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# **BASICS TRACK: REGISTRATION & DISCLOSURE**

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## Table of Contents

I.	National Pre-Sale Franchise Regulation.....	1
A.	Federal Trade Commission’s Franchise Rule.....	1
1.	Historical Overview.....	1
2.	When is Compliance with the FTC Franchise Rule Required .....	1
3.	Disclosure Obligations .....	2
B.	State Regulation.....	5
1.	Franchise Registration States .....	5
2.	State Disclosure Obligations .....	6
II.	Franchise Disclosure Document Requirements.....	6
A.	Federal FDD Requirements.....	6
1.	Federal and State Cover Pages.....	6
2.	Item 1: The Franchisor and any Parents, Predecessors and Affiliates .....	8
3.	Item 2: Business Experience.....	8
4.	Item 3: Litigation .....	8
5.	Item 4: Bankruptcy .....	9
6.	Item 5: Initial Fees.....	9
7.	Item 6: Other Fees .....	9
8.	Item 7: Estimated Initial Investment.....	10
9.	Item 8: Restrictions on Sources of Products and Services.....	10
10.	Item 9: Franchisee’s Obligations.....	11
11.	Item 10: Financing.....	11
12.	Item 11: Franchisor’s Assistance, Advertising, Computer Systems and Training .....	12
13.	Item 12: Territory .....	13
14.	Item 13: Trademarks .....	14
15.	Item 14: Patents, Copyrights and Proprietary Information.....	14
16.	Item 15: Obligation to Participate in the Actual Operation of the Franchised Business..	15
17.	Item 16: Restrictions on What the Franchisee May Sell .....	15
18.	Item 17: Renewal, Termination, Transfer and Dispute Resolution .....	15
19.	Item 18: Public Figures .....	15
20.	Item 19: Financial Performance Representations .....	16
21.	Item 20: Outlets and Franchisee Information.....	19
22.	Item 21: Financial Statements.....	20
23.	Item 22: Contracts .....	20

24.	Item 23: Receipts.....	21
B.	State Requirements .....	21
1.	Additional FDD Disclosure Requirements.....	23
2.	State Risk Factors .....	24
3.	State Addenda.....	24
C.	Drafting Tips.....	25
D.	State Disclosure Obligations .....	26
III.	Securing State Franchise Registration.....	27
A.	State Registration Filing Requirements.....	27
B.	State Examiner Review Process and Comment Letters.....	27
C.	Strategies for Managing the Registration Process.....	28
IV.	Franchise Amendment and Renewal Requirements .....	30
A.	When is an Amendment Necessary .....	30
1.	Federal Requirements .....	30
2.	State Requirements .....	31
B.	Annual Renewal Requirements.....	31
1.	Federal Requirements .....	31
2.	State Requirements .....	32
V.	Navigating Franchise Exemptions.....	32
A.	FTC Franchise Rule Exemptions.....	32
1.	Fractional Franchise Exemption.....	33
2.	Minimal Franchise Fee Exemption .....	33
3.	Large Franchisee Exemption .....	34
4.	Large Investment Exemption.....	34
5.	Other Exemptions.....	35
B.	State Exemptions .....	35
1.	Large Franchisor Exemption .....	36
2.	Large Franchisee Exemption .....	36
3.	Fractional Franchise Exemption.....	36
4.	Other Exemptions.....	37
VI.	Additional Filing Requirements Beyond the FDD.....	37
A.	Advertising Registration Requirements.....	37
B.	Franchise Seller / Broker Requirements .....	38
VII.	Conclusion .....	38

## **I. National Pre-Sale Franchise Regulation**

Franchising is a powerful growth vehicle for brands, franchise systems and the franchisees that own and operate individual franchised businesses. A complex patchwork of federal and state regulations govern the offer and sale of franchises in the United States and compliance with these laws is an essential piece of the foundation for franchising's continued success for generations to come. This paper explores certain fundamentals of franchise registration and disclosure in the United States in an effort to help practitioners new to franchising more effectively "issue spot" as they advise clients. It intentionally is designed to provide a broad overview of key concepts, as a detailed analysis on the nuances of all relevant laws and regulations is far beyond the scope of this presentation. Further, the authors note that no summary – no matter how thorough – is a substitute for the text of the actual laws in play.

### **A. Federal Trade Commission's Franchise Rule**

#### **1. Historical Overview**

The Federal Trade Commission's Rule on Franchising (the "Franchise Rule"), codified at 16 CFR Part 436, was enacted in 1979 after a lengthy rule-making process.<sup>1</sup> The boom in business format franchising after World War II, coupled with countless stories of unchecked franchisors duping innocent "mom and pop" operators who had invested their life savings with the expectation of big returns that rarely came, served as the catalysts for the enactment of the Franchise Rule's pre-sale disclosures.<sup>2</sup> Later, in 2007, the Franchise Rule was amended again (the "Amended Rule") to address certain realities unaccounted for in the original version of the rule (e.g., electronic disclosure, franchise relationship nuances, and so on) and to address and clarify points of confusion or unnecessary complexity after nearly thirty years working under the original Franchise Rule.<sup>3</sup> All references to federal regulations in this paper relate to the Amended Rule unless specifically noted otherwise.

#### **2. When is Compliance with the FTC Franchise Rule Required**

The Amended Rule governs the "offer and sale" of franchises throughout the United States and is intended to provide certain pre-sale disclosures to prospective franchisees. Included in the scope of the Amended Rule are all U.S. territories, specifically, Puerto Rico, Guam, Northern Mariana Islands, the U.S. Virgin Islands, and

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<sup>1</sup> 16 C.F.R. §436.1 (1978) Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures.

<sup>2</sup> William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, Vol. 28, Franchise L.J., 23-33 (Summer 2008). Mr. Killion provides a thorough "history lesson" on franchising and argues that "after nearly forty years of franchise presale disclosure and relationship regulations, ever-increasing competition among franchisors for franchisees, and a marked change in the sophistication of franchisees, franchising should not continue to suffer a hangover in the twenty-first century from abuses that may or may not have been rampant decades earlier. The wrong that the legislators set out to correct beginning in 1970 has now been righted." *Id.* at 24.

<sup>3</sup> 16 C.F.R. §436, 437 (2007). The full text of the official version of the Amended Rule is found in the Federal Register, Vol. 72, No. 61 at pages 15444-63 (March 30, 2007).

American Samoa.<sup>4</sup> Importantly, the Amended Rule does not apply to all businesses in which one party uses the mark of another.<sup>5</sup> Rather, the Amended Rule applies only to the offer and sale of franchises.

A franchise, by definition in the Amended Rule, is a business in which the franchisor: (1) grants to the franchisee the right to use the franchisor's trademark or other commercial symbol; (2) retains the right to exert significant control or provide significant assistance to the franchisee with respect to the operation of the business (e.g., specifying a method for doing business under the mark); and (3) charges a fee greater than \$570 during the first six months of operations.<sup>6</sup> Once these criteria are established, whether by contract or by practice, the terms of the Amended Rule apply. Further, the parties cannot contract around applicability of the Amended Rule. For example, the business relationship will be deemed to be a "franchise" subject to the Amended Rule even if the parties' contract specifically disclaims the applicability of the Amended Rule.<sup>7</sup>

### 3. Disclosure Obligations

The Amended Rule seeks to ensure that prospective franchisees receive adequate disclosures about key aspects of a franchise business opportunity before entering into a business relationship with the franchisor. The items that must be disclosed are presented to the prospective franchisee in a "Franchise Disclosure Document" or, as it is more commonly abbreviated, an "FDD." Franchisors are solely responsible for ensuring the adequacy and accuracy of the disclosures made.<sup>8</sup> As thoroughly discussed in Section II below, the FDD contains 23 specific areas (or "Items") of disclosure that correspond to the requirements of the Amended Rule, along with copies of the material contracts that a franchisee must sign as a condition of doing business, the franchisor's financial statements, and other key information related to the franchise opportunity (e.g., lists of current and former franchisees – including their contact information).<sup>9</sup> While the disclosure requirements are many and costly in terms of manpower and funds, franchisors will agree that providing prospective franchisees with detailed information on key aspects of the franchise system is a good thing—both

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<sup>4</sup> 16 C.F.R. §436.2.

<sup>5</sup> Of note, the Amended Rule does not apply to business opportunities. The offer and sale of business opportunities are governed by 16 C.F.R. §437 and fall outside the scope of this paper. As briefly addressed in Section III.B below, some states also have adopted a state-level business opportunity law. Franchisors subject to the Amended Rule are required, in some states, to file paperwork confirming the franchisor is exempt from the state's business opportunity law. Counsel is wise to review these laws and be prepared to guide clients through the exemption process related to business opportunities.

<sup>6</sup> 16 C.F.R. §436.1(h). The Amended Rule originally set the minimum fee requirement at \$500. The Amended Rule, however, requires the Federal Trade Commission (the "Commission") to adjust the minimum fee threshold every four years to account for inflation. The Commission adjusted the minimum fee threshold to \$570 effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," (May 16, 2016), <https://www.ftc.gov/news-events/press-releases/2016/05/ftc-adjusts-monetary-thresholds-three-exemptions-franchise-rule>.

<sup>7</sup> See, 16 C.F.R. §436.9(h). See also, William L. Killion and Sarah J. Yatchak, *But it Doesn't Walk or Talk Like a Duck: The Perils of the Hidden Franchise*, Bus. Law Today Vol. 17, No.1 (Sept. / Oct. 2007).

<sup>8</sup> 16 C.F.R. §436.6(a).

<sup>9</sup> 16 C.F.R. §436.3.

for the prospective franchisee and the franchise system as a whole. Educated potential franchisees are able to make sound business decisions, and ensuring that they enter into the business relationship with an “eyes wide open” approach means these franchisees generally are better suited to proactively address the challenges associated with any new business, thereby increasing the likelihood that they achieve success.

#### a. Timing

Except as modified by a handful of states (as described in Section I.B.2 below), the Amended Rule requires that a franchisor provide prospective franchisees with a copy of the FDD at least 14 calendar days prior to the date that the prospect signs any binding contract or pays any money in furtherance of the franchise to the franchisor or its affiliates.<sup>10</sup> In calculating whether the requisite 14-calendar day waiting period has passed, the franchisor neither counts the day that it delivered the FDD to the prospect nor does it count the 14<sup>th</sup> day.<sup>11</sup> Franchisors must view the dates of FDD delivery and signing as “bookends” around the 14-calendar day waiting period. Effectively, this means that a total of 16 calendar days must pass between FDD delivery and the prospect signing or paying any money to the franchisor or its affiliates.

Prospective franchisees may request a copy of the FDD earlier in the franchise qualification process, and the Amended Rule requires a franchisor to comply with that request so long as it is “reasonable.”<sup>12</sup> Determining what constitutes a “reasonable” request is left to the circumstances of each request, but generally includes the prospective franchisee’s completion of an acceptable franchise application and commencement of the franchise sales process. Practically speaking, most franchisors provide the prospect with a copy of the FDD far earlier than 14-calendar days before the prospect is obligated to sign a binding contract or pay money to the franchisor or its affiliates. In fact, the best franchisors ensure that prospective franchisees receive the FDD early in the process so as to ensure that both parties have adequate time to engage with each other on the nuances of the business relationship and corresponding expectations.

In addition to the 14-calendar day disclosure obligation, the Amended Rule imposes an additional pre-signing disclosure obligation on a franchisor that unilaterally and materially alters the terms and conditions of the form franchise agreement (or any related agreements) attached as exhibits to the FDD.<sup>13</sup> Specifically, if a franchisor has unilaterally and materially altered the terms and conditions of the form franchise agreement (or other required agreement), a franchisor is required to afford the prospective franchisee additional time – seven calendar days – to review the revised agreement prior to signing.<sup>14</sup> This mandatory seven calendar day waiting period does not apply where: (1) the only differences between the form agreement and the ready-

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<sup>10</sup> 16 C.F.R. §436.2(a).

<sup>11</sup> FTC, *Franchise Rule Compliance Guide* at p. 20 (May 2008), <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf> (hereafter, the “Compliance Guide”).

<sup>12</sup> 16 C.F.R. §436.9(e).

<sup>13</sup> 16 C.F.R. §436.2(b).

<sup>14</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 22.

for-execution version are non-substantive “fill-in-the-blank” provisions,<sup>15</sup> or (2) the modifications to the agreement reflect changes initiated at the prospective franchisee’s request.<sup>16</sup>

## **b. Electronic Disclosure**

The Amended Rule explicitly addressed a practice that franchisors had undertaken for years prior to the Amended Rule’s adoption in 2007: Disclosing prospective franchisees with electronic copies of the FDD. Electronic disclosure can be made via email, CD-ROM, via a secure portal (where a prospect can access the password-protected document), or through any number of third-party vendors that specialize in helping franchisors comply with the technical aspects of tracking FDD delivery and signing dates.<sup>17</sup> Despite the Amended Rule’s express acknowledgment of the electronic age in which we are living, it specifically prohibits franchisor use of pop-ups, audio, video and links to external documents as such items could be distracting to the prospective franchisee and minimize the thrust of the content of the required disclosures.<sup>18</sup> The Amended Rule does permit franchisors, however, to implement tools in electronic documents aimed at helping prospective franchisees to review an FDD more efficiently.<sup>19</sup> These tools include scroll bars, search features, and internal links between disclosure items and other parts of the FDD.

Nearly every franchisor now utilizes electronic disclosure. Accordingly, the Amended Rule’s additional requirement that the franchisor provide advance disclosure to prospects related to the form in which the FDD is available is part of most franchisors’ standard operating procedures.<sup>20</sup> This “pre-disclosure disclosure” for electronic transmittal of an FDD often is made on the franchisor’s website, franchise application, or cover letter that first engages the prospective franchisee in a dialogue about the opportunity.<sup>21</sup>

A final issue that arises in connection with electronic disclosure of the FDD is the requirement that a franchisor furnish the FDD in a format that enables the prospective franchisee to keep the FDD for future reference.<sup>22</sup> Accordingly, if a franchisor elects to furnish the FDD as an email attachment or through a secure portal, the FDD must be in a format that the prospective franchisee can download to a computer or CD-ROM.<sup>23</sup>

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<sup>15</sup> *Id.* According to the Compliance Guide, “fill-in-the-blank” provisions include items such as date, name and address of the franchisee. The addition of substantive terms such as a protected territory, interest rate, number of stores to be opened, or other contractual terms that were not previously disclosed in the FDD or its attachments will trigger the seven calendar day waiting period.

<sup>16</sup> *Id.* at 23.

<sup>17</sup> 16 C.F.R. §436.2(c).

<sup>18</sup> 16 C.F.R. §436.6(d).

<sup>19</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 122.

<sup>20</sup> See, 16 C.F.R. §436.6(g).

<sup>21</sup> Sample language for this type of disclosure may include the following sentence: “The Franchise Disclosure Document is available to you in one of three formats: Electronic PDF, paper hard copy, or via CD-ROM. To access PDF, you will need the most current version of Adobe Acrobat Reader installed on your PC.”

<sup>22</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 121.

<sup>23</sup> *Id.*

The FDD also must be printable as a single document, and may not be provided in multiple, discrete parts.<sup>24</sup> For example, a franchisor that provides the FDD as an email attachment may not also attach a separate copy of the Receipt pages for signing convenience. The purpose of the Receipt pages is to serve as confirmation that the prospective franchisee received the FDD – that purpose is lost if the Receipt pages are included as a separate attachment.

## **B. State Regulation**

In addition to the disclosure obligations required by the Amended Rule, certain states have enacted separate franchise laws that impose additional state-level disclosure and registration requirements.<sup>25</sup> While the original Franchise Rule was enacted in 1979 after an extensive, multi-year rulemaking process, the state of franchising in the decades prior spurred several state legislatures to take earlier action. For example, California was the first state to enact a law—the California Franchise Investment Law—requiring that the franchisor not only make specific disclosures to prospective franchisees, but also affirmatively register the FDD with the state agency tasked with enforcing the statute.<sup>26</sup> Several other states followed suit and enacted laws aimed at ensuring a higher level of franchisor compliance with required disclosure obligations by enforcing a registration requirement. In short, and as further described below, states with these types of laws in place prohibit a franchisor from engaging in the franchise sales process unless the franchisor is effectively “registered” to offer and sell franchises in the state.

### **1. Franchise Registration States**

A total of fourteen franchise registration states exist (the “Registration States”).<sup>27</sup> These states specifically prohibit a franchisor from engaging in the offer and sale of

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<sup>24</sup> *Id.*

<sup>25</sup> Although outside the scope of this paper, several states have enacted “franchise relationship” statutes, which govern the circumstances under which a franchise relationship may be cancelled, terminated, not renewed or otherwise materially changed. See, Christine E. Connelly, Aron Friedman and Mark Inzetta, *Franchise Default and Termination – Best Practices to Enforce the Contract and Protect the System*, 49th Annual Legal Symposium (2016), for a primer on these laws.

