Franchise Sales and Disclosure Law

Franchise Sales and Disclosure Law - Impact of the Amended FTC Rule

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FRANCHISE SALES AND DISCLOSURE LAW COMPLIANCE TRAINING

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Franchise Sales and Disclosure Compliance Training

Agenda

- Overview of Federal & State Regulation
- Federal Regulation
- State Regulation
- Disclosure Documents
- Earnings Claims
- Franchise Recruitment Advertising Rules & Prohibitions
- Compliance Program, Record Keeping and Documentation
- Administrative, Civil and Criminal Penalties for Violations
Business Goals of Compliance Program

- Close franchise sales with franchisee confident that he or she has made an informed decision; Avoid buyer’s remorse
- Comply with applicable laws and regulations to avoid potential regulatory fines, penalties and associated disclosures
- Avoid risks to business from administrative remedies that prohibit franchise sales activity
- Avoid accounting reserves from contingent liabilities
- Avoid remedies that pay more to franchisee than franchisor received
- Avoid civil and criminal penalties that may involve personal liability to control persons and officers
The Three Bodies of Franchise Law

- Federal and state registration / disclosure statutes and regulations govern the offer and sale of franchises
- State ‘relationship’ laws govern the post-sale relationship and franchise contract
- Federal and state business opportunity laws govern marketing plans without a trademark at their core; broad scope covers franchises without registered marks
Federal And State Franchise Registration/ Disclosure Laws

- **FTC Franchise Rule** - since 1978
  - NO REGISTRATION REQUIRED – Not equivalent of Securities Acts
  - Governs selling process and content of disclosure, not substance of offering
  - Creates disclosure regimen and specifies disclosure document

- **State Approaches:**
  - California Franchise Investment Law - 1971
  - Midwest Securities Commissioners Assn. adopted first franchise offering circular format in 1974; NASAA format disclosure documents adopted in 1986 and 1993
  - Merit review of disclosure content and offering terms
  - Annual Notice Filings
  - Single Notice Filing – Business Opportunity Law Exemptions
Registration States in Red
Pre-sale Merit Review
Do Not Offer Or Sell Unless Registered Or Exempt

California

Hawaii

Illinois

Maryland

Minnesota

New York

North Dakota

Rhode Island

South Dakota

Virginia

Washington
### Pre-Sale Notice Registration
**Do Not Offer Or Sell Until NoticeFiled**

**Annual:**
- Florida*
- Indiana
- Michigan
- Utah*
- Wisconsin

**One time:**
- Connecticut (Marks newer than 10/1/96)*
- Kentucky*
- Nebraska*
- Texas*

*Business Opportunity Law, not Franchise Law, Filing*
Franchise Relationship States
Franchise Relationship Law States

- Arkansas
- California
- Connecticut
- Delaware
- Hawaii
- Idaho
- Illinois
- Indiana
- Iowa
- Michigan
- Minnesota
- Mississippi
- Missouri
- Nebraska
- New Jersey
- North Dakota
- Rhode Island
- South Dakota
- Virginia
- Washington
- Wisconsin
Business Opportunity Laws

- Alabama
- Alaska
- California
- Connecticut
- Florida
- Georgia
- Illinois
- Indiana
- Iowa
- Kentucky
- Louisiana
- Maine
- Maryland
- Michigan
- Minnesota
- Nebraska
- New Hampshire
- N. Carolina
- Ohio
- Oklahoma
- S. Carolina
- S. Dakota
- Texas
- Utah
- Virginia
- Washington
- FTC Franchise Rule
FTC Rule – Source is FTC ACT, 15 U.S.C. Sec. 45

- **Sec. 5.** (a) (1) Unfair methods of competition in or affecting commerce, and *unfair or deceptive acts or practices* in or affecting commerce, are hereby declared unlawful.

