Failure to disclose consequences should franchisor and franchisee fail to agree upon a site within a prescribed period of time.
3. Failure to disclose whether or not the advertising fund is audited.
4. Failure to disclose estimated cost of computer hardware and electronic cash registers and the cost of maintenance/upgrades
5. Failure to disclose the training table heading
6. Inclusion of categories in the training table which are not required by the Rule.
7. Cross-referencing Item 2 for description of training instructor's experience

### **Item 12**

1. Failure to disclose the minimum territory granted to the franchisee.
2. Replacing territorial exclusivity continuation with termination provisions.

### **Item 13**

1. Inclusion of references to specific states in the response to paragraph (5)

### **Item 17**

1. Failure to disclose in Item 17(c) the statement advising the franchisee that the contract signed upon renewal may contain materially different terms than the original contract
2. Failure to include all required categories and/or including new categories prior to the end of the table
3. Failure to disclose "subject to state law" in Items 17(v) and (w). (Illinois only)

### **Item 19**

1. When no FPR is disclosed, failure to disclose both required paragraphs of negative language and/or changing the prescribed language.
2. Inclusion of numerous disclaimers.
3. When averages are disclosed, failure to include the number or percentage of units upon which the data is based that achieved the averages disclosed.
4. Use of affiliate data when the franchisor has company owned units and/or franchisees

## **Item 20**

1. Failure to properly format tables
2. Failure to include all tables
3. Failure to disclose information which is current within 120 days (Illinois only)

## **Item 21**

1. Failure to include financial statements required by the state in which the application is filed
2. Failure to include parent company financial statements when the parent performs post-opening obligations to the franchisee
3. Failure to comply with financial assurance requirements of the states in which the application is being filed when such requirement is warranted
4. Failure to include statements which are current within 120 days (Illinois only)

## **Item 22**

1. Disclosure of all exhibits to the disclosure document rather than just contracts and agreements

## **General Issues**

1. Failure to respond to each Item of the disclosure requirements
2. Failure to use active, rather than passive tense. Closely related to this issue is franchisors stating in Item 1 that the franchisor will be referred to using personal pronouns, but then refer to the franchisor by their business name in the document
3. Inconsistent disclosure within each Item; between two or more different Items; and, between the disclosure in the Items and that in the exhibits.
4. The filing of both the "old" UFOC application document and the "new" 2008 NASAA documents.

**EXHIBIT E**

**SAMPLE OFFICER/DIRECTOR QUESTIONNAIRE**

- 1. Name: \_\_\_\_\_
- 2. Current Title/Position with Franchisor: \_\_\_\_\_
- 3. Business Address: \_\_\_\_\_
- 4. Business Phone Number: \_\_\_\_\_

5. Beginning with the date of the job you held 6 years ago, please list below your employer(s), positions held, location of employment, and start and end dates for each position held even if the employer and location were the same:

<b>Employer</b>	<b>Job Title</b>	<b>Location (City, State)</b>	<b>Start Date of Position (Month/Year)</b>	<b>End Date of Position (Month/Year)</b>

6. During the past 10 years, have you been convicted of a felony or pleaded *nolo contendere* to a felony charge?

Yes \_\_\_\_\_ No \_\_\_\_\_

7. During the past 10 years, have you been a party in a civil action involving an alleged violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations, such as fraud, embezzlement, restraint of trade or fraudulent conversion?

Yes \_\_\_\_\_ No \_\_\_\_\_

8. Are you a party to any proceeding which could make you subject to or are you subject to an injunction or restraining order brought by a federal, state, or Canadian public agency or department?

Yes \_\_\_\_\_

No \_\_\_\_\_

9. Have you filed in bankruptcy, been adjudicated a bankrupt, been reorganized due to insolvency, or been a principal, director, executive officer, trustee or general partner of any other entity that has filed in bankruptcy, been adjudicated a bankrupt, or been reorganized due to insolvency?

Yes \_\_\_\_\_

No \_\_\_\_\_

10. If you are an officer of the franchisor, do you own an interest in any approved supplier of goods or services to the franchisees?

Yes \_\_\_\_\_

No \_\_\_\_\_

If you answered "yes," to any of questions 6-9, please provide the following information on the attached sheet: Case name and number; court; date of conviction or judgment for concluded cases; initial filing date; current status of matter; summary of the facts; damages or other relief awarded in a civil case; sentence or penalty imposed in a criminal case; nature, terms and conditions of the order or decree for an injunctive or restrictive order.

If you answered "yes," to question 10, please provide the name of the supplier and the nature and percentage of your ownership interest on the attached sheet.