<sup>26</sup> See, *California Franchise Investment Law*, California Corporations Code, Div. 5, Parts 1-6, Section 31000 *et seq.*

<sup>27</sup> *California Franchise Investment Law*, California Corporations Code, Div. 5, Parts 1-6, Section 31000 *et seq.*; *Hawaii Franchise Investment Law*, Hawaii Rev. Stat., Title 26, Ch. 482E, Section 482-E1 *et seq.*; *Illinois Franchise Disclosure Act*, Illinois Compiled Statutes, Ch. 815, Section 705/1 *et seq.*; Indiana Code, Title 23, Article 2, Ch. 2.5, Section 1 *et seq.*; *Maryland Franchise Registration and Disclosure Law*, Ann. Code of Maryland, Business Regulation, Title 14, Section 14-201 *et seq.*; *Michigan Franchise Investment Law*, Michigan Compiled Laws, Ch. 445, Section 445.1501 *et seq.*; *Minnesota Statutes*, Ch. 80C, Section 80C.01 *et seq.*; *New York General Business Law*, Art. 33, Section 680 *et seq.*; *North Dakota Franchise Investment Law*, North Dakota Century Code Ann., Title 51, Ch. 51-19, Section 51-19-01 *et seq.*; *Rhode Island Franchise and Distributorship Investment Regulations Act*, General Laws of Rhode Island, Title 19, Ch. 28.1, Section 19-28.1-1 *et seq.*; *South Dakota Franchises for Brand-Name Goods and Services Law*, South Dakota Codified Laws, Title 37, Ch. 37-5B, Section 37-5B-1 *et seq.*; *Virginia Retail Franchising Act*, Virginia Code, Title 13.1, Ch. 8, Section 13.1-557 *et seq.*; *Washington Franchise Protection Act*, Revised Code of Washington, Title 19, Ch. 19.100, Section 19,100.010 *et seq.*; *Wisconsin Franchise Investment Law*, Wisconsin Stats., Ch. 553, Section 553.01 *et seq.*

franchises absent first securing an effective franchise registration with the applicable state agency. As discussed further in Section III below, the state registration process varies from state to state. Practitioners tasked with managing the FDD registration process are advised to understand the various state nuances and requirements prior to submitting a franchise registration application to a particular state.

## 2. State Disclosure Obligations

In addition to the disclosure obligations promulgated by the Amended Rule, certain states have adopted regulatory schemes that impose state disclosure obligations on a franchisor and, in certain instances, greater disclosure than required by the Amended Rule. A total of fifteen states impose state-specific disclosure obligations on franchisors in addition to those required under the Amended Rule (the “Franchise States”).<sup>28</sup> Generally speaking, the Franchise States have adopted the same disclosure obligations as codified in the Amended Rule with a few exceptions. Specifically, certain Franchise States require a franchisor to include additional disclosures in the FDD and/or require a franchisor to provide the FDD to a prospective franchisee earlier in the sales process. These additional, state-specific disclosure obligations are detailed further in Sections II.B and II.D below.

## II. Franchise Disclosure Document Requirements

As noted above, the Amended Rule requires a franchisor to provide a prospective franchisee with an FDD that contains 23 Items of disclosure that correspond with the requirements of the Amended Rule. This Section II.A provides a brief summary of the key disclosures required in each of the 23 Items. This Section II.A does not, however, address and identify every disclosure required by the Amended Rule. Please refer to the Amended Rule and FTC Franchise Rule Compliance Guide (the “Compliance Guide”) when preparing an FDD to ensure full compliance.

### A. Federal FDD Requirements

#### 1. Federal and State Cover Pages

The FDD begins with a federal cover page. The federal cover page explains to prospective franchisees the purpose of the FDD, basic information about the franchise system and certain protection mechanisms that have been put in place for franchisees.<sup>29</sup> On the federal cover page, the Amended Rule requires a franchisor to include certain scripted language and other information in a required order and form. Specifically, the Amended Rule requires the title of the FDD – “**FRANCHISE DISCLOSURE DOCUMENT**” – to appear in both capital letters and boldface type.<sup>30</sup> The title must be followed by basic information about the franchisor – i.e., name, type of business organization, principal business address, telephone number and the

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<sup>28</sup> See, *supra* note 23 & *Oregon Franchise Transactions Law*, Oregon Revised Statutes, Title 50 Ch. 650, Section 650.005 *et seq.*

<sup>29</sup> 16 C.F.R. §436.3.

<sup>30</sup> *Id.*

franchisor's email address and web page – the primary business trademark for the franchise system, and a brief description of the franchised business.<sup>31</sup> Certain other prescribed statements must also be included on the cover page including:

The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7]. This includes [the total amount in Item 5] that must be paid to the franchisor or affiliate.<sup>32</sup>

This disclosure document summarizes certain provisions of your franchise agreement and other information in plain English. Read this disclosure document and all accompanying agreements carefully. You must receive this disclosure document at least 14 calendar-days before you sign a binding agreement with, or make any payment to, the franchisor or an affiliate in connection with the proposed franchise sale. **Note, however, that no governmental agency has verified the information contained in this document.**<sup>33</sup>

[OPTIONAL] You may wish to receive your disclosure document in another format that is more convenient to you. To discuss the availability of disclosures in different formats, contact [name or office] at [address] and [telephone number].<sup>34</sup>

The terms of your contract will govern your franchise relationship. Don't rely on the disclosure document alone to understand your contract. Read all of your contract carefully. Show your contract and this disclosure document to an advisor, like a lawyer or an accountant.<sup>35</sup>

Buying a franchise is a complex investment. The information in this disclosure document can help you make up your mind. More information on franchising, such as "*A Consumer's Guide to Buying a Franchise*," which can help you understand how to use this disclosure document, is available from the Federal Trade Commission. You can contact the FTC at 1-877-FTC-HELP or by writing to the FTC at 600 Pennsylvania Avenue, NW, Washington, D.C. 20580. You can also visit the FTC's home page at [www.ftc.gov](http://www.ftc.gov) for additional information. Call your state agency or visit your public library for other sources of information on franchising.<sup>36</sup>

There may also be laws on franchising in your state. Ask your state agencies about them.<sup>37</sup>

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<sup>31</sup> *Id.*

<sup>32</sup> 16 C.F.R. §436.3(e)(1).

<sup>33</sup> 16 C.F.R. §436.3(e)(2).

<sup>34</sup> 16 C.F.R. §436.3(f).

<sup>35</sup> 16 C.F.R. §436.3 (e)(3).

<sup>36</sup> 16 C.F.R. §436.3 (e)(4).

<sup>37</sup> 16 C.F.R. §436.3 (e)(5).

Finally, the federal cover page must include the issuance date for the FDD.<sup>38</sup> The issuance date is the date on which the franchisor finalizes the FDD.<sup>39</sup>

In addition to the federal cover page, state law may require, or state franchise administrators may request, that franchisors include a state cover page and certain risk factors on the state cover page.<sup>40</sup> See Section II.B.2 below and Exhibit C for a discussion on possible state risk factors.

## **2. Item 1: The Franchisor and any Parents, Predecessors and Affiliates**

Item 1 aims to capture and deliver important information to the prospective franchisee related to the franchisor, the nature of its system and any competitors owned by its parents and affiliates, as well as its corporate history by way of predecessor and affiliate disclosures.<sup>41</sup> Also in this Item, franchisors must disclose to their prospective franchisees information related to the types of laws and regulations applicable to the franchised business, as well as general information related to the types of businesses that compete with the franchised business.<sup>42</sup>

## **3. Item 2: Business Experience**

The experience of key executives and leaders in a franchise system are of utmost importance to prospective franchisees as they consider where they want to invest their life savings and build a future with a particular brand. Accordingly, Item 2 requires that key franchisor leaders disclose their business experience for the past five years.<sup>43</sup> Key leaders include not only executive officers and directors, but those individuals that have “management responsibility” related to the sale or operation of franchises.<sup>44</sup> Thus, in addition to key officers and directors, individuals in lead operations or sales roles must be disclosed in Item 2.<sup>45</sup>

## **4. Item 3: Litigation**

Item 3 requires that certain types of litigation against the franchisor, its predecessors, parents and affiliates be disclosed to prospective franchisees.<sup>46</sup> To qualify for disclosure, the litigation must be a pending lawsuit, lawsuit involving the franchise relationship, prior lawsuit, and current government injunctive or restrictive orders.<sup>47</sup> Further, and generally speaking, the litigation must involve allegations that the franchisor has violated a franchise, antitrust, or securities law, or allege fraud, unfair or

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<sup>38</sup> 16 C.F.R. §436.3 (e)(6).

<sup>39</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 26.

<sup>40</sup> 16 C.F.R. §436.3(g).

<sup>41</sup> 16 C.F.R. §436.5(a).

<sup>42</sup> *Id.*

<sup>43</sup> 16 C.F.R. §436.5(b).

<sup>44</sup> *Id.*

<sup>45</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 33.

<sup>46</sup> 16 C.F.R. §436.5(c).

<sup>47</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 34.

deceptive practices or comparable allegations.<sup>48</sup> The Item 3 disclosure obligations extend for a 10-year period prior to the issuance date of the FDD.<sup>49</sup>

Lawsuits involving persons disclosed in Item 2 also may be required to be identified in Item 3 of the FDD if, based on all facts and circumstances, the action and/or claims are material in the sense that they may influence a prospective franchisee's investment decision.<sup>50</sup> The Amended Rule also requires that franchisors disclose franchisor-initiated litigation against franchisees (current and former) to enforce the terms of the franchise relationship, but limits this disclosure to only those lawsuits that have been filed within the franchisor's last fiscal year.<sup>51</sup> Litigation falling into this category typically includes the enforcement of noncompete covenants, collection actions to require payment of amounts owed, and lawsuits to enforce system standards.

## **5. Item 4: Bankruptcy**

As with the Item 3 litigation disclosure, the bankruptcy disclosures required in Item 4 must include bankruptcy and related proceedings that have occurred in the immediately preceding 10-year period.<sup>52</sup> Disclosures must include information for the franchisor, its parent, predecessors and affiliates, as well as individuals identified in Item 2.<sup>53</sup>

## **6. Item 5: Initial Fees**

Item 5 is intended to provide the prospective franchisee with information related to both the amount and types of fees collected by the franchisor or its affiliates as a condition of opening the franchisee's business. Both lump sum and installment payments must be disclosed.<sup>54</sup> The Amended Rule also requires the franchisor to disclose the range of fees collected during the prior fiscal year and whether any of the required fees are refundable.<sup>55</sup>

## **7. Item 6: Other Fees**

Unlike Item 5, which captures the pre-opening fees payable to the franchisor and its affiliates, Item 6 captures other fees paid to the franchisor and its affiliates (whether recurring or occasional) that are associated with operating a franchised outlet.<sup>56</sup> Examples of fees that fall within this category include royalty fees, advertising fund payments, software fees, transfer fees, renewal fees and the like. Item 6 covers payments made to the franchisor or its affiliate directly, or to the franchisor or its affiliate

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<sup>48</sup> 16 C.F.R. §436.5(c).

<sup>49</sup> 16 C.F.R. §436.5(c)(1)(iii).

<sup>50</sup> While lawsuits against Item 2 individuals related to "routine business matters" need not be disclosed in Item 3, counsel for franchisors must critically assess the inclusion of such lawsuits under the materiality standard based on all facts and circumstances.

<sup>51</sup> 16 C.F.R. §436.5(c)(1)(ii).

<sup>52</sup> 16 C.F.R. §436.5(d).

<sup>53</sup> 16 C.F.R. §436.5(d)(1).

<sup>54</sup> 16 C.F.R. §436.5(e).

<sup>55</sup> *Id.*

<sup>56</sup> 16 C.F.R. §436.5(f).

in a pass-through capacity.<sup>57</sup> In helping prospective franchisees frame the impact of these additional fees to their businesses, franchisors must describe the nature and frequency of the fees, whether they are subject to increase (and, if so, by what amount [if known] or methodology), whether the fees are uniformly imposed among all franchisees and outlets, and whether (and under what circumstances, if any) the fees are refundable.<sup>58</sup>

## **8. Item 7: Estimated Initial Investment**

Whereas Item 5 and Item 6 require disclosure of fees imposed by and payable to the franchisor or its affiliates, Item 7 captures a broader range of estimated fees and charges that the prospective franchisee can expect to incur prior to the opening of its franchised business or outlet.<sup>59</sup> The Item 7 disclosure must be made in a prescribed table that captures clearly the type of expenditure, amount due or payable, method of payment, when the payment is due, and to whom the payment must be made.<sup>60</sup> Item 7 is not exhaustive, as by nature a franchisee's experience is unique and may vary from that of the other franchisees from whom the estimated initial investment figures were compiled. Despite this, required categories of disclosure (which are standard throughout most or all systems) include (1) initial franchise fee, (2) training expenses, (3) real property (purchased or leased), (4) equipment, (5) beginning inventory, (6) business licenses and fees, and (7) a category for "additional funds" (which are additional monies the franchisee will need during the initial period of operation of the business, typically three or six months, but sometimes longer depending on the business opportunity).<sup>61</sup> Beyond these required categories, franchisors must take a critical look at their business structure and disclose other types of fees payable by franchisees prior to opening—such fees may include, for example, charges for additional pre-opening training, travel, grand opening advertising, and required co-op contributions.

## **9. Item 8: Restrictions on Sources of Products and Services**

A hallmark of franchising is the uniformity of products and services, such that consumers have the same great experience regardless of whether the same or different franchisee owns the outlets they visit. Against this backdrop, it is common for franchisors to specify certain products, services, ingredients and vendors—some of which may be proprietary to the franchisor and system—that franchisees must use in connection with the operation of their franchised businesses. To maintain the desired uniformity, franchisors typically have a process by which they will review and assess any new proposed product, service or vendor. Moreover, some franchisors receive payments and other consideration from vendors of products and services based on sales to franchised outlets. Item 8 captures disclosures related to these important areas of a franchisor's business model by requiring disclosures that capture obligatory purchases, restrictions on sources of products and services, and the amount of revenue

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<sup>57</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 45.

<sup>58</sup> 16 C.F.R. §436.5(f)(4).

<sup>59</sup> 16 C.F.R. §436.5(g).

<sup>60</sup> *Id.*

<sup>61</sup> 16 C.F.R. §436.5(g) (1)(i)-(iii).

that franchisors may receive from suppliers.<sup>62</sup> In some systems, purchasing or distribution cooperatives exist; if present, disclosures related to these purchasing-related systems must be included in Item 8.<sup>63</sup>

As alluded to above, Item 8 contains one of the most oft-discussed aspects of franchising – the franchisor’s right to receive rebates and other consideration based upon franchisee purchases of products and services from system suppliers. When making Item 8 revenue disclosures, franchisors must fully and clearly provide the following information to prospective franchisees: (1) the franchisor’s total revenue, (2) the franchisor’s revenues from all required purchases and leases of products and services by franchisees, (3) the percentage of the franchisor’s total revenues that come from purchases or leases required by the franchisor, (4) the revenues received by affiliates of the franchisor from purchases or leases required by the franchisor, and (5) the estimated portion of the franchisee’s required purchases and leases to all purchases and leases by the franchisee in establishing or operating the franchise.<sup>64</sup>

#### **10. Item 9: Franchisee’s Obligations**

Item 9 captures key obligations of the franchisee in a prescribed table by detailing the obligation at issue, the section in the agreement that references the obligation, and the corresponding “Item” in the FDD that addresses that franchisee’s obligation.<sup>65</sup> The Item 9 chart captures everything from the franchisee’s obligations related to site selection, compliance with system standards, noncompetition covenants, personal guarantees and everything in between. A sample Item 9 chart is attached as Exhibit A.

#### **11. Item 10: Financing**

If the franchisor provides direct or indirect financing to franchisees, or guarantees franchisee loans or leases, the franchisor must provide detail in Item 10 related to each such arrangement.<sup>66</sup> Elements of required disclosures vary depending on the type of arrangement at hand, but generally include detail related to interest rates and finance charges, number of payments, penalties for default and, in the case of preferred lending arrangements, any consideration or benefit that a franchisor receives for referring a prospective franchisees to a lender.<sup>67</sup> The Amended Rule permits a franchisor to disclose any Item 10 financing by use of a prescribed table. A sample Item 10 table is attached as Exhibit B.

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<sup>62</sup> 16 C.F.R. §436.5(h).