- (2) The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations, ... from using unfair methods of competition in or affecting commerce and *unfair or deceptive acts or practices* in or affecting commerce.
Federal Trade Commission Rule

Applies to All Franchise Transactions in the United States
- In effect since 1979
- Cannot be waived
- No private right of action
- Created FTC format disclosure document
- Lady of America cases highlight State “Little FTC Act” private remedies
- Amended January 2007, mandatory July 1, 2008; optional July 1, 2007
The 1979 Franchise Rule:

16 CFR Part 436.1

- In connection with the advertising, offering, licensing, contracting, sale, or other promotion in or affecting commerce, as "commerce" is defined in the Federal Trade Commission Act, of any franchise, or any relationship which is represented either orally or in writing to be a franchise, it is an unfair or deceptive act or practice within the meaning of section 5 of that Act for any franchisor or franchise broker:

- To fail to furnish any prospective franchisee with the following information accurately, clearly, and concisely stated, in a legible, written document at the earlier of the "time for making of disclosures" or the first "personal meeting"
Time for Making of Disclosures

• **The Ten Business Day Rule:**

The Franchise Offering Circular must be delivered to the prospective franchisee at the earlier of the first personal meeting at which the sale of a franchise is discussed

-or-

**10 business days** before any contract is signed or consideration ($ or anything of value) is paid.
First Personal Meeting

• “Personal meeting" means a face-to-face meeting between a franchisor or franchise broker (or any agent, representative, or employee thereof) and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise.
• Doesn’t include electronic or voice communications that are not direct, in-person meetings
• If you discuss specific territories or fees, it’s a personal meeting
• Casual meet & greet at a trade show isn’t a personal meeting
• The sit-down rule
Final Agreement Rule

• The **Five Business Day Rule:**

The definitive Agreements to be signed by the franchisee must be delivered to the franchisee at least **5 business days** before the Agreements are signed and the franchise fee is paid.
Counting the Days

- Date of delivery does not count
- Action days bracket waiting period
- Entire waiting period must elapse between action days
- What about the anxious/sophisticated franchisee?
- **Revised Rule** – 14 calendar days; can sign on 15th day after delivery
- **Revised Rule** – 5 business days are now 7 calendar days; can sign on 8th day after delivery of definitive agreements
The 2007 Franchise Rule:
16 CFR Part 436.2

- ...offer or sale of a franchise...located in the United States...unless...exempted...is unfair or deceptive, in violation of Section 5 of the...FTC Act:

- (a) For any franchisor to fail to furnish a prospective franchisee with a copy of the franchisor's current disclosure document... at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate...

- (b) For any franchisor to alter unilaterally and materially...the basic franchise agreement or any related agreements without furnishing the prospective franchisee with a copy of each revised agreement at least seven calendar-days before the ..franchisee signs the revised agreement. Changes...that arise out of negotiations initiated by the...franchisee do not trigger this seven...day period.
Transition Period Options

- Follow Existing (1979) FTC Rule and use FTC Format disclosure document
- Follow 1979 FTC Rule and use NASAA UFOC format disclosure document
- Follow Revised Rule in its entirety (merit review states will allow filings under their transition period plan for the Revised Rule) for disclosure regimen and disclosure document
- Transition Period ends June 30, 2008
- No Mix & Match – select 1979 or 2007 Rule as compliance plan
- Revised Rule preempts all but more stringent state regulation of pre-sale disclosure
- Electronic Disclosure immediately permitted under either regimen
First Personal Meeting - Transition Issues

- Eliminated in Revised Rule
- Remains applicable under certain state disclosure and business opportunity laws and regulations, state large franchisor exemptions:
  - Illinois
  - Iowa
  - Maryland
  - New York
  - Oklahoma
  - Rhode Island
  - South Dakota
- NASAA has not acted to replace UFOC officially
  - UFOC 1993 Guidelines Item 23 receipt still refers to First Personal Meeting
Who Discloses?

- Franchisor – officers, employees
- **Franchise Broker** - any person other than a franchisor or a franchisee who sells, offers for sale, or arranges for the sale of a franchise
- Subfranchisor
- **Revised Rule** – franchisor responsible; franchise broker concept eliminated
  - States clinging to franchise broker disclosure in addenda; risk factor added
  - Replaced by franchise seller designation
Who Gets Disclosed?