Name: \_\_\_\_\_

Signature \_\_\_\_\_

Date \_\_\_\_\_

## EXHIBIT F

State	Effective Period	Renewal	Sales Activity Once Renewal Filed <sup>59</sup>	Filing an Amendment Material Change	Disclosure to Franchisees
<b>California</b>	110 days after fiscal year end	15 days before expiration of current registration	Limited to offers, provided the franchisor provides certain additional information to the prospective franchisee	Promptly after material change	14 days before execution of binding agreement or payment of consideration
<b>Hawaii</b>	3 months after fiscal year end	90 days after fiscal year end	May not sell until 7 days after a complete and accurate renewal application is filed	Promptly after material change	14 days before execution of binding agreement or payment of consideration
<b>Illinois</b>	120 days after fiscal year end	1 business day before expiration of current registration	No limitations, provided that all information for a renewal is timely filed	Promptly after material change	14 days before execution of binding agreement or payment of consideration
<b>Indiana</b>	1 year from filing date	No later than expiration of current registration	No limitations (if a stop order is not issued) since renewal is effective upon expiration of current registration	No filing required	14 days before execution of binding agreement or payment of consideration

<sup>59</sup> This information was obtained from state regulators / examiners.

<b>State</b>	<b>Effective Period</b>	<b>Renewal</b>	<b>Sales Activity Once Renewal Filed<sup>59</sup></b>	<b>Filing an Amendment Material Change</b>	<b>Disclosure to Franchisees</b>
<b>Maryland</b>	1 year from approval date	15 days before expiration of current registration	No limitations, provided that a renewal is timely filed and the current registration remains in effect; if a renewal is pending and the current registration expires, all sales activity must cease	Promptly if there is a material change	Earlier of first personal meeting or 10 business days
<b>Michigan</b>	1 year from approval date	By or before expiration of current registration	No limitations since Michigan is a notice filing state	Promptly after a change in the franchisor's name, tradename(s), principal business address or business activity	10 business days before execution of binding agreement or payment of consideration
<b>Minnesota</b>	120 days after fiscal year end	120 days after fiscal year end	No limitation, provided the renewal application is accurate and does not contain deficiencies	30 days after occurrence of any material change	14 days before execution of binding agreement or payment of consideration



<b>State</b>	<b>Effective Period</b>	<b>Renewal</b>	<b>Sales Activity Once Renewal Filed<sup>59</sup></b>	<b>Filing an Amendment Material Change</b>	<b>Disclosure to Franchisees</b>
<b>New York</b>	120 days after fiscal year end	120 days after fiscal year end	No limitations, provided that renewal is timely filed; if an offer is made while the renewal is pending, the franchisor must hold in escrow all fees from the franchisee until the renewal is approved, re-disclose the approved FDD and offer to rescind the signed franchise agreement and refund all fees after re-disclosure	Promptly if there is a material change	Earlier of first personal meeting or 10 business days
<b>North Dakota</b>	1 year from approval date	15 business days before expiration of current registration	No limitations, provided that a renewal is timely filed and the current registration remains in effect; if a renewal is pending and the current registration expires, all sales activity must cease	Promptly if there is a material change	14 days before execution of binding agreement or payment of consideration
<b>Rhode Island</b>	120 days after fiscal year end	30 days before expiration of fiscal year end	No limitations, provided that the current registration remains in effect; after approval franchisor should re-disclose	Within 10 days after a material change	Earlier of first personal meeting or 10 business days

<b>State</b>	<b>Effective Period</b>	<b>Renewal</b>	<b>Sales Activity Once Renewal Filed<sup>59</sup></b>	<b>Filing an Amendment Material Change</b>	<b>Disclosure to Franchisees</b>
<b>South Dakota</b>	120 days after end fiscal year end	1 year from date of effectiveness	No limitations, unless the audited financial statements contain a going concern opinion	No filing required	14 days before execution of binding agreement or payment of consideration
<b>Virginia</b>	1 year from approval date	30 days before expiration of current registration	No limitations if affidavit of compliance is filed with the renewal; if affidavit is not filed, all sales activity must cease until the renewal is approved	Upon the occurrence of a material change	14 days before execution of binding agreement or payment of consideration
<b>Washington</b>	1 year from approval date	15 business days before expiration of current registration	No limitations, provided that a renewal is timely filed and the current registration remains in effect; if a renewal is pending and the current registration expires, all sales activity must cease	As soon as reasonably possible	10 business days before execution of binding agreement or payment of consideration
<b>Wisconsin</b>	1 year from approval date	By or before expiration of current registration	No limitations	Within 30 days after happening of any material change	14 days before execution of binding agreement or payment of consideration

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