<sup>63</sup> 16 C.F.R. §436.5(h)(9).

<sup>64</sup> 16 C.F.R. §436.5(h)(6)-(7).

<sup>65</sup> 16 C.F.R. §436.5(i).

<sup>66</sup> 16 C.F.R. §436.5(j).

<sup>67</sup> *Id.*

## 12. Item 11: Franchisor's Assistance, Advertising, Computer Systems and Training

While the entirety of the FDD is intended to capture detail related to the franchise system and opportunity, including the franchisor's related obligations, Item 11 creates specific focus on disclosing information related to the franchisor's obligations related to general assistance, advertising, computer systems and training. Prior to the franchisor's recitation of assistance provided during the term of the franchise appears a clear admonition warning the prospective franchisee that "except as listed below, [the franchisor] is not obligated to provide you with any assistance."<sup>68</sup> Following that stark introduction, the franchisor then must identify the specific pre-opening assistance it provides to the franchisee (e.g., site selection criteria and acceptance of sites), the specific continuing assistance it provides after the franchised business is operational (e.g., review and approval of local advertising materials, as well as others that depend on the nature of the franchised business), and any optional assistance provided during the term of the franchise.<sup>69</sup>

Unique disclosures related to the franchisor's assistance with respect to advertising programs, materials and the advertising fund also appear in Item 11. The franchisor specifically must disclose the following: (1) whether the franchisee must conduct local advertising; (2) the types of media used for advertising (e.g., print, radio, television, internet); (3) the source of the advertising; (4) the geographical scope of advertising (e.g., local, regional or national); (5) whether franchisees must contribute to an advertising fund or spend any specific amounts toward advertising in their local markets; and (6) the role of advertising councils or cooperative associations (and a description of how they operate).<sup>70</sup> As it relates to advertising funds, franchisors must disclose the amount, sources and uses of advertising funds—as a percentage—during the preceding fiscal year.<sup>71</sup> Required categories of disclosure for advertising fund expenditures will vary based on the specific permitted uses described in each franchisor's agreement, but generally include production (including internal costs related to supplies, photography, etc.), media placement, administrative expenses (including all or some of the salaries of franchisor personnel involved in advertising the franchise system's products and services, if reasonable), and other described expenses.<sup>72</sup>

In addition, franchisors must provide a general description of the computer systems required to be purchased or leased by franchisees, along with corresponding costs and a statement as to whether the franchisor will have access to any of the information that appears in such systems.<sup>73</sup> Item 11 demands that franchisors identify whether the franchisor, an affiliate or another third party must provide ongoing maintenance, repairs, upgrades or updates.<sup>74</sup> Likewise, Item 11 requires that franchisors identify whether the franchisee has any obligation to upgrade or update the

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<sup>68</sup> 16 C.F.R. §436.5(k).

<sup>69</sup> 16 C.F.R. §436.5(k)(1) and (3).

<sup>70</sup> 16 C.F.R. §436.5(k)(4).

<sup>71</sup> 16 C.F.R. §436.5(k)(4)(v).

<sup>72</sup> 16 C.F.R. §436.5(k)(4)(v)(G).

<sup>73</sup> 16 C.F.R. §436.5(k)(5).

<sup>74</sup> 16 C.F.R. §436.5(k)(5)(ii).

systems and whether there is any contractual limitation on the frequency and cost of such updates.<sup>75</sup>

Item 11 also captures important information related to the franchisor's required training program (to appear in a specific tabular format that delineates between "on the job" and "classroom training") and insights into its operating manuals.<sup>76</sup> As it relates to the training program, franchisors must specify who from the franchisee's organization may attend training, whether all or some attendees must successfully complete the training, and associated costs for training attendance (e.g., tuition and travel costs).<sup>77</sup> The franchisor also must identify the corporate officer tasked with administering the required training programs.<sup>78</sup>

As it relates to the operating manuals, a franchisor may provide a copy of the entire manual to prospective franchisees prior to consummating a sale; in this event, the franchisor may require the prospect to sign a confidentiality agreement, which is acceptable under the Amended Rule so long as that requirement is disclosed in Item 11 and the confidentiality agreement contains no other provisions that would require separate disclosure.<sup>79</sup> As an alternative, and to preserve confidentiality, many franchisors resort to disclosing the table of contents to their operating manual, which is common practice and entirely acceptable under the Amended Rule.<sup>80</sup>

### **13. Item 12: Territory**

Item 12 provides a snapshot of the parties' respective rights and obligations related to geographic footprint of the franchised business. Specifically, this item details the methodology for defining the designated area or protected territory in which the franchised business will operate, along with conditions (if any) that the franchisee must meet so as to maintain the "protected" nature of the area.<sup>81</sup> The franchisor also must specify in Item 12 the extent to which, if at all, the franchisee may solicit for sales outside of its protected territory.<sup>82</sup> Finally, and unless the franchisor truly reserves no right for itself inside the franchisee's protected area—including with respect to alternative channels of distribution like the internet or unique venues (something that is commonplace given that the internet knows no boundaries)—the Amended Rule requires that the franchisor include a specific statement to put the franchisee on notice that it will not receive an "exclusive territory." The statement reads as follows:

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.<sup>83</sup>

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<sup>75</sup> 16 C.F.R. §436.5(k)(5)(iii).

<sup>76</sup> 16 C.F.R. §436.5(k)(6)-(7).

<sup>77</sup> 16 C.F.R. §436.5(k)(7)(ii)(D).

<sup>78</sup> 16 C.F.R. §436.5(k)(7)(ii)(B).

<sup>79</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 67.

<sup>80</sup> 16 C.F.R. §436.5(k)(6).

<sup>81</sup> 16 C.F.R. §436.5(l).

<sup>82</sup> 16 C.F.R. §436.5(l)(6)(ii).

<sup>83</sup> 16 C.F.R. §436.5(l)(5)(i).

#### **14. Item 13: Trademarks**

As franchised systems are built on brand recognition, prospective franchisees must receive certain disclosures related to the primary marks associated with the franchised business they intend to operate, including the registration status of each mark, any limitations on the franchisee's use of the mark (through settlement agreement or otherwise), and whether the marks have been contested via court actions or administrative proceedings—and Item 13 intends to accomplish just that.<sup>84</sup> Each disclosure is intended to assist the franchisee in determining the value of the overall mark associated with the franchise system at issue. Further, as to any key mark that does not have an effective registration (including marks that are pending registration) with the United States Patent and Trademark Office, the Amended Rule requires the franchisor to include the following language in Item 13:

We do not have a federal registration for our principal trademark. Therefore, our trademark does not have as 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.<sup>85</sup>

#### **15. Item 14: Patents, Copyrights and Proprietary Information**

As with the Item 13 trademark disclosures, Item 14 seeks to provide information to prospective franchisees related to other intellectual property of the franchisor that is used in the operation of the franchise system and franchised businesses.<sup>86</sup> Nearly all franchisors seek to highlight the confidential nature of their operating manuals by specifically listing the operating manuals in Item 14 and noting that all information contained therein is not only proprietary and confidential to the franchisor, but subject to common law copyright protection. Some franchise systems rely on certain technologies or protected processes in connection with the products and services provided by franchised outlets, and for these franchise systems, disclosures related to these protected technologies or processes must be referenced in Item 14. The disclosures are similar to the Item 13 disclosures, in that the franchisor must generally identify the protected technology or process and provide statements as to any limitations on the franchisee's use of such items (through settlement agreements or otherwise), and whether the protected items have been contested via court actions or administrative proceedings.<sup>87</sup> Recognizing that litigation is common with respect to trade secrets, patents and proprietary information, franchisors may include an attorney's opinion as to the merits of any court action or administrative proceeding provided that the attorney consents to inclusion of its opinion in the FDD.<sup>88</sup>

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<sup>84</sup> 16 C.F.R. §436.5(m).

<sup>85</sup> 16 C.F.R. §436.5(m)(4).

<sup>86</sup> 16 C.F.R. §436.5(n).

<sup>87</sup> *Id.*

<sup>88</sup> 16 C.F.R. §436.5(n)(3).

## **16. Item 15: Obligation to Participate in the Actual Operation of the Franchised Business**

Item 15 notifies the prospective franchisee about the franchisor's requirements and expectations related to franchisee involvement in the business.<sup>89</sup> Some franchise systems allow absentee owners while others require that a franchisee be intimately involved in business operations. Franchisors thus must describe in Item 15 the requirements for franchisees with respect to these and related matters, including minimum experience and equity requirements for an absentee franchisee's on-premises operations executive.<sup>90</sup>

## **17. Item 16: Restrictions on What the Franchisee May Sell**

As noted earlier, uniformity of products and services is a hallmark of franchise systems. As such, it comes as no surprise that the FDD must describe limitations on a franchisee's ability to sell products and services. Item 16 specifically requires the franchisor to describe whether the franchisee may sell only items approved by the franchisor, whether the franchisee must sell all goods and services authorized by the franchisor, and whether and under what conditions the franchisor may change the goods and services to be sold by the franchised business.<sup>91</sup>

## **18. Item 17: Renewal, Termination, Transfer and Dispute Resolution**

Item 17 contains a chart with detailed disclosures about the franchised relationship. In this chart, franchisors must make a general statement about the provision that impacts the relationship (e.g., "length of the franchise term"), identify the section in the agreement that contains the provision (e.g., "Section \_\_\_\_"), and must include a summary description of the provision (e.g., "Term is for a period of twenty years from the opening date").<sup>92</sup> An example of an Item 17 chart is attached hereto as Exhibit C.

## **19. Item 18: Public Figures**

Some franchise systems use an affiliation with a publicly recognizable figure—an athlete, actor, musician or other celebrity—to help them attract prospective franchisees and, ultimately, sell franchises.<sup>93</sup> In Item 18 of the FDD, franchisors must disclose the nature of the affiliation, including whether the public figure is involved in the ownership or management of the franchise system, or whether the public figure is a paid spokesperson.<sup>94</sup> As to the latter point, if the public figure is a paid spokesperson,

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<sup>89</sup> 16 C.F.R. §436.5(o).

<sup>90</sup> 16 C.F.R. §436.5(o)(2).

<sup>91</sup> 16 C.F.R. §436.5(p).

<sup>92</sup> 16 C.F.R. §436.5(q).

<sup>93</sup> For example, Papa John's International, Inc. disclosed in its 2013 FDD that Peyton Manning was a public figure for the Papa John's franchise system.

<sup>94</sup> 16 C.F.R. §436.5(r).

compensation details must be disclosed.<sup>95</sup> Franchisors need not make Item 18 disclosures for public figures that help attract customers to the products and services associated with the franchised system and brand, so long as the public figure is not used in the offer and sale of franchises.<sup>96</sup>

## 20. Item 19: Financial Performance Representations

Recalling that projections of potential financial gain served as one catalyst for broad franchise regulation, it is no surprise that the Amended Rule requires robust disclosures for any franchisor that wishes to speak to prospective franchisees about potential financial returns.<sup>97</sup> Long known as “earning claims,” the Amended Rule adopted the term “financial performance representation” (or “FPR”) in recognition that certain types of franchise systems use unique metrics beyond “earnings” to assess financial health of the business (for example, hotel franchisors use room occupancy rates).

In fact, Section 436.1(e) of the Amended Rule defines a “financial performance representation” broadly, as follows:

Financial performance representation means 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. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.<sup>98</sup>

Essentially, an FPR is any statement to a prospective franchisee regarding the return on investment they may achieve or that others have achieved. Regardless of whether a franchisor decides to make an FPR in Item 19, the Amended Rule requires the franchisor to begin its Item 19 disclosure with the following preamble:

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be

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<sup>95</sup> 16 C.F.R. §436.5(4)(1).

<sup>96</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 84.

<sup>97</sup> The North American Securities Administrators Association, Inc. (“NASAA”) has been hard at work over the past few years preparing an FPR Commentary, the most-current, proposed version of which was released on September 14, 2016 (“Current Proposed FPR Commentary”). Once finalized and adopted, the FPR Commentary will not only provide instruction to franchise practitioners who prepare and review FPRs, but also will help ensure that the FPRs prospective franchisees receive are more uniform and expansive, and less likely to mislead. For further information on the Current Proposed Commentary, see, Dale Cantone, Eric Karp, and Max Schott, II, *Advanced Drafting of Financial Performance Representations*, 39th Annual ABA Forum on Franchising (2016).

<sup>98</sup> 16 C.F.R. §436.1(e).

given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.<sup>99</sup>

The decision to include an FPR in the FDD is personal to each franchisor. The Amended Rule made clear, however, that specific language must be included “word-for-word” in Item 19 if a franchisor declines to make a financial performance representation. That language is as follows:

We do not make any representations about a franchisee’s future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor’s management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory authorities.<sup>100</sup>

Franchisors that do elect to include a financial performance representation in their FDD must ensure that it satisfies several important criteria, the first of which is that the full extent of the FPR is contained within Item 19 of the FDD itself.<sup>101</sup> The franchisor also must have a “reasonable basis” for the representation at the time the representation is made. The Compliance Guide has defined “reasonable basis” with reference to a number of factors, including, among others, that the FPR is grounded in written factual information that supports the representation at the time it was made and that the written information would be meaningful to a “prudent businessperson” as part of their decision-making process related to the particular franchise opportunity at hand.<sup>102</sup> For example, in its recent commentary, NASAA clarified that a franchisor’s use of company-owned outlets alone is not “reasonable” when the franchisor has operational franchised outlets in the system.<sup>103</sup>

Financial performance representations can be based on historical information or projections of future performance, with the latter type of disclosure being subject to even

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<sup>99</sup> 16 C.F.R. §436.5(s)(1).

<sup>100</sup> 16 C.F.R. §436.5(s)(2).

<sup>101</sup> 16 C.F.R. §436.9(c). Representations outside of the FDD are expressly prohibited unless they involve the actual historical operating results of a specific outlet that the prospective franchisee intends to purchase. See also, FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 93.

<sup>102</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 135.

<sup>103</sup> NASAA, *Current Proposed FPR Commentary* at 19.8 (September 14, 2016), <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2016/09/FPR-Commentary-Public-Comment-09132016.pdf>. While the recent NASAA Commentary is not effective until 2018, NASAA has advised that many Registration States will begin enforcing the new Item 19-related requirements in connection with the 2017 franchise registration and renewal season.

greater scrutiny than already exists for FPRs generally.<sup>104</sup> For efficiency and relevancy, the remainder of this section will focus on the requirements associated with an historical performance projection, as historical projections are the most commonly provided level of performance (and, arguably, the most relevant given that prospective franchisees can gauge the actual performance of franchised outlets).

One relatively common, albeit basic, type of historical financial performance representation includes a statement of “average gross sales,” although as noted in the opening paragraph of this section, other metrics (such as occupancy rates, customer counts, “gross profit,” and the like) may be more meaningful depending on the business model at hand. In any event, a franchisor making a financial performance representation must detail, in writing, the surrounding material context for the information provided. Using the example of an historical “average gross sales” FPR, the franchisor must ensure that its Item 19 statement details the following important information, such that a prospective franchisee views the Item 19 statement with the full context in which it is framed:<sup>105</sup>

- Clear identification of the “group measured” – In other words, is the franchisor’s FPR based on the performance of all outlets in the system, or only a subset of outlets? Remember that company-owned outlet performance alone is not an acceptable substitute for franchised outlet performance. Further, the recent NASAA commentary specifically prohibits a franchisor from measuring the performance of its best performing outlets without also disclosing the corresponding measurements for its lowest performing outlets.<sup>106</sup> In short, franchisors must ensure that it clearly identifies the group measured and the basis for that measurement.
- Statement of the time period at play – Over what period of time did the measurement occur? Franchisors must ensure that the time period measured is relevant in light of facts and circumstances present at the time the FPR is made.
- Contrast between the number of outlets that were measured and the number of outlets that actually reported – In other words, franchisors should articulate the reasons why not all outlets eligible to be measured were included in the actual measurement. For example, is the sample to be measured limited to outlets that have been in operation for 12 months or longer? Is the sample tied to a specific type of operating style in a system with different service

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<sup>104</sup> Franchisors must proceed cautiously with respect to including FPRs grounded in projections of future performance, as absent robust disclosure related to all elements of the projection (and why those elements support the franchisor’s projection of future performance metrics to be attained by the prospective franchisee), a franchisor could find itself not only in violation of applicable federal and state disclosure requirements but perhaps also defending a variety of fraud and misrepresentation claims. See, FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 135-136 for additional detail on making reasonable projections of future performance.

<sup>105</sup> See generally, FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 87-91. For additional information regarding necessary disclosures related to projections of future performance, see *Id.* at 91-92 and 135-136.