A Prospective Franchisee:

- any person, including any representative, agent, or employee of that person, who **approaches or is approached** by a franchisor or franchise broker, or any representative, agent, or employee thereof, for the purpose of **discussing the establishment, or possible establishment**, of a franchise relationship involving such a person.
Who Gets Disclosed?

- Pre-formation: All individuals involved as principals
- Formed Entities – E&F Rule – executives and fiduciaries
- Corporation: any officer
- Partnerships – all general partners
- LLC – any member if member managed, officer if officer or director managed, or person designated as managing member
- A line manager doesn’t count
- If the recipient drops out of the deal, REDISCLOSE!
- Revised Rule: Allows representative (agent) to be recipient
  - Applies only in non-registration states
  - Relationship should be confirmed in writing by principal before closing
Disclosure Document

- 1979 Rule: FTC allowed choice of formats – FTC or UFOC
- UFOC form changed in 1995 to plain English with FTC consent
- Most Franchisors followed UFOC because registration states do not accept FTC format
- Registration state variations addressed in Addenda or Separate UFOC’s
- **Revised Rule:** Unified format under revised FTC rule for Franchise Disclosure Document created by FTC with state input and recognition as **Uniform Franchise Disclosure Document**
What’s a Material Change?

• The terms "material," "material fact," and "material change" shall include any fact, circumstance, or set of conditions which has a **substantial likelihood of influencing** a reasonable franchisee or **a reasonable prospective franchisee** in the making of a significant decision relating to a named franchise business or which has **any significant financial impact** on a franchisee or prospective franchisee.

**Maryland** Regulations specify:

• (a) Termination ...of more than 10 percent of the ... in-state franchises ...during any 3 month period; (b) Termination ...of more than 5 percent of all franchises during any 3 month period; (c) Reorganization; (d) A change in control, corporate name, or state of incorporation; (e) The commencement of any new product, service, or model line requiring, directly or indirectly, additional franchisee investment; and (f) The discontinuation or modification of the marketing plan or system of any product or service which accounts for at least 20 percent of the annual gross sales of the franchisor.
Disclosure Document

- FTC 1979 and Revised Rules: amend quarterly for material changes; supplements allowed under Revised Rule
  - But merit review state rules demand more timely amendments for material changes and do not yet recognize supplements
- Must amend annually within 90 (Revised Rule – 120) days after end of fiscal year for latest annual audited financial statements and update Item 20
- Good news later, bad news now.
- Stop selling until amendments completed, then redisclose (if material adverse changes) and restart 10 business day (14 day) waiting period
- Revised Rule – duty to deliver supplements to prospects; duty to track prospect interest in supplements; duty to inform about changes in Item 19
Franchise Disclosure Law

- Acknowledgment of Receipt
  - last page of UFOC/FDD
    - Prospective Franchisee signs and dates both copies in back of UFOC/FDD
    - Put one original in file
    - Sender keeps own copy
- Guilty until proven innocent
- **Revised Rule** – identifies specific franchise seller and contact info for each transaction
Franchise Disclosure Law

Immutable Truths:
• You are deemed guilty of a violation until you prove your compliance with the 10 business (14 calendar) day and 5 business (7 calendar) day rules.
• If you discuss specific fees or territories, it’s a personal meeting.
• If you disclose the wrong person, there is no disclosure.
• Assume the other party has amnesia and hates your guts.
State Franchise Registration/ Disclosure Laws

- Disclosure trigger – the “offer”
- Jurisdictional coverage – which state laws may apply?
- Be wary of meetings and shows

The Key Questions:

- What is an offer?
- Where is the offer directed from?
- Where is the offer directed to?
- Where is the offer accepted?
- Where is the franchisee’s domicile or residence?
- Where will the unit be located?
State Law Franchise Definitions

Marketing Plan:
Disclosure laws: California, Illinois, Maryland, New York, North Dakota, Oregon, Rhode Island, Virginia, Washington
Relationship laws: 14 states

Community of Interest:
Disclosure laws: Hawaii, Minnesota, South Dakota
"Community of interest" means a continuing financial interest between the franchisor and franchisee in the operation of the franchise business.
Relationship laws: California, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Wisconsin

- 10 Factor “totality of circumstances” test
Marketing Plan:
California Franchise Law Definition

a. "Franchise" means a **contract or agreement**, either expressed or implied, whether **oral or written**, between two or more persons by which:

1. A franchisee is granted the **right to engage in the business** of offering, selling or distributing **goods or services under a marketing plan or system prescribed in substantial part** by a franchisor; and

2. The operation of the franchisee's business pursuant to such plan or system is **substantially associated with the franchisor's trademark**, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and

3. The franchisee is required to pay, directly or indirectly, a **franchise fee**.
New Jersey Franchise Practices Act Definition

• “Franchise” means a written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trade mark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.

• “…complex of mutual and continuing advantages which induced the franchisor to reach his ultimate consumer through entities other than his own which, although legally separate, are nevertheless economically dependent upon him.”

• Means more interdependence than wholesaler/retailer
Offers Unlawful Unless Registered in Merit Review States

- **California**: it shall be unlawful for any person to offer or sell any franchise in this state unless the offer of the franchise has been registered (FIL §311110)

- **Illinois**: It is unlawful for any person to offer or sell any franchise required to be registered under this Act unless the franchise has been registered under this Act or is exempt (FDA §705/5)

- **New York**: It shall be unlawful and prohibited for any person to offer to sell or sell in this state any franchise unless and until there shall have been registered with the department of law prior to such offer or sale, a written statement to be known as an "offering prospectus" (GBL§683)
What is an offer to sell?

California:

- "Sale" or "sell" includes every contract or agreement of sale of, contract to sell, or disposition of, a franchise or interest in a franchise for value.
- "Offer" or "offer to sell" includes every attempt to offer to dispose of, or solicitation of an offer to buy, a franchise or interest in a franchise for value.
- An offer or sale of a franchise is made in this state when an offer to sell is made in this state, or an offer to buy is accepted in this state, or, if the franchisee is domiciled in this state, the franchised business is or will be operated in this state.

BUT:

- Transaction with a resident of another state or any territory or foreign country, shall be exempt if all locations of franchised business are physically located outside this state.
What is an offer to sell?

New York:

- "Offer" or "offer to sell" includes any attempt to offer to dispose of, or solicitation of an offer to buy, a franchise or interest in a franchise for value.

- An offer or sale of a franchise is made in this state when an offer to sell is made in this state, or an offer to buy is accepted in this state, or, if the **franchisee is domiciled in this state**, the **franchised business is or will be operated in this state**.

- An offer to sell is made in this state when the offer either originated from this state or is directed by the offeror to this state and received at the place to which it is directed. An offer to sell is accepted in this state when acceptance is communicated to the offeror from this state.
What is not an offer to sell?

Illinois:

- National media advertising
- the offer or sale of a franchise by a franchisee for its own account if the sale is not effected by or through a franchisor. A sale is not effected by or through a franchisor merely because a franchisor has a right to approve or disapprove a different franchisee or requires payment of a reasonable transfer fee.
- the extension or renewal of an existing franchise or the exchange or substitution of a modified or amended franchise agreement where there is no interruption in the operation of the franchise business by the franchisee.
State Disclosure Laws - Presale Waiting Period

• Registration states have set their own waiting periods
• California and Illinois now 14 calendar days
• Other states vary between 72 hours and 10 business days
• 1979 Rule: Waiting period is 10 business days except in California and Illinois
• **Revised Rule:** Waiting period is longer of 14 calendar days or 10 business days in Iowa, Maryland, Michigan, New York, Oklahoma, Rhode Island, Washington, Wisconsin
State Exemptions

- Similar to securities laws, there are:
  - Exempt Franchisors
  - Exempt Franchisees
  - Exempt transactions
  - Discretionary Exemptions
- Exemption from registration only, not civil and criminal remedies
- CA – exempt from negotiated change supplement to UFDD
Exempt Franchisors