<sup>106</sup> NASAA, Current Proposed Commentary at 19.14.

styles or formats? Franchisors must ensure that all relevant information is presented so that prospective franchisees understand the full scope (and limitations) of the FPR provided.

- The number and percentage of outlets that achieved the stated performance – This ensures that prospective franchisees easily can identify whether the stated performance level (average gross sales, for example) was achieved by a majority of the franchised outlets or whether one or two high volume locations skewed the average. Under the proposed NASAA Commentary, Franchisors that disclose average information in an FPR also must disclose the “median” as well as the “actual high” and “actual low” performance figures for outlets included in the sample.<sup>107</sup>
- Other material information – This is the catch-all where franchisors must identify any other material information, which if known, would add or retract from the likelihood that a prospective franchisee might achieve similar performance to that stated in Item 19. For example, franchisors should ask themselves whether the stated performance level varies by geography, weather conditions, urban or suburban environments, and other numerous factors.

Franchisors that make financial performance representations in Item 19 must provide written substantiation of the statement to prospective franchisees upon reasonable request, the precise determination of which is to be made based on all surrounding facts and circumstances associated with the request. A “supplemental representation” also may be warranted where the franchisor seeks to provide an FPR for a unique outlet for sale or for a type of outlet with abnormal characteristics (e.g., airport location). Supplemental representations must be written, state the reason the information differs from the stated performance level in Item 19, and comply with all requirements for making Item 19 disclosures generally.

Finally, while franchisors are required to include an “admonition” in Item 19 that warns prospective franchisees that their performance may differ from the stated level,<sup>108</sup> a franchisor’s Item 19 may not be littered with numerous other disclaimers that negate a prospective franchisee’s ability to rely on the information presented.

## **21. Item 20: Outlets and Franchisee Information**

Item 20 contains a detailed visual representation of how the franchise system has changed over the past three-year period. Included in Item 20 are five separate charts that provide detail related to the following: (1) system-wide outlet summary (franchised and company units, if applicable), (2) transfers, (3) status of franchised outlets (i.e., number of outlets at the beginning of the year, outlets opened, outlets terminated, outlets not renewed for additional term, outlets reacquired by the franchisor,

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<sup>107</sup> *Id.* 19.16 and 19.17.

<sup>108</sup> For a statement of historical performance, the required admonition reads as follows: “Some outlets have [sold] this amount. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.” See, *Id.* at 19.13.

outlets that ceased operations for other reasons, and total outlets at the end of the year), (4) status of company-owned outlets, and (5) projected openings (both franchised outlets and company outlets).<sup>109</sup> Further, Item 20 captures contact information for current and former franchisees (usually appended as an exhibit to the FDD), as well as for franchisee associations.<sup>110</sup> In addition to franchisor-sponsored franchisee groups and councils, Item 20 discloses contact information for independent franchisee associations so long as the independent association is organized under state law and submits to the franchisor a written request for inclusion in the FDD within 60 days of the franchisor's fiscal year end.<sup>111</sup> Finally, and in connection with the franchisor's disclosure of former franchisee contact information, the Amended Rule requires that franchisors affirmatively disclose whether any former franchisees have signed confidentiality agreements restricting their ability to speak about the franchised business and their related experiences.<sup>112</sup>

## 22. Item 21: Financial Statements

To help prospective franchisees gain a clearer picture of the franchise system's stability, Item 21 requires that the franchisor disclose copies of its financial statements audited in accordance with generally accepted accounting principles ("GAAP") for the franchisor's most recent three fiscal years; these statements must appear in tabular format for at least two years so that prospective franchisees can assess financial trends.<sup>113</sup> In some cases, a parent of the franchisor will commit to provide post-sale obligations of the franchisor or will guaranty its obligations; in these instances, the audited financial statements of the parent—along with a manually-signed guaranty—must be included in Item 21 of the FDD.<sup>114</sup>

For franchisors that are new to franchising and do not yet have audited financial statements (let alone three years' worth of audited financials), the Amended Rule allows these franchisors to phase-in the use of audited financials over a three-year period.<sup>115</sup> In this instance, the new franchisor would begin in year one with an opening unaudited balance sheet, followed by audited financials in year two, and then another set of audited financials in year three.<sup>116</sup> Notably, the phase-in option is not allowed for the franchisor's affiliated entities or spin-offs; it is only permitted for unaffiliated entities that are completely new to franchising.<sup>117</sup>

## 23. Item 22: Contracts

Item 22 contains a list of all contracts related to the franchise that the franchisor requires or for which the franchisor makes arrangements.<sup>118</sup> For example, the form

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<sup>109</sup> 16 C.F.R. §436.5(t).

<sup>110</sup> 16 C.F.R. §436.5(t)(4) and (5).

<sup>111</sup> 16 C.F.R. §436.5(t)(8).

<sup>112</sup> 16 C.F.R. §436.5(t)(7).

<sup>113</sup> 16 C.F.R. §436.5(u).

<sup>114</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 114.

<sup>115</sup> 16 C.F.R. §436.5(u)(2).

<sup>116</sup> *Id.*

<sup>117</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 115.

<sup>118</sup> 16 C.F.R. §436.5(v).

Franchise Agreement must be listed in the Item 22 list of contracts (and appended to the FDD as an exhibit), as that document must be signed by the franchisor and the prospective franchisee. Likewise, if the franchisor will sublease property to the franchisee for the franchised outlet, a copy of the franchisor's master lease and the sublease it plans to enter into with the franchisee must be referenced in Item 22 and appended to the FDD.

## **24. Item 23: Receipts**

Item 23 is a summary disclosure related to the location of the FDD Receipt pages, however, the detail that appears on the Receipt pages is specific and must be adhered to closely. While the Receipt page is signed by the prospective franchisee and captures the date that they were disclosed with a specific FDD, it also informs the prospective franchisee of important information and rights under federal and state law.<sup>119</sup> The Amended Rule also requires that the prospective franchisee identify all "franchise sellers" involved in the offer and sale of the franchise and places the burden on the franchisor for ensuring that the franchise seller is properly identified.<sup>120</sup>

### **B. State Requirements**

It is important to keep in mind that the Amended Rule provides the baseline – or minimum – disclosure requirements that apply to franchise offerings. As noted in Section I.B. above, there are fifteen Franchise States that impose pre-sale disclosure obligations on a franchisor. These state disclosure obligations vary by state, with certain Franchise States requiring additional language (or disclosures) be added to the FDD and/or other states requiring a franchisor to provide the FDD to a prospect earlier in the sales process than required by the Amended Rule. In addition to the state-specific disclosure obligations imposed by the Franchise States, the fourteen Registration States also impose a pre-sale registration requirement.

If a franchisor desires to offer or sell franchises in a state that regulates franchising, the franchisor must first comply with any additional state disclosure and/or registration requirements. This does not mean, however, that a franchisor must prepare a separate, state-specific FDD to account for these unique state requirements. In fact, the Compliance Guide states that so long as the required state-specific disclosure are not inconsistent with the Amended Rule, the required state disclosures can be presented in the body of the FDD, the state cover page, or in an addendum to the FDD or agreements.<sup>121</sup> This does not mean that a franchisor can (or should) include additional or modified disclosures that are not required by the Amended Rule, state law, or requested by a state examiner. As discussed further below, the inclusion of such extraneous information may result in a "comment" or "deficiency" letter from a state administrator and unnecessary delay in the franchise registration process.

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<sup>119</sup> 16 C.F.R. §436.5(w).

<sup>120</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 118.

<sup>121</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 26.

As a threshold matter, it is important to remember that the laws of more than one state may apply to a single offer and sale of a franchise. As such, when considering which, if any, state franchise laws may impose additional requirements on a franchisor, counsel must review the applicable state franchise laws to determine which laws may be triggered. Although state franchise sales laws may be worded differently, generally speaking an “offer” or “sale” is deemed to be made in the state (and compliance with the applicable state franchise act is required) where any of the following events occur:

- Meetings between the franchisor and prospective franchisee at which the parties have substantive communications about the franchise opportunity.
- The offer to sell a franchise originates in the state (e.g., from the franchisor’s headquarters in the state).<sup>122</sup>
- The offer to sell a franchise is directed by the franchisor to the state and received by the prospective franchisee in the state where it is directed.
- The prospective franchisee accepts the offer to buy the franchise in the state.
- The offer or sale is made to a franchisee who is domiciled in the state. Under some state laws, the franchisee’s domicile in the state is enough. Under other state laws, the franchisee must be a domiciliary and operate the franchise business in the state.
- The offer or sale is made to a franchisee who resides in the state. Like domicile, in some states the franchisee’s residence in the state is enough; in other states the franchisee must be a resident and operate the franchise business in the state.
- The franchise business will be operated in the state or any portion of the franchise territory is in the state.
- The franchise contemplates or requires the franchisee to establish or maintain a place of business in the state.

As you can see, it is very possible for the franchise laws of more than one state to apply to a single offer or sale of a franchise. Due to the broad jurisdictional scope of the state franchise laws, a franchisor must take steps to ensure that their own sales

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<sup>122</sup> California, Hawaii, Illinois, Maryland, Michigan, Minnesota, Rhode Island, South Dakota, Virginia and Wisconsin each provide an exemption from registration for, or simply do not cover, “out-of-state” sales. These are sales made by a franchisor headquartered in one of these registration states to an out-of-state prospective franchisee who neither resides nor will operate the franchise business in the same state as the franchisor’s headquarters. The out-of-state sales exemption allows a franchisor to have its principal place of business in a registration state without having to register to sell franchises there as long as: (1) all sales activities are with a non-resident who will operate franchises in a different state, and (2) the franchisor complies with the Amended Rule and all other state franchise sales laws that apply to the transaction.

activities do not inadvertently trigger application of a franchise sales law in a state where the franchisor is not registered. Otherwise, an unsuspecting franchisor may find that it is responsible for making an unregistered offer to a franchise candidate in violation of a state's franchise sales law.

The remainder of this Section II.B summarizes some of the most common additional state disclosure requirements.

## **1. Additional State-Specific Disclosure Requirements**

### **a. Item 1: State-Specific Laws & Regulations**

As noted in Section II.A.2 above, the Amended Rule requires franchisors to summarize for prospective franchisees any laws and regulations applicable to the franchised business. While there are a number of federal laws that apply to businesses generally that a franchisor will reference in its Item 1 disclosure, depending on the nature of the franchised business and the states in which the franchise will be offered, additional state-specific laws, regulations and/or licensing requirements may need to be disclosed. Take, for example, a medical or health care franchise offering. Franchisors in the health care space are prudent to consider whether references to certain state or local health care related laws, regulations and/or licensure requirements – such as compliance with any state home health agency laws and licensure requirements – in Item 1 of the FDD are necessary. Likewise, franchisors in the home improvement or construction industry may need to disclose any state law requirements to obtain a contractor's license or bond. Finally, franchisors that operate in the restaurant space should consider referencing any applicable food safety, menu labeling, or other local licensing requirements.

### **b. Item 4: Bankruptcy Disclosures**

As noted in Section II.A.5 above, the Amended Rule requires franchisors to disclose bankruptcy and related proceedings that have occurred in the prior ten years. Minnesota, however, requires an additional bankruptcy disclosure. Under Minnesota law, the bankruptcy disclosure is 15 years – five years longer than the required Amended Rule.<sup>123</sup> The unknowing franchisor who deletes a bankruptcy disclosure after ten years will be opening itself up to liability from those Minnesota franchisees who purchased franchises during the five year period after deletion of the disclosure.

### **c. Item 8: Rebate Disclosures**

As summarized in Section II.A.9 above, the Amended Rule requires a franchisor to make certain disclosures related to any obligatory purchases, sourcing restrictions, and rebates received from suppliers. The Maryland regulations require franchisors to take these disclosures a few steps further. Specifically, the Maryland regulations require the following additional detail: (1) a disclosure of any affiliation between the franchisor and these sources of supply, (2) if the source is affiliated with the franchisor,

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<sup>123</sup> Minn. R. 2860.3500(4)(D).

the cost to the seller of the items, (3) the prevailing market price for the goods, and if none exists, an explanation as to why market price cannot be determined, and (4) the manner, if any, in which the franchisor or its affiliate under the terms of the franchise agreement ensures the availability of the goods.<sup>124</sup>

#### **d. Item 11: Advertising Disclosure**

In addition to the Item 11 advertising fund disclosures required under the Amended Rule, the Maryland regulations also require franchisors to disclose: (1) how fees related to advertising are to be raised or spent, and (2) how a franchisee may obtain an accounting of the advertising expenditures.<sup>125</sup>

#### **e. Item 21: Financial Statements**

As discussed in Section II.A.22 above, the Amended Rule permits franchisors that are new to franchising to “phase-in” the use of audited financial statements over a three-year period, and specifically allows for the use of an unaudited opening balance sheet during year one. The use of an unaudited opening balance sheet to satisfy the Item 21 disclosure requirement is not, however, permissible under certain state franchise acts. Specifically, the states of Minnesota, New York and Virginia require that a franchisor audit its opening balance sheet by a certified public accountant.<sup>126</sup>

### **2. State Risk Factors**

As noted in Section II.A.1 above, state law (and certain state administrators) may require franchisors to include a state cover page as part of the FDD. State administrators also may request that certain disclosures – or state risk factors – be incorporated into the “State Cover Page.” Whether a particular risk factor will be required depends, in large part on: (1) the state in which the franchise is being offered, (2) the dispute resolution provision selected by the franchisor, (3) whether minimum performance obligations are imposed, (4) whether any conditions are imposed on the owner’s spouse, and (5) the financial condition and experience of the franchisor. Unfortunately, state administrators have not adopted uniform risk factors or a uniform approach for when a particular risk factor will be required. A list of sample risk factors commonly imposed by state administrators is attached hereto as Exhibit D.

### **3. State Addenda**

A final FDD disclosure requirement imposed by a number of the Franchise States is the inclusion of mandatory state addenda. Depending on the state, a state-specific addendum may be required for the FDD, as well as any contract signed by the parties – e.g., the franchise agreement, area development agreement or area representative agreement. Generally speaking, the disclosures required in a state addendum fit into the following two categories: (1) disclosures required to advise prospective franchisees

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<sup>124</sup> Md. Code Regs. 02.02.08.16.

<sup>125</sup> Md. Code Regs. 02.02.08.04.

<sup>126</sup> Minn. Stat. Ann. § 80C.04; N.Y. Comp. Codes R. & Regs. tit. 13, § 200.2; 21 Va. Admin. Code 5-110-55.

of the limitations of the state agency's review of the FDD, and (2) modifications to the FDD disclosures and agreement provisions to comply with a state's franchise relationship laws – including, rights in connection with termination and non-renewal of the agreement, as well as a clear affirmation that the state franchise laws and protections afforded to franchisees may not be waived or modified by the franchise or other agreement. Finally, if a franchisor is required to provide a financial assurance as a condition of registration due to the franchisor's financial condition and/or years of franchising experience, disclosure of the financial assurance is typically found in the applicable state addendum.<sup>127</sup>

Sample state FDD addenda are attached hereto as Exhibit E. Keep in mind that additional modifications to the FDD may be required in a state-specific FDD addendum depending on the franchised business being offered. The attached sample state FDD addenda identify those common modifications required by certain states. Note, however, that certain Franchise States require similar addenda modifying the terms of any agreement signed by the parties. Since the contractual terms of these agreements can vary significantly by franchise, sample state addenda for the contracts between the parties are not included with this paper.

### **C. Drafting Tips**

The Amended Rule requires franchisors to disclose all information clearly, legibly, and in plain English.<sup>128</sup> The Amended Rule considers “plain English” to include words and phrases understandable by a person unfamiliar with the franchised business.<sup>129</sup> Practitioners who are responsible for preparing FDDs are advised to use short sentences, everyday language, active voice and avoid legal jargon and highly technical business terms. In fact, a number of state agencies require franchisors to remove all “legalese” from the FDD and franchise agreement, citing the Amended Rule's plain English requirement.

Further, a franchisor must limit the content of its FDD to the requirements imposed by the Amended Rule, state law or disclosures requested by a state administrator. Extraneous information that is not responsive to the Amended Rule, state law or required by a particular state administrator is not permissible.<sup>130</sup>

Moreover, when discussing certain information in one Item of an FDD some practitioners like to include cross-references to other Items that discuss the topic in

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<sup>127</sup> Depending on the franchisor's financial condition and years of franchise experience, a state may require a franchisor to provide a financial assurance as a condition of registration. The specific financial assurance required varies by state, but typically a franchisor may satisfy the financial assurance by doing one of the following: (1) deferring collection of the initial franchise fee (or other initial fees) until the franchisor satisfies its pre-opening obligations and the franchisee commences operation, (2) escrowing payment of the initial fees, (3) posting of a surety bond, or (4) parent or affiliate of franchisor guarantees the obligations of the franchisor and attaches a copy of the parent's or affiliate's audited financial statements to the FDD.

<sup>128</sup> 16 C.F.R. §436.6(b).

<sup>129</sup> 16 C.F.R. §436.1(o).

<sup>130</sup> 16 C.F.R. §436.6(d).

fuller detail. This can be helpful because it directs readers to additional information. Some state administrators, however, have requested that practitioners remove such cross-references because it can confuse a reader who is not familiar with the layout and function of the FDD. State Administrators that request the removal of such cross-references are likely looking for the FDD to provide exactly the information required by the Amended Rule, in the location required.

Lastly, and as mentioned above, when preparing an FDD a franchisor must address every disclosure requirement outlined in the Amended Rule.<sup>131</sup> If any required disclosure is not applicable to the franchise system, then the FDD must include a negative response to the required disclosure. Examples include:

- Item 3: No litigation is required to be disclosed in this Item.
- Item 4: No bankruptcy information is required to be disclosed in this Item.
- Item 10: We do not offer any direct or indirect financing.
- Item 14: There are no patents or pending patent applications that are material to the franchised business.

Furthermore, if a statement is prescribed or required by the Amended Rule, such statements cannot be modified – these statements must be presented verbatim as specified in the Amended Rule.<sup>132</sup> Some such prescribed statements are:

- Item 9: 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.<sup>133</sup>
- Item 11: Except as listed below, [the franchisor] is not required to provide you with any assistance.<sup>134</sup>
- Item 17: This table lists certain important provisions of the franchise and related agreements. You should read these provisions in the agreements attached to this disclosure document.<sup>135</sup>

#### **D. State Specific Disclosure Obligations**

In addition to requiring extra disclosures in the FDD, three states – Iowa, Michigan and New York – impose different timing obligations for disclosing prospective franchisees. As summarized in Section I.A.3.a above, the Amended Rule (and most

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<sup>131</sup> 16 C.F.R. §436.6(c).

<sup>132</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 122.

<sup>133</sup> 16 C.F.R. §436.5(i).

<sup>134</sup> 16 C.F.R. §436.5(k).

<sup>135</sup> 16 C.F.R. §436.5(q).

Franchise States) requires a franchisor to provide a prospective franchisee with a copy of the FDD at least fourteen calendar days prior to the date the prospect signs a binding agreement or pays any money to the franchisor or its affiliates. Iowa and New York, however, require a franchisor to provide a copy of the FDD at the earlier of the “first personal meeting” with the prospective franchisee or at least ten business days (or fourteen calendar days in Iowa) prior to the prospect’s payment of monies or signing any contract.<sup>136</sup> Michigan requires that a franchisor provide a copy of the FDD at least ten business days before signing or the prospect’s payment of money.<sup>137</sup>

### **III. Securing State Franchise Registration**

As mentioned above, the Amended Rule is a disclosure-only rule. There is no federal franchise registration requirement imposed by the Amended Rule. As noted in Section I.B.1 above, there are fourteen Registration States that impose some form of pre-sale registration obligation on a franchisor before the franchisor may offer or sell a franchise in that state. The “registration” or “approval” of a franchise registration by a Registration State essentially grants the franchisor a license to “offer” and “sell” franchises within the state. Registration is on a state-by-state basis, and a franchisor is only required to comply with a state registration requirement if the franchisor desires to offer or sell franchises in the state.

#### **A. State Registration Filing Requirements**

Not unlike the differing FDD disclosure obligations imposed by each Franchise State, the registration requirements of the various Registration States differ from state to state. Generally speaking, most Registration States require a franchisor to submit copies of its FDD, along with various state registration forms and signature documents, along with information regarding the franchisor’s franchise sellers – those individuals who will sell franchises on the franchisor’s behalf. Not only do the specific materials required for registration vary by state, but the materials required by a particular Registration State also vary depending on the type of registration application – i.e., initial, renewal, amendment or an exemption application. Finally, the method by which a franchisor submits its franchise application varies by state. For example, some states permit online filing, some states mandate online filing, and others require paper and/or CD-ROM submissions. Exhibit F attached hereto summarizes the specific franchise registration materials and filing requirements imposed for an initial application in each Registration State. Importantly, the franchise registration materials required in connection with a renewal, amendment or exemption application may differ from the information provided in Exhibit F depending on the state.

#### **B. State Examiner Review Process and Comment Letters**

Most state franchise acts provide a limited period of time during which a state franchise administrator must approve or deny a franchise application. These rules generally provide that a FDD will be automatically registered when the statutory period

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<sup>136</sup> Iowa Code Ann. § 551A.4; N.Y. Gen. Bus. Law § 683(8)(a).

<sup>137</sup> Mich. Comp. Laws Ann. §445.1508.

expires unless: (1) the administrator has issued a stop order or obtained an injunction barring the registration, or (2) the administrator has issued a comment or deficiency letter to the applicant describing the corrections or additional disclosure the franchisor must make to effect registration. The degree of scrutiny devoted to a franchise application varies significantly from state to state. Registration States can be broken into two types: (1) full review states, and (2) notice filing states.

Full review states are states in which a franchisor's FDD and franchise application are subject to full review by a state administrator before a registration decision is made. Full review states include: California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia and Washington. A franchise examiner's response to an application for registration in a full review state usually takes the form of a "comment letter" or "deficiency letter" to the franchisor, requesting additional information and/or revisions to the FDD. It is not uncommon – especially in connection with an initial franchise application – for a state administrator to issue subsequent comment letters until all matters are resolved to his or her satisfaction.

Notice filing states are states in which the franchise registration application is deemed registered, by statute, when the state receives all required information. Notice filing states include Indiana, Michigan and Wisconsin. While administrators in these states have the authority to review the documents filed with the state and issue comments, they seldom, if ever do.

In addition to the Registration States, and as noted in Section I.A.2 above, there are five business opportunity states that require a franchisor to file a simple notice of exemption with a state agency in order to qualify for an exemption from the state's business opportunity law. Business opportunity notice filing states include: Florida, Kentucky, Nebraska, Texas and Utah. The frequency by which the notice of exemption must be filed varies by state. For example, Florida and Utah require that annual notices of exemption be filed, whereas Kentucky, Nebraska and Texas impose a one-time only exemption filing requirement.<sup>138</sup>

### **C. Strategies for Managing the Registration Process**

A successful franchise registration process begins long before a franchise practitioner prepares the initial franchise registration application. A prudent practitioner

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<sup>138</sup> In other business opportunity law states, exemption from the definition of a "business opportunity" depends on the franchisor awarding a license to the franchisee to use a federally (or state) registered mark as part of the franchised business, or offering a franchise in compliance with the Amended Rule. If a franchisor does not satisfy the conditions for exemption from the state business opportunity law, the franchisor will be deemed to be a "business opportunity seller" and must comply with all business opportunity pre-sale disclosure and registration requirements – which requirements are comparable to, though less complex than, the franchise registration process. This issue most frequently arises for a new franchisor that has not yet obtained a federal registration for its principal trademark. Business Opportunity Law compliance is outside the scope of this paper. See, Beata Krakus, Alexander Tuneski, *Caught in the Web of Federal & State Business Opportunity Laws: Managing & Avoiding the Entanglement of Regulations*, 36th Annual ABA Forum on Franchising (2013) for more information.

exhibits a keen attention to detail, conducts the necessary research, and follows very strict guidelines for preparing the FDD. Below are some best practice tips for expediting the initial franchise registration process:

- Ensure the FDD is compliant with the Amended Rule. Franchise practitioners should start at the top: Review the Amended Rule, Compliance Guide, and NASAA Commentary.<sup>139</sup> The Amended Rule FAQs also are especially helpful.<sup>140</sup>
- Make the FDD compliant with applicable state law. Review each state's individual state statutes, guidelines and commentary.
- Comply with all state filing requirements (see Exhibit F for more information) and use any forms prescribed by a particular state.
- Do not blindly prepare an FDD based upon information or documents provided by a franchisor client and simply accept everything presented without independent review. Rather, it is important to scrutinize the information supplied by a franchisor client that makes up the FDD.
- Review the franchisor's financial statements and the prescribed text of the accountant consent. In many states, administrators begin their review of a franchise application with the financial statements. If the financial statements are missing or the FDD contains the incorrect financial statements, the application may be denied with no further review. Further, some state administrators will reject a franchise application if the accountant consent fails to include the prescribed statements.
- Respond promptly and completely to all comment and deficiency letters. Upon receipt of a comment letter, the practitioner must first understand what the regulator is asking. Collect and review all information available, including references to the state regulations or other resources. If the practitioner is still unclear about or disagrees with a comment, seek guidance from the state administrator.
- Keep in mind that states have very particular requirements for how they want to receive responses to a comment or deficiency letter. For instance, some require a complete blacklined copy of the FDD; others want only the pages that show the changes made. Some regulators want a copy on a CD; others want only hard copies (but no changes marked in color, only black ink). Address all comments in a single response. The prudent practitioner will

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<sup>139</sup> See, 16 C.F.R. §436, *supra* note 3; *Franchise Rule Compliance Guide*, *supra* note 11; NASAA, *Current Proposed FPR Commentary*, *supra* note 103.

<sup>140</sup> See, FTC, *Frequently Asked Questions*, <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs>.

communicate in manner that makes an appropriate record, but is also responsive to the content and form required by the state administrator.

During the franchise registration process, a franchisor (or its counsel) should maintain a current “state status summary” detailing the franchise registration status in each state. The state status summary should be regularly shared with all franchise sellers to ensure that they have an accurate resource they can consult before engaging in any franchise sales activities or before closing a franchise sale. A good state status summary not only includes information on whether the FDD has been approved by a particular state, but any other state specific requirements. For example, if a particular state requires the franchisor to defer collection of the initial fees, include this requirement on the state status summary.

#### **IV. Franchise Amendment and Renewal Requirements**

A franchisor must ensure that its FDD is accurate and up to date at all times. To that end, the Amended Rule imposes three basic updating requirements: (1) annual updates, (2) quarterly updates, and (3) notification of changes in financial performance information. Similarly, Registration States require franchisors to renew their franchise registration on a yearly basis, and impose an amendment obligation upon the occurrence of a material change.

##### **A. When is an Amendment Necessary**

###### **1. Federal Requirements**

The Amended Rule imposes a quarterly updating requirement. Specifically, within a reasonable time after the close of each fiscal quarter, a franchisor must prepare and include in Item 22 an attachment to its FDD reflecting any material change to a franchisor’s FDD.<sup>141</sup> Determining whether an amendment is necessary requires an analysis of whether there has been a “material change” to any of the information presented in the FDD. According to the Compliance Guide, material changes include events such as bankruptcy filings and the filing of legal actions against the franchisor that could negatively impact the franchisor’s financial condition.<sup>142</sup> Despite this, certain FDD disclosure requirements require only annual updating. For example, the franchisor-initiated litigation disclosures in Item 3 need to be updated only once a year. Likewise, the statistical information about franchised outlets required by Item 20 as well as the franchisee lists need to be revised only on an annual basis. In addition, any financial information required to be audited need not be re-audited for a quarterly update, unless there is a material change affecting the previously audited financial information – and, in that event, a franchisor may furnish unaudited information in the quarterly update.<sup>143</sup>

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<sup>141</sup> 16 C.F.R. §436.7(b).

<sup>142</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 126.

<sup>143</sup> *Id.*

One key exception to the federal quarterly update requirement is if the update relates to any financial performance information contained in Item 19 of the FDD. The Amended Rule requires that, when furnishing a disclosure document, franchise sellers notify the prospective franchisee of any material changes that the seller knows or should have known occurred with respect to any financial performance representation made in Item 19.<sup>144</sup>

## 2. State Requirements

Certain states require a franchisor to update the FDD in response to material changes in the system. In many instances, the timeframe to update the FDD in the event of a material change at the state level is much shorter than the quarterly requirement set forth in the Amended Rule. For example, in California, Maryland, Michigan, New York, North Dakota and Rhode Island, a franchisor must “promptly” file an amendment when a material changes occurs.<sup>145</sup> In Hawaii, Virginia and Washington, a franchisor must amend upon the occurrence of a material change.<sup>146</sup> In Minnesota and Wisconsin, a franchisor must amend within 30 days of a material change.<sup>147</sup> Illinois and South Dakota are more closely aligned with the Amended Rule and require franchisors to prepare and file amendments after the end of each fiscal quarter to reflect any material changes.<sup>148</sup> In Indiana, a franchisor does not need to file an amendment for a material change unless requested by the state, however, a franchisor can voluntarily amend at any time to reflect any post-effective amendments to the FDD.<sup>149</sup> Since the state laws vary in terms of the required timing to file an amendment, franchisors are wise to put procedures in place to identify potential material changes and then amend its FDD in short order to comply with the state law amendment requirements.

### B. Annual Renewal Requirements

In addition to the quarterly update requirement under the Amended Rule (or earlier amendment obligation under state law), both federal and state law obligate franchisors to update their FDDs on an annual basis. This annual update commonly is referred to as the “renewal” process. The annual renewal requirement under both the Amended Rule and state laws are discussed further in this Section IV.B below.

### 1. Federal Requirements

The Amended Rule requires a franchisor to update the information in the FDD each year within 120 days after its fiscal year end.<sup>150</sup> After the 120-day period has

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<sup>144</sup> 16 C.F.R. §436.7(d).

<sup>145</sup> Cal. Corp. Code § 31123, Md. Code Ann., Bus. Reg. § 14-220, Mich. Comp. Laws Ann. § 445.1519, N.Y. Gen. Bus. Law § 683, N.D. Cent. Code Ann. § 51-19-07, 19 R.I. Gen. Laws Ann. § 19-28.1-11.

<sup>146</sup> Haw. Rev. Stat. Ann. § 482E-3, 21, Va. Admin. Code 5-110-40, Wash. Rev. Code Ann. § 19.100.070.

<sup>147</sup> Minn. Stat. Ann. § 80C.07, Wis. Stat. Ann. § 553.31.

<sup>148</sup> 815 Ill. Comp. Stat. Ann. 705/11, S.D. Codified Laws § 37-5B-7.

<sup>149</sup> Ind. Office of the Sec’y of State Secs. Div., *Order Regarding Franchise Registrations by Notification*, Order No. 01-0109 AO, Bus. Franchise Guide (CCH) ¶ 5,140.012 (June 4, 2001).

<sup>150</sup> 16 C.F.R. §436.7(a).

expired, franchisors may only use the updated FDD and must discontinue the franchise sales process until the updates have been completed. While amendments to the FDD can be made throughout the year, most franchisors incorporate new system changes as part of the annual renewal process. At a minimum, during the annual renewal process a franchisor must revise its FDD to include new audited financial statements, update the Item 20 charts and list of franchises, and update any other disclosures that describe the status of the franchisor or franchised business over the prior fiscal year.

## **2. State Requirements**

As with the Amended Rule, the Registration States require a franchisor to update the FDD and franchise registration each year. Depending on the state, the annual renewal filing must be made within 90 to 120 days following the end of the franchisor's fiscal year, or prior to the anniversary of the effective date of the previous franchise registration. If the state requires the renewal filing based on the anniversary date of the previous year's franchise registration, the state generally requires that the renewal filing be made within 15 to 30 days before the previous year's registration expires. The period of time between the filing of the renewal application and the date of effectiveness of the renewal filing varies by state. This is not a long period in Illinois, Indiana, Michigan, South Dakota and Wisconsin, as a renewal application is deemed effective upon receipt. In Hawaii, a renewal application is deemed effective seven days after receipt. If the renewal application is not filed in a timely fashion, the franchisor's registration will lapse, all sales activity in the state must cease, and the franchisor must once again file an initial franchise registration application with the state.

## **V. Navigating Franchise Exemptions**

If a business relationship constitutes a franchise under either federal or state law, a franchisor is required to comply with the pre-sale franchise disclosure obligations (and, if applicable, registration requirements) summarized above unless the transaction (or the parties involved in the transaction) satisfy one or more statutory exemptions. It is important to keep in mind that the exemptions available at the federal level may not necessarily be available, or even necessarily be the same, at the state level. Moreover, if a franchise is exempt under the Amended Rule, but the offer or sale of the franchise falls within the jurisdiction of a state that regulates franchising, a franchisor must satisfy both a federal and state exemption. Further complicating matters, some state exemptions only relieve a franchisor from the state registration obligation, and disclosure is still required. In short, franchisors must be careful when navigating the franchise exemption maze.