- Large Experienced Companies
- Audited net worth of franchisor or parent as of last fiscal year end meets specific level
- Experience of at least 5 years operating or franchising
- Minimum number of units (usually 25) owned or franchised for experience period
- Available in California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington
- Deliver disclosure document
- **Revised Rule:** Deliver disclosure document in California, Maryland, Rhode Island, South Dakota, Virginia, Washington using longer of 14 days or 10 business days for waiting period
- File notice with State and pay fee annually
- Consent to service of process
- Burden of proof on franchisor to prove qualification
Exempt Franchisees

- High net worth or high income individuals
  - Franchisor insider
- Financial institutions
- Experience with investments
- Notice required for each transaction
- Disclosure document delivered
- No resale or plan of distribution
- Burden of proof on franchisor
- Available in California, Illinois, Maryland, Rhode Island, Washington, Wisconsin
Exempt Transactions

- Sale to existing franchisee under previously disclosed form of franchise agreement and no material changes in contract terms
- Renewal or extension of existing franchise if no material changes in contract terms
- Sale by franchisee for own account, no proceeds to franchisor, whose role is limited to approval of transferee
State Franchise Registration/ Disclosure Laws

- Franchisor capitalization requirements
  - Financial Statements reviewed
  - Supplemental Information Page sources of funds for pre-opening services reviewed
  - FAS 45 causes delayed recognition of revenue until substantially all services provided, causes negative working capital
  - Low capital means impound/escrow or surety bond
State Approach to Disclosure Transition

- NASAA announced interim policy on revised format disclosure document:
  http://www.nasaa.org/industry regulatory resources/uniformforms/3697.cfm
- UFOC renamed Uniform Franchise Disclosure Document (UFDD)
- General consistency with Revised Rule
- Legacy approaches remain – brokers covered by statutes or regulations in Hawaii, Illinois, New York, Virginia, Washington
- State Risk Factors on Renewal and Franchise Brokers
What’s in a UFDD - 22 Nuggets and a Receipt

- Franchisor & History
- Managers
- Litigation History
- Bankruptcy of Franchisor, Managers
- Initial Fees
- On-Going Fees
- Initial Investment
- Designated Sources
- Agreement Terms
- Financing
- Franchisor Obligations

- Territorial Protection
- Trademarks
- Patents
- Franchisee Participation
- Restrictions on Franchisee
- Relationship Inflection Points
- Public Figure Involvement
- Earnings Claims/Financial Performance Representations
- Franchise Census Data
- Financial Statements
- Contract Forms
- Receipt
State Franchise Registration/ Disclosure Laws

- **Registration Process**
  - Fee - Registration costs over $6,000 initially, plus over $2,000 annually and over $1,000 for each amendment
  - Facing Page
  - Supplemental Information Page
  - Franchise Sales agent disclosures
  - Consent to Service of Process
  - Certifications
  - Auditors’ Consent
  - Ancillary State Forms – waiver of automatic effectiveness, authorization to release financial information
  - Guaranty if affiliate financial statements used
- **Wait until clearance issued to sell and close transactions**
  - Comments routinely exchanged
  - **Submission of response ≠ clearance**
State Franchise Registration/ Disclosure Laws

UFDD Amendments / Renewals Of Franchise Registrations
- Amend when information changes materially
- No offers until amendment filed
- No sales until amendment cleared and redisclosure completed
- Opportunity/Obligation to calibrate UFDD and transaction experience
- Registration is effective either for a one year period (Illinois, Indiana, Maryland, Michigan, North Dakota, Virginia, Washington, Wisconsin), or until 90, 110 or 120 days (California, Hawaii, Minnesota, New York, Rhode Island, South Dakota) after the end of the franchisor’s fiscal year
Sales Agent and Broker Disclosure

• Item 2 directors, executive officers
• Franchise brokers (non-employee sales people)
• Employee sales people
• Not finders who merely introduce
• All must complete personal information and civil and criminal history disclosure form
• May submit full version and redacted version of form for public records to reduce prospect of identity theft
• Expect background investigation/records check
• **Revised Rule** eliminates broker disclosure in Item 2;
  – Registration states have not eliminated or modified broker disclosure yet
  – Identify specific franchise sellers in Receipt
  – Expanded concept of responsible executives and managers
  – Area Representatives are brokers/agents
Earnings Claims/ Financial Performance Representations

**1979 Rule:**
- Information given to a prospective franchisee by, on behalf of or at the direction of the franchisor or its agent, from which a specific level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained.

**Revised Rule:**
- 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.
Earnings Claims/ FPR’s

- **1979 Rule**: A chart, table or mathematical calculation presented to demonstrate possible results based upon a combination of variables (such as multiples of price and quantity to reflect gross sales) is an earnings claim subject to this item.

- **Revised Rule**: The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.
Earnings Claims/ FPR’s

- Must be in Item 19 of the disclosure document and must have reasonable basis
- Many ways to slice/dice if not misleading
- Keep separate records of supporting data
- Key is specific level of financial performance
- Ratification of franchisee projections is an earnings claim/FPR
- Separate rule for sale of company-owned stores
  - 3 year look back on revolving ownership info
- Limited to info directed at franchisee – other parties may receive
- Recirculated articles with financial data are FPR’s
FPR Disclosure - New Item 19

• Explanatory Note:
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 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.
Earnings Claims

Supplemental earnings claim:

- Item 19 earnings claim in UFOC/UFDD
- directed to a particular location or circumstance, apart from the offering circular
- must be in writing
- explain the departure from the earnings claim in the offering circular,
- be prepared in accordance with item 19,
- be left with the prospective franchisee.
Sample Earnings Claims

- Gross Sales reported by franchisees
- Average Costs for labor, materials, equipment, rent as a percent of sales
- Merchandise margin (Gross Margin)
- Retail sales versus commercial sales
- Composite Average P&L by Percent of Sales reported by franchisees, using franchise system chart of accounts
- Company Stores composite P&L
- Closing Rate of sales calls
- Pets groomed, percentage of repeats, average price per groom
Franchise Recruitment Advertising

- General Media Claims v. Point of Sale
- Point of Sale is specifically directed at franchise prospect and has 4 key elements
  - Reasonable basis
  - Franchisor can substantiate accuracy
  - Must be Geographically relevant
  - **1979 Rule:** Must be accompanied by UFOC and appropriate cautions and disclaimers or separate Earnings Claim Document
  - **Revised Rule:** Geographic relevance dropped, must be accompanied by UFDD
Franchise Recruitment Advertising

- General media claim is a permitted indirect earnings claim/FPR provided:
  - Franchisor has reasonable basis with supporting documentation
  - Must include number and percentage of outlets including company stores that achieved claimed level of financial performance
  - Include disclaimer for historical/projected claims
- Covers claims in broadcast and print advertising, speeches, press releases, internet, if directed at franchise recruitment
- Excludes Financial journals, trade press, news stories directed at other constituencies, if not used in franchise recruitment
- SEC filings excluded from obligation for separate substantiation and disclosure requirements applicable to FPR’s
Franchise Recruitment Advertising

- File in advance of use
- Negative option review – deemed approved unless affirmatively disapproved
- Clearance period ranges from 3 days to 7 days
- Covers all forms of general solicitation advertising
- Does not cover specific communications directed at individuals that are not part of campaign or similar activity
- Prohibited – “success” or “profits”
State Franchise Registration/Disclosure Laws

- 8 States with advance filing requirements for franchise advertising:
  - California
  - Maryland
  - Minnesota
  - New York
  - North Dakota
  - Rhode Island
  - South Dakota
  - Washington
Franchise Recruitment Advertising

• California Standards

...disclose fairly and accurately such relevant facts concerning the franchise, the terms and conditions ...necessary to make the advertisement not misleading. ..

An advertisement **should not contain** any statement or inference that a purchase of a franchise is a **safe investment** or that **failure**, loss or default is **impossible or unlikely**, or that **earnings or profits** are **assured**.