### **A. FTC Franchise Rule Exemptions**

There are a number of exemptions from disclosure provided by the Amended Rule, and Exhibit G to this paper includes a list of the available federal exemptions. If an exemption is available under the Amended Rule, a franchisor is not required to prepare an FDD or comply with the federal pre-sale disclosure obligations.<sup>151</sup> While a

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<sup>151</sup> 16 C.F.R. §436.8.

detailed analysis of all the exemptions available under the FTC Rule is outside the scope of this paper, below we summarize four of the most commonly utilized exemptions under the Amended Rule.<sup>152</sup>

## 1. Fractional Franchise Exemption

Under the Amended Rule, a “fractional franchise” exists when the following two criteria are satisfied: (1) the franchisee, any of its current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business, and (2) the parties to the transaction have a reasonable basis to believe 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.<sup>153</sup>

Under the Amended Rule, “same type of business” means selling competitive goods, or being in a business that would ordinarily be expected to sell the type of goods to be offered by the franchised business.<sup>154</sup> The Compliance Guide provides the example of an independent ice cream store owner. Most likely an independent ice cream store owner will qualify as a fractional franchisee if he or she were to enter into a franchise relationship with an ice cream cake supplier, but would not qualify if the franchise relationship expanded the store’s product line to include items not typically found in ice cream stores, like greeting cards.<sup>155</sup>

With respect to the second condition, sales volume may include sales resulting from multiple locations operated by the franchisee. For example, the parties may compare sales resulting from the fractional franchise against total sales at all stores owned by the franchisee (franchised or non-franchised).<sup>156</sup> According to the Compliance Guide, an individual owning several hardware stores may introduce a new product at only one store and measure the increase in sales attributed to the new product against the aggregate total sales volume for all products sold through his or her business.<sup>157</sup>

## 2. Minimal Franchise Fee Exemption

Disclosure obligations under the Amended Rule do not apply if the franchisor can establish that the total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee’s business is less than \$570.<sup>158</sup> A

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<sup>152</sup> See Alan R. Greenfield, Theresa Leets, and Karen B. Satterlee, *Franchise Disclosure Challenges for Large, Sophisticated, or Multi-Brand Franchise Companies*, 37th Annual ABA Forum on Franchising (2014), for a detailed discussion of the applicable federal and state franchise law exemptions.

<sup>153</sup> 16 C.F.R. §436.1(g).

<sup>154</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 8.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 8-9.

<sup>157</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 9.

<sup>158</sup> 16 C.F.R. §436.8(a)(1). The Commission is required to adjust the threshold for the minimum payment exemption every four years to account for inflation. The Commission adjusted the minimum payment threshold to \$570, effective July 1, 2016. See, “FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule,” *supra* note 6.

franchisee commences operation when it first makes goods or services available for sale. A commitment entered into during the first six months that requires a payment later than six months after commencing operation (such as a promissory note or that portion of lease payments made after six months) is not counted toward the \$570 minimum.<sup>159</sup>

### 3. Large Franchisee Exemption

Another exemption available under the Amended Rule is the large franchisee exemption. Under this exemption, a franchise relationship is exempt from the federal disclosure rules when the franchisee (or its parent or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least \$5,715,500.<sup>160</sup> To qualify for the exemption, the large entity must have five years of prior business experience. Notably, the prior experience need not be in franchising or even in the same industry as the franchised business.<sup>161</sup> As alluded to above, when determining the prior experience and net worth of a franchisee entity, a franchisor may consider the prior experience and net worth of the prospective franchisee's affiliates and parents.<sup>162</sup> Accordingly, franchisors may aggregate commonly-owned franchisee assets in determining the availability of the large entity exemption.

### 4. Large Investment Exemption

Depending on the amount of the franchisee's initial investment in the franchised business, the franchise may be exempt from the disclosure requirements of the Amended Rule. Specifically, the large investment exemption under the Amended Rule is satisfied when the franchisee's initial investment, excluding any financing received from the franchisor or an affiliate (and excluding the cost of unimproved land) totals at least \$1,143,100, and the prospective franchisee signs an acknowledgment verifying the grounds of the exemption.<sup>163</sup> The Amended Rule requires that certain language be included in the acknowledgment, specifically:

The franchise sale is for more than \$1,143,100 – excluding the cost of unimproved land and any financing received from the franchisor or an affiliate – and thus is exempted from the Federal Trade Commission's Franchise Rule disclosure requirements, pursuant to 16 CFR 436.8(a)(5)(i).<sup>164</sup>

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<sup>159</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 7.

<sup>160</sup> 16 C.F.R. § 436.8(a)(5)(ii). As with the minimum franchise fee exemption, the Commission adjusted the minimum net worth requirement to \$5,715,500, effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," *supra* note 6.

<sup>161</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 13.

<sup>162</sup> *Id.*

<sup>163</sup> 16 C.F.R. § 436.8(a)(5)(i). The Commission adjusted the large investment threshold to reflect \$1,143,100, effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," *supra* note 6.

<sup>164</sup> 16 C.F.R. §436.8(a)(5)(i).

One of the first issues to address when determining whether the large franchise investment exemption is satisfied is what is an “initial investment”? A franchisee’s “initial investment” is limited to the type of expenses that would ordinarily appear in an Item 7 disclosure – i.e., expenses paid through the opening of the outlet and additional expenses paid through the three-month initial period thereafter.<sup>165</sup> It does not include all possible payments made over the life of the franchise agreement, costs associated with unimproved land,<sup>166</sup> or funds obtained through franchisor (or affiliate) financing.

Often one of the biggest obstacles to satisfying this exemption is that at least one individual must invest at the minimum threshold level for the exemption to apply.<sup>167</sup> The large investment exemption is premised on the assumption that a franchisee’s ability to pay a large sum equates with sophistication, and this assumption fails when no one person, standing alone, invests at the requisite threshold level.<sup>168</sup> For purposes of this provision, a husband and wife can be considered a single individual since their assets are typically commingled.<sup>169</sup>

## 5. Other Exemptions

In addition to the federal exemptions outlined above, the Amended Rule recognizes the following exemptions: (1) leased department, (2) insider exemption, (3) franchise relationships covered by the Petroleum Marketing Practice Act, or (4) where there exists no written document that describes any material term or aspect of the relationship or arrangement.<sup>170</sup> Given the infrequency of the usage of these exemptions, this paper does not address in detail the criteria for establishing these exemptions.

### B. State Exemptions

As noted above, franchisors that wish to avail themselves of an exemption must recognize that, not only must a federal exemption be satisfied, but also the elements of a state exemption must be satisfied. As summarized below and in Exhibit G attached to this paper, not all federal exemptions are available at the state level and often the exemption requirements differ. Further, for practitioners advising franchise clients on the applicability of state law exemptions, it is critical to understand the scope of a particular state exemption to determine whether exemption is from both the state’s disclosure and registration obligations. Often, the exemption is from the state registration requirement only, thus requiring a franchisor to still comply with any state-mandated disclosure obligation.

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<sup>165</sup> FTC, *Franchise Rule Compliance Guide*, *supra* note 11 at 10.

<sup>166</sup> The Franchise Compliance Guide clarifies what is included in the unimproved land determination by noting that the cost of buildings, fixtures, equipment and other improvements to the land may be included, but not the unimproved land itself. *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at 12.

<sup>169</sup> *Id.*

<sup>170</sup> See, 16 C.F.R. §436.8(a)(3), (4), (6), and (7).

## **1. Large Franchisor Exemption**

While perhaps the most commonly used state exemption, the large franchisor exemption is not available under the Amended Rule and exempts a qualifying franchisor from certain state registration obligations only. The states that currently recognize the large franchisor (or the “net worth” or “seasoned franchisor”) exemption include: California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, Virginia and Washington. While the precise requirements of this exemption vary by state, generally the large franchisor exemption requires a certain level of experience and net worth. Typically, the franchisor or parent of the franchisor must have a minimum of five years of experience, at least 25 franchisees in the same business as offered, and a minimum net worth ranging from \$5 million to \$15 million. While the state large franchisor exemption exempts qualifying franchisors from the state registration requirements, each state still requires the franchisor to comply with the state pre-sale disclosure requirement. As a result, franchisors that qualify for the large franchisor exemption still must prepare an FDD and comply with all pre-sale disclosure obligations.

## **2. Large Franchisee Exemption**

Similar to the Amended Rule’s large franchisee exemption, five states have a large franchisee exemption.<sup>171</sup> Satisfaction of a state large franchisee exemption is based on two criteria: (1) the experience of the prospective franchisee or its underlying owners, and (2) the prospective franchisee’s net worth. For example, under the Illinois Franchise Act, a franchise offering is exempt from the state registration requirement if: (1) the franchisee (or a parent of franchisee) has been in business for at least five years, and (2) the franchisee (or a parent of franchisee) has a net worth of at least \$5 million.<sup>172</sup> As with all state exemptions, the precise requirements needed to satisfy the exemption varies from state to state, as does the scope of the exemption.

## **3. Fractional Franchise Exemption**

A number of states provide a fractional franchise exemption similar to the Amended Rule.<sup>173</sup> Similar to the federal exemption, the state fractional franchise exemptions hinge on the experience of the prospective franchisee and the anticipated gross sales of the franchised business. For example, the Minnesota fractional franchise exemption requires that: (1) the franchisee has a minimum of two years of experience in the same type of business, and (2) the parties anticipate (or should anticipate) that the sales from the franchised business will not exceed 20% of the franchisee’s total sales.<sup>174</sup>

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<sup>171</sup> California, Illinois, Rhode Island, South Dakota and Washington.

<sup>172</sup> 815 Ill. Comp. Stat. 705/8(2).

<sup>173</sup> California, Illinois, Indiana, Michigan, Minnesota, New York, Oregon, South Dakota, Virginia and Wisconsin.

<sup>174</sup> Minn. Stat. Ann. § 80C.03(f); 80C.01(18).

#### **4. Other Exemptions**

In addition to the exemptions identified above, other state exemptions include: (1) large investment exemption, (2) insider exemption, (3) institutional franchisee exemption, (4) single franchise exemption, (5) nominal fee exemption, (6) sale by judicial officer exemption, (7) sale by existing franchisee exemption, (8) exemption by order, (9) leased department exemption, (10) securities exemption, (11) out-of-state exemption, and (12) exemption for renewal, extension, amendment or modification of agreement. The states that provide for each of the exemptions listed above are noted in Exhibit G attached to this paper.

#### **VI. Additional Filing Requirements Beyond the FDD**

##### **A. Advertising Registration Requirements**

In addition to the franchise (FDD) registration obligations required by the Registration States, the following states also require the filing of franchise sales advertising materials before use: California, Maryland, Minnesota, New York, North Dakota and Washington. The advertising registration requirements imposed by each of these states are summarized in the attached Exhibit H. An advertisement is generally deemed approved by a particular state if no comments are received within a specified number of days from the date the advertisement is received by the state. Submission or filing of advertisements is generally not required outside of the states identified above.

The proliferation of the internet as a promotional tool has confronted franchisors with the challenge of determining how traditional advertising rules (including the advertising registration requirements noted above) apply to this invaluable communications medium. Given this reality, several states have adopted an exemption process for web-based franchise sales advertisements. In general, internet-based franchise sales advertising is exempt from statutory registration requirements if each of the following requirements are met: (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.<sup>175</sup> To account for the state internet exemptions noted above, franchisors should ensure that their websites contain disclaimers that are drafted to take advantage of these internet exemptions. For example, the franchise sales portion of a franchisor's website should prominently display words such as the following:

This website and the franchise sales information on this site do not constitute an offer to sell a franchise. The offer of a franchise can only be made through the delivery of a franchise disclosure document. Certain states require that we register the franchise disclosure document in those states. The communications on this website are not directed by us to the residents of any of those states. Moreover, we will not offer or sell franchises in those states until we have registered the franchise (or obtained an applicable exemption from registration) and delivered the

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<sup>175</sup> Bus. Franchise Guide (CCH) ¶ 5,230.81 (Dec. 4, 2002).

franchise disclosure document to the prospective franchisee in compliance with applicable law.

Of course, a franchisor must ensure that its actual internet practices are consistent with any disclaimer published by the franchisor on its website.

## **B. Franchise Seller / Broker Requirements**

A final state registration requirement of which franchisors should be aware relates to any franchise sellers and/or brokers used by a franchisor in connection with the franchise sales process. Under the Amended Rule, a “franchise seller” is a person that offers, sells or arranges for the sale of a franchise.<sup>176</sup> This includes the franchisor and its employees, agents, area representatives, subfranchisors and third-party brokers, but does not include existing franchisees.

With the exception of South Dakota, Virginia and Wisconsin, all other Registration States require a franchisor to file a franchise seller disclosure form for each of its “franchise sellers” in connection with a franchisor’s initial or renewal franchise application process. (See, Exhibit E to this paper for more information.) The franchise seller disclosure form includes the franchise seller’s previous five years of employment history, and discloses whether the franchise seller has been named in certain litigation or arbitration actions during the prior ten years. In addition to filing the franchise seller disclosure forms, three states – Illinois, Maryland and Washington – require third party brokers to register with the state as an authorized broker of the franchise system prior to engaging in any sales activities in the state.<sup>177</sup> As a franchisor authorizing the broker to sell its franchise, the franchisor should ensure that all broker registration requirements have been satisfied.

## **VII. Conclusion**

The various rules and requirements that govern the offer and sale of franchises in the U.S. are complex and readers are wise to keep in mind that the information provided above is just the tip of the iceberg. Counsel for franchisors must study applicable laws and ensure that they have a keen sense of the franchise system’s details (both operational and financial), as doing so will help ensure that the required disclosure and registration requirements are honored.

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<sup>176</sup> 16 C.F.R. §436.1(j).

<sup>177</sup> Ill. Admin. Code tit. 14, § 200.900; Wash. Rev. Code Ann. § 19,100.140.

## Exhibit A

### Sample Item 9 Table

	Obligation	Section in Agreement	Disclosure Document Item
a.	Site selection and acquisition/lease		
b.	Pre-opening purchases/lease		
c.	Site development and other pre-opening requirements		
d.	Initial and ongoing training		
e.	Opening		
f.	Fees		
g.	Compliance with standards and policies/Operating Manual		
h.	Trademarks and proprietary information		
i.	Restrictions on products/services offered		
j.	Warranty and customer service requirements		
k.	Territorial development and sales quotas		
l.	Ongoing product/service purchases		
m.	Maintenance, appearance and remodeling requirements		
n.	Insurance		
o.	Advertising		
p.	Indemnification		
q.	Owner's participation/ management/staffing		
r.	Records and reports		
s.	Inspections and audits		
t.	Transfer		
u.	Renewal		
v.	Post-termination obligations		
w.	Non-competition covenants		
x.	Dispute resolution		
y.	Other (describe)		



**Exhibit C**

**Sample Item 17 Chart**

ITEM 17

RENEWAL, TERMINATION, TRANSFER AND DISPUTE RESOLUTION

**THE FRANCHISE RELATIONSHIP**

**This table lists certain important provisions of the franchise and related agreements. You should read these provisions in the agreements attached to this Disclosure Document.**

<b>Provision</b>	<b>Section in franchise or other agreement</b>	<b>Summary</b>
(a) Length of the term of the franchise		
(b) Renewal or extension of the term		
(c) Requirements for you to renew or extend		
(d) Termination by you		
(e) Termination by us without cause		
(f) Termination by us with cause		
(g) "Cause" defined –defaults which can be cured		
(h) "Cause" defined – defaults which cannot be cured		
(i) Your obligations on termination/nonrenewal		
(j) Assignment of contract by us		
(k) "Transfer" by you-defined		
(l) Our approval of transfer by you		
(m) Conditions for our approval of transfer by you		
(n) Our right of first refusal to acquire your business		
(o) Our option to purchase your business		
(p) Your death or disability		
(q) Non-competition covenants during the term of the franchise		
(r) Non-competition covenants after the franchise is terminated or expires		
(s) Modification of the agreement		
(t) Integration/merger clause		
(u) Dispute resolution by arbitration or mediation		
(v) Choice of forum		
(w) Choice of law		

## Exhibit D

### Sample State Risk Factors

Please consider the following RISK FACTORS before you buy this franchise:

1. THE FRANCHISE AGREEMENT REQUIRES YOU TO RESOLVE DISPUTES WITH US BY MEDIATION, ARBITRATION OR LITIGATION ONLY IN [insert state]. OUT-OF-STATE MEDIATION, ARBITRATION OR LITIGATION MAY FORCE YOU TO ACCEPT A LESS FAVORABLE SETTLEMENT FOR DISPUTES. IT MAY ALSO COST MORE TO MEDIATE, ARBITRATE OR LITIGATE WITH US IN [insert state] THAN IN YOUR OWN STATE.
2. ALL OWNERS OF THE FRANCHISE AND THEIR SPOUSES WILL BE REQUIRED TO SIGN PERSONAL GUARANTIES. THIS REQUIREMENT PLACES THE PERSONAL AND MARITAL ASSETS OF THE FRANCHISE OWNER(S) AT RISK.
3. YOU MUST MAKE MINIMUM ROYALTY OR ADVERTISING PAYMENTS, REGARDLESS OF YOUR SALES LEVELS. YOUR INABILITY TO MAKE THE PAYMENTS MAY RESULT IN TERMINATION OF YOUR FRANCHISE AND LOSS OF YOUR INVESTMENT.
4. THE FRANCHISOR IS AT AN EARLY STAGE OF DEVELOPMENT AND HAS A LIMITED OPERATING HISTORY. THIS FRANCHISE COULD BE A HIGHER RISK INVESTMENT THAN A SYSTEM WITH A LONGER OPERATING HISTORY.
5. THE FRANCHISOR HAS LIMITED FINANCIAL RESOURCES WHICH MIGHT NOT BE ADEQUATE TO FUND THE FRANCHISOR'S PRE-OPENING OBLIGATIONS TO EACH FRANCHISEE AND PAY OPERATING EXPENSES.
6. THE FRANCHISOR WAS FORMED IN [month / year] HAS LITTLE OPERATING HISTORY OR RECORD OF PERFORMANCE. A FRANCHISEE'S ESTIMATED INITIAL INVESTMENT RANGING FROM [insert Item 7 range] EXCEEDS THE FRANCHISOR'S TOTAL STOCKHOLDER'S EQUITY OF [insert stockholder's equity from financial statements] at [insert ending date of financial statements].
7. THERE MAY BE OTHER RISKS CONCERNING THIS FRANCHISE.

**Exhibit E**

**Sample State FDD Addenda**

## CALIFORNIA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the California Franchise Investment Law, Cal. Corp. Code §§ 31000-31516 or the California Franchise Relations Act, Cal. Bus. & Prof. Code §§20000-20043 applies, the terms of this Addendum apply.

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

OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT AND COMPLAINTS CONCERNING THE CONTENTS OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT AT [WWW.DBO.CA.GOV](http://WWW.DBO.CA.GOV).

SECTION 31125 OF THE CALIFORNIA CORPORATIONS CODE REQUIRES US TO GIVE YOU A DISCLOSURE DOCUMENT, IN A FORM CONTAINING THE INFORMATION THAT THE COMMISSIONER MAY BY RULE OR ORDER REQUIRE, BEFORE A SOLICITATION OF A PROPOSED MATERIAL MODIFICATION OF AN EXISTING FRANCHISE.

### Item 3, Additional Disclosure:

Neither we nor any person described in Item 2 of the Disclosure Document is subject to any currently effective order of any National Securities Association or National Securities Exchange, as defined in the Securities Exchange Act of 1934, 15 U.S.C.A. 78a et seq. suspending or expelling such persons from membership in such association or exchange.

### Item 6, Additional Disclosure:

The highest interest rate allowed by law in California is 10% annually.

### Item 17, Additional Disclosures:

The franchise agreement requires franchisee to execute a general release of claims upon renewal or transfer of the franchise agreement. California Corporations Code Section 31512 provides that any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of that law or any rule or order there under is void. Section 31512 voids a waiver of your rights under the Franchise Investment Law (California Corporations Code Section 20010 voids a waiver of your rights under the Franchise Relations Act (Business and Professions Code Sections 20000 – 20043).

The franchise agreement requires application of the laws of \_\_\_\_\_. This provision may not be enforceable under California law.

The franchise agreement contains a liquidated damages clause. Under California Civil Code §1671, certain liquidated damages clauses are unenforceable.

California Business and Professions Code Sections 20000 through 20043 provide rights to the franchisee concerning termination, transfer or non-renewal of a franchise. If the franchise agreement contains a provision that is inconsistent with the law, the law will control.

The franchise agreement provides for termination upon bankruptcy. This provision may not be enforceable under federal bankruptcy law (11 U.S.C.A. §101 et seq.)

The franchise agreement requires binding arbitration. The arbitration will occur in \_\_\_\_\_ with the cost being borne by the parties as determined by the arbitrator. Prospective franchisees are encouraged to consult with private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California.

The franchise agreement contains a covenant not to compete which extends beyond the termination of the franchise. This provision may not be enforceable under California law.

Item 19, Additional Disclosures:

The financial performance figures do not reflect the costs of sales, operating expenses, or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit. You should conduct an independent investigation of the costs and expenses you will incur in operating your franchised business. Franchisees or former franchisees listed in the Disclosure Document may be one source of this information.

## HAWAII ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Hawaii Franchise Investment Law, Hawaii Rev. Stat. §§482E-1 – 482E-12 applies, the terms of this Addendum apply.

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

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

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

## ILLINOIS ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Illinois Franchise Disclosure Act, Ill. Comp. Stat. §§705/1 – 705/44 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures. The following statements are added to Item 17:

The Illinois Franchise Disclosure Act governs the Franchise Agreement.

Section 4 of the Illinois Franchise Disclosure Act provides that any provision in a franchise agreement that designates jurisdiction or venue outside the State of Illinois is void. However, a franchise agreement may provide for arbitration outside of Illinois.

Section 41 of the Illinois Franchise Disclosure Act provides that any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with the Illinois Franchise Disclosure Act or any other law of Illinois is void.

Your rights upon termination and non-renewal of a franchise agreement are set forth in section 19 and 20 of the Illinois Franchise Disclosure Act.

## MARYLAND ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Maryland Franchise Registration and Disclosure Law, Md. Code Bus. Reg. §§14-201 – 14-233 applies, the terms of this Addendum apply.

### Item 17, Additional Disclosures:

Our termination of the Franchise Agreement because of your bankruptcy may not be enforceable under applicable federal law (11 U.S.C.A. 101 et seq.).

You may bring a lawsuit in Maryland for claims arising under the Maryland Franchise Registration and Disclosure Law.

Any claims arising under the Maryland Franchise Registration and Disclosure Law must be brought within 3 years after the grant of the franchise.

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

## DISCLOSURES REQUIRED BY MICHIGAN LAW

**[Per statute, the Michigan Addendum must immediately follow the cover sheet of the FDD and be in 12 point font.]**

To the extent the Michigan Franchise Investment Law, Mich. Comp. Laws §§445.1501 – 445.1546 applies, the terms of this Addendum apply.

THE STATE OF MICHIGAN PROHIBITS CERTAIN UNFAIR PROVISIONS THAT ARE SOMETIMES IN FRANCHISE DOCUMENTS. IF ANY OF THE FOLLOWING PROVISIONS ARE IN THESE FRANCHISE DOCUMENTS, THE PROVISIONS ARE VOID AND CANNOT BE ENFORCED AGAINST YOU.

(a) A prohibition on the right of a franchisee to join an association of franchisees.

(b) A requirement that a franchisee assent to a release, assignment, novation, waiver, or estoppel which deprives a franchisee of rights and protections provided in this act. This shall not preclude a franchisee, after entering into a franchise agreement, from settling any and all claims.

(c) A provision that permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause. Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.

(d) A provision that permits a franchisor to refuse to renew a franchise without fairly compensating the franchisee by repurchase or other means for the fair market value at the time of expiration of the franchisee's inventory, supplies, equipment, fixtures, and furnishings. Personalized materials which have no value to the franchisor and inventory, supplies, equipment, fixtures, and furnishings not reasonably required in the conduct of the franchise business are not subject to compensation. This subsection applies only if: (i) the term of the franchise is less than 5 years, and (ii) the franchisee is prohibited by the franchise or other agreement from continuing to conduct substantially the same business under another trademark, service mark, trade name, logotype, advertising, or other commercial symbol in the same area subsequent to the expiration of the franchise or the franchisee does not receive at least 6 months advance notice of franchisor's intent not to renew the franchise.

(e) A provision that permits the franchisor to refuse to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances. This section does not require a renewal provision.

(f) A provision requiring that arbitration or litigation be conducted outside this state. This shall not preclude the franchisee from entering into an agreement, at the time of arbitration, to conduct arbitration at a location outside this state.

(g) A provision which permits a franchisor to refuse to permit a transfer of ownership of a franchise, except for good cause. This subdivision does not prevent a franchisor from exercising a right of first refusal to purchase the franchise. Good cause shall include, but is not limited to:

(i) The failure of the proposed transferee to meet the franchisor's then-current reasonable qualifications or standards.

(ii) The fact that the proposed transferee is a competitor of the franchisor or subfranchisor.

(iii) The unwillingness of the proposed transferee to agree in writing to comply with all lawful obligations.

(iv) The failure of the franchisee or proposed transferee to pay any sums owing to the franchisor or to cure any default in the franchise agreement existing at the time of the proposed transfer.

(h) A provision that requires the franchisee to resell to the franchisor items that are not uniquely identified with the franchisor. This subdivision does not prohibit a provision that grants to a franchisor a right of first refusal to purchase the assets of a franchise on the same terms and conditions as a bona fide third party willing and able to purchase those assets, nor does this subdivision prohibit a provision that grants the franchisor the right to acquire the assets of a franchise for the market or appraised value of such assets if the franchisee has breached the lawful provisions of the franchise agreement and has failed to cure the breach in the manner provided in subdivision (c).

(i) A provision which permits the franchisor to directly or indirectly convey, assign, or otherwise transfer its obligations to fulfill contractual obligations to the franchisee unless provision has been made for providing the required contractual services.

**THE FACT THAT THERE IS A NOTICE OF THIS OFFERING ON FILE WITH THE ATTORNEY GENERAL DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION, OR ENDORSEMENT BY THE ATTORNEY GENERAL.**

If the franchisee has any questions regarding this notice, those questions should be directed to the Michigan Department of Attorney General, Consumer Protection Division, Attn.: Franchise, 670 Law Building, Lansing, Michigan 48913, telephone: (517) 373-7117.

## MINNESOTA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Minnesota Franchise Act, Minn. Stat. §§80C.01 – 80C.22 applies, the terms of this Addendum apply.

### State Cover Page and Item 17, Additional Disclosures:

Minn. Stat. Sec. 80C.21 and Minn. Rule 2860.4400J prohibit us from requiring litigation to be conducted outside of Minnesota, requiring waiver of a jury trial or requiring the franchisee to consent to liquidated damages, termination penalties or judgment notes. In addition, nothing in the Disclosure Document shall abrogate or reduce any of your rights as provided for in Minn. Stat. Sec. 80C, or your rights to any procedure, forum or remedies provided for by the laws of the jurisdiction.

Franchisee cannot consent to the franchisor obtaining injunctive relief. The franchisor may seek injunctive relief. A court will determine if a bond is required.

### Item 6, Additional Disclosure:

NSF checks are governed by Minn. Stat. 604.113, which puts a cap of \$30 on service charges.

### Item 13, Additional Disclosures:

The Minnesota Department of Commerce requires that a franchisor indemnify Minnesota Franchisees against liability to third parties resulting from claims by third parties that the franchisee's use of the franchisor's trademark infringes upon the trademark rights of the third party. The franchisor does not indemnify against the consequences of a franchisee's use of a franchisor's trademark except in accordance with the requirements of the franchise agreement, and as the condition to an indemnification, the franchisee must provide notice to the franchisor of any such claim immediately and tender the defense of the claim to the franchisor. If the franchisor accepts tender of defense, the franchisor has the right to manage the defense of the claim, including the right to compromise, settle or otherwise resolve the claim, or to determine whether to appeal a final determination of the claim.

### Item 17, Additional Disclosures:

Any condition, stipulation or provision, including any choice of law provision, purporting to bind any person who, at the time of acquiring a franchise is a resident of the State of Minnesota or in the case of a partnership or corporation, organized or incorporated under the laws of the State of Minnesota, or purporting to bind a person acquiring any franchise to be operated in the State of Minnesota to waive compliance or which has the effect of waiving compliance with any provision of the Minnesota Franchise Law is void.

We will comply with Minn. Stat. Sec. 80C.14, subds. 3, 4 and 5, which requires, except in certain specified cases, that a franchisee be given 90 days notice of termination (with 60 days to cure), 180 days notice for nonrenewal of the Franchise Agreement, and that consent to the transfer of the franchise will not be unreasonably withheld.

Minnesota Rule 2860.4400D prohibits a franchisor from requiring a franchisee to assent to a general release, assignment, novation, or waiver that would relieve any person from liability imposed by Minnesota Statute §§80C.01 – 80C.22.

The limitations of claims section must comply with Minn. Stat. Sec. 80C.17, subd. 5.

## NEW YORK ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the New York General Business Law, Article 33, §§680 - 695 applies, the terms of this Addendum apply.

### Cover Page, Additional Disclosure.

INFORMATION COMPARING FRANCHISORS IS AVAILABLE. CALL THE STATE ADMINISTRATORS LISTED IN EXHIBIT \_\_\_\_\_ OR YOUR PUBLIC LIBRARY FOR SOURCES OF INFORMATION. REGISTRATION OF THIS FRANCHISE BY NEW YORK STATE DOES NOT MEAN THAT NEW YORK STATE RECOMMENDS IT OR HAS VERIFIED THE INFORMATION IN THIS FRANCHISE DISCLOSURE DOCUMENT. IF YOU LEARN THAT ANYTHING IN THE FRANCHISE DISCLOSURE DOCUMENT IS UNTRUE, CONTACT THE FEDERAL TRADE COMMISSION AND NEW YORK STATE DEPARTMENT OF LAW, BUREAU OF INVESTOR PROTECTION AND SECURITIES, 120 BROADWAY, 23RD FLOOR, NEW YORK, NEW YORK 10271. THE FRANCHISOR MAY, IF IT CHOOSES, NEGOTIATE WITH YOU ABOUT ITEMS COVERED IN THE FRANCHISE DISCLOSURE DOCUMENT. HOWEVER, THE FRANCHISOR CANNOT USE THE NEGOTIATING PROCESS TO PREVAIL UPON A PROSPECTIVE FRANCHISEE TO ACCEPT TERMS WHICH ARE LESS FAVORABLE THAN THOSE SET FORTH IN THIS FRANCHISE DISCLOSURE DOCUMENT.

Item 3, Additional Disclosure. The last sentence in Item 3 is deleted and replaced with the following:

Neither we, nor any of our predecessors, nor any person identified in Item 2 above, nor any affiliate offering franchises under our trademark, has any administrative, criminal, or a material civil or arbitration action pending against him alleging a violation of any franchise law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property, or comparable allegations.

Neither we, nor any of our predecessors, nor any person identified in Item 2 above, nor any affiliate offering franchises under our trademark, has been convicted of a felony or pleaded nolo contendere to any other felony charge or, during the ten-year period immediately preceding the application for registration, been convicted of a misdemeanor or pleaded nolo contendere to any misdemeanor charge or been found liable in an arbitration proceeding or a civil action by final judgment, or been the subject of any other material complaint or legal or arbitration proceeding if such misdemeanor conviction or charge, civil action, complaint, or other such proceeding involved a violation of any franchise law, securities law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property, or comparable allegation.

Neither we, nor any of our predecessors, nor any person identified in Item 2 above, nor any affiliate offering franchises under our trademark, is subject to any currently effective injunctive or restrictive order or decree relating to franchises, or under any federal, state, or Canadian franchise, securities, antitrust, trade

regulation, or trade practice law as a result of a concluded or pending action or proceeding brought by a public agency; or is subject to any currently effective order of any national securities association or national securities exchange, as defined in the Securities and Exchange Act of 1934, suspending or expelling such person from membership in such association or exchange; or is subject to a currently effective injunctive or restrictive order relating to any other business activity as a result of an action brought by a public agency or department, including, without limitation, actions affecting a license as a real estate broker or sales agent.

Item 4, Additional Disclosure. Item 4 is deleted and replaced with the following:

Neither we nor any of our predecessors, affiliates, or officers, during the 10-year period immediately before the date of the Disclosure Document: (a) filed as debtor (or had filed against it) a petition to start an action under the U.S. Bankruptcy Code; (b) obtained a discharge of its debts under the Bankruptcy Code; or (c) was a principal officer of a company or a general partner in a partnership that either filed as a debtor (or had filed against it) a petition to start an action under the U.S. Bankruptcy Code or that obtained a discharge of its debts under the U.S. Bankruptcy Code during or within one year after the officer or general partner of the franchisor held this position in the company or partnership.

Item 5, Additional Disclosures.

The initial franchise fee constitutes part of our general operating funds and will be used as such in our discretion.

Item 17, Additional Disclosures.

The following is added to the Summary sections of Item 17(c) and 17(m): To the extent required by applicable law, all rights you enjoy and any causes of action arising in your favor from the provisions of Article 33 of the General Business Law of the State of New York and the regulations issued thereunder shall remain in force; it being the intent of this proviso that the non-waiver provisions of General Business Law Section 687.4 and 687.5 be satisfied.

The Summary section of Item 17(d) is deleted and replaced with the following language: You may terminate the agreement on any grounds available by law.

The following is added to the Summary section of Item 17(j): No assignment will be made except to an assignee who in good faith and judgment of the franchisor is willing and financially able to assume the franchisor's obligations under the Franchise Agreement.

The following is added to the Summary sections of Items 17(v) and 17(w): The foregoing choice of law should not be considered a waiver of any right conferred upon the franchisor or upon the franchisee by Article 33 of the General Business Law of the State of New York.

## NORTH DAKOTA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the North Dakota Franchise Investment Law, N.D. Cent. Code, §§51-19-01 – 51-19-17 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures. The following statements are added to Item 17:

Any provision requiring franchisees to consent to the jurisdiction of courts outside North Dakota or to consent to the application of laws of a state other than North Dakota may be unenforceable under North Dakota law. Any mediation or arbitration will be held at a site agreeable to all parties. If the laws of a state other than North Dakota govern, to the extent that such law conflicts with North Dakota law, North Dakota law will control.

Any general release the franchisee is required to assent to as a condition of renewal is not intended to nor shall it act as a release, estoppel or waiver of any liability franchisor may have incurred under the North Dakota Franchise Investment Law.

Covenants not to compete during the term of and upon termination or expiration of the franchise agreement are enforceable only under certain conditions according to North Dakota law. If the Franchise Agreement contains a covenant not to compete that is inconsistent with North Dakota law, the covenant may be unenforceable.

The Franchise Agreement includes a waiver of exemplary and punitive damages. This waiver may not be enforceable under North Dakota law.

The Franchise Agreement stipulates that the franchisee shall pay all costs and expenses incurred by franchisor in enforcing the agreement. For North Dakota franchisees, the prevailing party is entitled to recover all costs and expenses, including attorneys' fees.

The Franchise Agreement requires the franchisee to consent to a waiver of trial by jury. This waiver may not be enforceable under North Dakota law.

The Franchise Disclosure Document and Franchise Agreement state that franchisee must consent to the jurisdiction of courts outside that State of North Dakota. That requirement may not be enforceable under North Dakota law.

The Franchise Disclosure Document and Franchise Agreement may require franchisees to consent to termination or liquidated damages. This requirement may not be enforceable under North Dakota law.

The Franchise Agreement requires the franchisee to consent to a limitation of claims within one year. To the extent this requirement conflicts with North Dakota law, North Dakota law will apply.

## RHODE ISLAND ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Rhode Island Franchise Investment Act, R.I. Gen. Law ch. 395 §§19-28.1-1 – 19-28.1-34 applies, the terms of this Addendum apply.

Item 17, Additional Disclosure. The following statement is added to Item 17:

Section 19-28.1-14 of the Rhode Island Franchise Investment Act provides that:  
“A provision in a franchise agreement restricting jurisdiction or venue to a forum outside this state or requiring the application of the laws of another state is void with respect to a claim otherwise enforceable under this Act.”

## VIRGINIA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Virginia Retail Franchising Act, Va. Code §§13.1-557 – 13.1-574 applies, the terms of this Addendum apply.

### Item 17, Additional Disclosures:

Any provision in any of the contracts that you sign with us which provides for termination of the franchise upon the bankruptcy of the franchisee may not be enforceable under federal bankruptcy law (11 U.S.C. 101 et. seq.).

“According to Section 13.1 – 564 of the Virginia Retail Franchising Act, it is unlawful for a franchisor to cancel a franchise without reasonable cause. If any grounds for default or termination stated in the franchise agreement does not constitute “reasonable cause,” as that term may be defined in the Virginia Retail Franchising Act or the laws of Virginia, that provision may not be enforceable.”

## WASHINGTON ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Washington Franchise Investment Protection Act, Wash. Rev. Code §§19.100.010 – 19.100.940 applies, the terms of this Addendum apply.

### Item 17, Additional Disclosure:

The state of Washington has a statute, RCW 19.100.180 which may supersede the Franchise Agreement in your relationship with the franchisor including the areas of termination and renewal of your franchise. There may also be court decisions which may supersede the Franchise Agreement in your relationship with the franchisor including the areas of termination and renewal of your franchise.

In any arbitration involving a franchise purchased in Washington, the arbitration site shall be either in the state of Washington, or in a place mutually agreed upon at the time of the arbitration, or as determined by the arbitrator.

In the event of a conflict of laws, the provisions of the Washington Franchise Investment Protection Act, Chapter 19.100 RCW shall prevail.

A release or waiver of rights executed by a franchisee shall not include rights under the Washington Franchise Investment Protection Act except when executed pursuant to a negotiated settlement after the agreement is in effect and where the parties are represented by independent counsel.

Provisions such as those which unreasonably restrict or limit the statute of limitations period for claims under the Act, rights or remedies under the Act such as a right to a jury trial may not be enforceable.

Transfer fees are collectable to the extent that they reflect the franchisor's reasonable estimated or actual costs in effecting a transfer.

## WISCONSIN ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Wisconsin Franchise Investment Law, Wis. Stat. §§553.01 – 553.78 or Wisconsin Fair Dealership Law, Wis. Stat. §§135.01 – 135.07 applies, the terms of this Addendum apply.

### Item 17, Additional Disclosures:

For all franchisees residing in the State of Wisconsin, we will provide you at least 90 days' prior written notice of termination, cancellation or substantial change in competitive circumstances. The notice will state all the reasons for termination, cancellation or substantial change in competitive circumstances and will provide that you have 60 days in which to cure any claimed deficiency. If this deficiency is cured within 60 days, the notice will be void. If the reason for termination, cancellation or substantial change in competitive circumstances is nonpayment of sums due under the franchise, you will have 10 days to cure the deficiency.

For Wisconsin franchisees, Ch. 135, Stats., the Wisconsin Fair Dealership Law, supersedes any provisions of the Franchise Agreement or a related contract which is inconsistent with the Law.

## **Exhibit F**

### **Initial State Registration Requirements**

State	Initial Franchise Application Filing Requirements	Filing Fee	Electronic Filing
California	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Customer Authorization of Disclosure of Financial Records, California Internet Advertising Exemption Notice, Franchise Seller Disclosure Forms, and 1 copy of the FDD.	\$675	Permitted
Hawaii	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 2 copies of the FDD.	\$250	N/A
Illinois	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, 1 paper copy of the FDD and 1 copy of the FDD on CD-ROM (in PDF format).	\$500	N/A
Indiana	Uniform Franchise Registration Application, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms on CD-ROM (if more than 1 or 2), and 1 copy of the FDD on CD-ROM.	\$500	N/A
Maryland	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 copy of the FDD (all documents must be in paper and on a CD-ROM).	\$500	N/A
Minnesota	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 paper copy of the FDD and 1 copy of the FDD on CD-ROM (in PDF format).	\$400	Permitted
New York	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Uniform Franchise Consent to Service of Process, Consent of Accountant, Franchise Seller Disclosure Forms, 1 copy of the Franchisor's financial statements, and 2 copies of the FDD.	\$750	N/A
North Dakota	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 copy of the FDD on CD-ROM.	\$250	N/A
Rhode Island	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 copy of the FDD.	\$600	Online or CD-ROM only
South Dakota	Franchise Notice Filing Application, Uniform Franchise Consent to Service of Process, and 1 copy of the FDD on CD-ROM.	\$250	N/A
Virginia	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, and 1 copy of the FDD (all documents must be in paper and on CD-ROM).	\$500	N/A
Washington	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 2 copies of the FDD.	\$600	Permitted
Wisconsin	Uniform Franchise Registration Application, Uniform Franchise Consent to Service of Process, and 1 copy of the FDD.	\$400	Required

## **Exhibit G**

### **Federal & State Franchise Exemptions**

## Franchise Exemptions Overview

The following tables were created as a quick reference guide only. Please remember the burden of proving eligibility for any exemption or exception is on the entity claiming it. It is strongly recommended that you read and then re-read the specific language of each statute before relying on an exemption or exception.

State	Large Franchisor	Large Franchisee	Large Investment	Insider	Institutional Franchisee	Fractional Franchise	Single Franchise
FTC		X	X	X		X	
California	X	X		X		X	
Hawaii					X		
Illinois	X	X	X	X	X	X	X
Indiana	X					X	X
Maryland	X		X		X		
Michigan					X	X	
Minnesota			X		X	X	X
New York	X				X	X	X
North Dakota	X						
Rhode Island	X	X		X			
South Dakota		X	X	X	X	X	
Virginia	X				X	X	
Washington	X	X		X	X		X
Wisconsin			X		X	X	

State	Out of State	Nominal Fee	Sale by Judicial Officer	Renewal, Extension, Amendment or Modification of Agreement <sup>178</sup>	Sale by Existing Franchisee <sup>179</sup>	Sale to Existing Franchisee <sup>2</sup>	By Order	Leased Departments	Securities
FTC		X		X	X	X		X	
California	X	X		X	X	X			
Hawaii	X		X	X	X	X	X		
Illinois	X	X		X	X		X	X	
Indiana				X	X		X		
Maryland	X	X		X	X	X	X		
Michigan	X	X	X	X	X	X			
Minnesota	X	X	X		X		X	X	X
New York <sup>180</sup>				X	X	X	X		
North Dakota				X	X		X		
Rhode Island	X		X	X	X	X	X	X	
South Dakota	X	X	X	X	X	X	X	X	
Virginia	X			X	X	X		X	
Washington		X	X		X	X			X
Wisconsin	X	X		X	X	X	X		X

<sup>178</sup> This assumes no material changes to the terms and conditions of the franchise agreement are required.

<sup>179</sup> Franchisor must not play a significant role in the sale (permissible for franchisor to approve transfer).

<sup>180</sup> New York also provides for a trade show exemption, which allows a franchisor to show at the trade show for three days. No offers of sales.

## **Exhibit H**

### **Advertising Registration Requirements**

## Summary of State Advertising Requirements

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
CA	<b>3 bus.</b>	<b>1</b>  <i>(but unpublished requirement of 2 copies for review purposes)</i>	Advertisement must: (1) include name and address of franchisor; (2) if referring to registration of a franchise, must include disclaimer of state endorsement in capital letters of no less than 10-point type: "THESE FRANCHISES HAVE BEEN REGISTERED UNDER THE FRANCHISE INVESTMENT LAW OF THE STATE OF CALIFORNIA. SUCH REGISTRATION DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION OR ENDORSEMENT BY THE COMMISSIONER OF CORPORATIONS NOR A FINDING BY THE COMMISSIONER THAT THE INFORMATION PROVIDED HEREIN IS TRUE, COMPLETE AND NOT MISLEADING."; (3) if including an endorsement of a public figure, disclose any compensation or benefit to that individual; and (4) if containing a claim of an exemption from or reduction in tax liability, such claim must be based on the opinion of counsel, which counsel must be named in the advertisement.	Advertisement should not contain any statement or inference that purchase of franchise is a safe investment or that failure, loss or default is impossible or unlikely, or that earnings or profits are assured and any actual earnings claims made must conform with Item 19 of the disclosure document. <sup>181</sup>	Internet offer exempt if: (1) franchisor files with the Commissioner a written notice, executed by franchisor's officer or general partner that includes (a) URL address, (b) statement that the franchisor agrees to comply with CFIL when posting any internet advertisement, and (c) franchisor's name, address, telephone number, and contact person; (2) advertisement is not directed to any state resident; and (3) preface, exhibit or appendix of the franchisor's disclosure document includes URL address and the following statement of not less than 12-point type: "OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT, ANY COMPLAINTS CONCERNING THE CONTENT OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT at <a href="http://www.dbo.ca.gov">www.dbo.ca.gov</a> ."  Cal. Code Regs. tit. 10, § 310.156.3. (Cal., ¶ 5050.355.)

<sup>181</sup> While "earnings claims" are now referred to as "financial performance representations," some states still have not changed their statutes to reflect the change.

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
MD	<p><b>5 days</b> Md., (CCH) ¶ 5200.09.</p> <p><i>but</i></p> <p><b>7 bus.</b> Md., (CCH) ¶ 3200.25.</p>	<b>1</b>	Advertisement must: (1) include name and address of franchisor in promotional materials; (2) submit written transcript for video/audio promotional materials and description of the contents; and (3) include name and address of counsel if opinion of counsel is provided in advertisement.	Advertisement for franchise offering may not refer to: (1) the purchase or sale of franchise as safe investment, as free from risk of loss or default, or as guarantee or assurance of earnings or profits; and (2) an earnings claim, unless otherwise permitted by Commissioner.	<p>Internet offer exempt from statutory filing requirements if (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>Md., ¶ 5200.18.</p>
MN	<p><b>5 bus.</b></p> <p><i>(may publish advertisement if examiner does not issue a comment letter within 3 bus. days after filing.)</i></p>	<b>1</b>	Advertisement must include: (1) name and address of franchisor, including primary commercial symbol of the franchisor; (2) state registration number assigned to the offering; and (3) name and address of counsel if opinion of counsel is provided in advertisement.	No advertisement shall make reference to: (1) acquiring of franchise as an assurance of earnings or profits, as safe investment, or as free from loss, default, or failure or that such is impossible or unlikely; and (2) projections or statements of operations or income from operation of any franchise.	<p>Internet offer exempt from statutory filing requirements if (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>Minn., ¶ 5230.81-.82</p>

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
NY	7	1  (2 copies must be submitted with the prospectus or disclosure document). N.Y., ¶ 5320.03.	<p>Advertisement must: (1) be verified in writing that the advertisement is not inconsistent with filed prospectus; (2) cover letter must state: “we verify that the enclosed advertisement is consistent with the filed Franchise Disclosure Document” (in addition to separate verification); and, (3) sales literature must state in easily readable print:</p> <p>“This advertisement is not an offering. An offering can only be made by a prospectus filed first with the Department of Law of the State of New York. Such filing does not constitute approval by the Department of Law.”</p> <p>Or, the following:<sup>182</sup></p> <p>“This offering is made by prospectus only.”</p> <p>(4) Any radio or television advertisement must include a statement that no offer of a franchise is made except by prospectus.</p>	No sales literature shall include any representation or statement inconsistent with prospectus on file with Department.	<p>Internet offer exempt if: (1) franchisor’s URL address is stated (a) on the cover page of a franchise disclosure document included with an application for state registration, (b) on the cover page of a franchise disclosure document included with an application for exemption from registration that is on file with the New York State Department of Law, or (c) on a notice filed with the New York State Department of Law, (2) the internet advertising is not directed at any person in the state, (3) the advertisement states that the offer is not directed to residents of the state, (4) the advertisement is not actually directed to any resident of the state, and (5) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>N.Y., ¶ 5320.12-.13.</p>
ND	5 bus.	1	None.	None.	<p>Internet offer exempt from statutory filing requirements if (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>N.D., ¶ 5340.02.</p>

<sup>182</sup> This second notice is to be used with print advertisements no more than 5” long/1 column wide and broadcast advertisements of 30 seconds or less.

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
WA	7	1	Advertisement must: (1) include name and address of franchisor in promotional materials, (2) if relying on endorsement of public figure, disclose any compensation or benefit to that individual; and (3) if advertisement contains a claim of an exemption from or reduction in tax liability, such claim must be based on the opinion of counsel, which counsel must be named in the advertisement.	Advertisement should: (1) not contain any statement or inference that purchase of franchise is safe investment or that failure, loss or default is impossible or unlikely, or that earnings or profits are assured; and (2) not normally contain projection of future franchisee earnings unless projection is (a) based on past earnings records of all franchisees operating under conditions, including location, substantially similar to conditions affecting franchises being offered (b) for a reasonable period only and (c) is substantiated by data which clearly supports projections	Internet offer not subject to registration requirement if (1) the offer is made pursuant to an exemption from registration; or (2) if the franchise is not registered, (a) the offer indicates that the franchises are not being offered to residents in the state, (b) the internet offer is not otherwise directed to any person in the state, (c) no franchises are sold in the state until the offering is registered.  Wash., ¶ 5470.25.  Internet offer that is required to be registered in the state is exempt from statutory filing requirements if (1) franchisor's URL address is stated (a) on the cover page of the franchise disclosure document included with an application for state registration, or (b) on a notice filed with the director within five business days after publication; and (2) the internet advertising is not directed at any person in the state.  Wash., ¶ 5470.24.