...Earnings Claims must conform with Item 19...

"**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.**"
Federal and State Franchise Registration/ Disclosure Laws

Permitted and prohibited negotiations with prospective franchisees
Franchise Relationship Laws

- Create Good Cause requirement for termination, renewal; may limit expansion, require local venue
- Grant franchisee rights that interfere with business decisions
- See Item 17 of UFOC & State Addenda for references
- Expanded by state regulation and administrative policy in certain states – Dakotas & Minnesota
- Beware Iowa, Puerto Rico, Rhode Island & New Jersey – difficult to terminate or expire without renewal
Record Keeping

- Goals:
  - Practice and demonstrate compliance in ordinary course of business
  - Prove compliance to auditors, litigators and regulators
  - Avoid rescission claims
  - Avoid management controls/risk assessment issues

- Key Dates & Actions: Track Deal Flow & Steps
  - What was done and when?
  - Who was involved?
  - What was delivered/received?
  - Who and what was checked, and when?
  - Were incipient violations found and corrected before the sale closed?
Sales Practice Training and Documentation

- Selling franchises is a regulated activity
- Monitor State registration status (red, yellow, green)
- Key points:
  - Process – waiting periods
  - Practices – advertising clearance and prohibitions
  - Substance – disclosure document and approved collateral material
  - Earnings Claims/Financial Performance Representations – what not to say or comment upon
  - Records – Acknowledgement of Receipt, UFDD
- Repetition and rosters
- Avoid the untruths
Federal Remedies

- No private right of action
- Violation to fail to return refundable fees
- FTC has a number of remedies
  - Civil investigation
    - Subpoena documents and witnesses
  - Cease and Desist Orders
  - Temporary and Permanent Injunctions
  - Civil Fines up to $11,000 per violation
  - Refer Crimes to Justice Department
  - Order Restitution
  - Order referral to IFA Compliance Training Program
State Violations

- Maryland Law violated by franchisor:
  - (i) without the offer of the franchise being registered under this subtitle; or
  - (ii) by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, if the person who buys or is granted a franchise does not know of the untruth or omission.

- Franchisee may sue to recover damages sustained by the grant of the franchise.

- A court may order franchisor to rescind the franchise and make restitution to the person who buys or is granted a franchise.

- Each person who directly or indirectly controls a franchisor has joint and several liability, including each partner in a partnership, each principal officer or director of a corporation, and each other person that has a similar status or performs similar functions, and each employee, if the employee materially aids in the act or transaction.
State Remedies

• Stop Order – cease selling
• Administrative Investigation – subpoena power
  – assurance of discontinuance; reimbursement of investigation costs
• Civil Remedies – cessation of violation; penalties up to $50,000 per violation
• Criminal Prosecution – misdemeanors and felonies
• Control person liability
• Private Rights of action
  – Strict liability – no causation
  – Right of rescission
  – Civil damages
  – Get out of jail free card
Franchise Sales And Disclosure Law Compliance Training

- Conclusion
- What questions do you have?
Franchise Sales and Disclosure Law—Impact of the Amended FTC Rule

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February 10, 2008
The Perceived Need for Continued Disclosure

- FTC seeks to insure honesty in the sales process regarding issues concerning
  - Nature of the franchised business
  - Costs associated with the business
  - Key contractual terms associated with the business
  - Prospects for the business’ success
  - Financial viability of the business
Amended Rule

• Recognizes the need for continued pre-sale disclosure
• Chooses disclosure over regulation
• Conforms FTC disclosure requirements to UFOC Guidelines
New Disclosure Format

- Format is essentially the same as UFOC format
- There are some significant changes
- We will focus on the more significant changes from a business and sales perspective
- Also consider how to deal with registration states in light of Amended Rule
Who Must Make Disclosure—Franchise Seller

- Anyone that offers for sale, sells, or arranges for the sale of a franchise
- These include the franchisor, its employees, representatives, agents, sub-franchisors and third party brokers who are involved in franchise sales activities are included
- Existing franchisees selling their own units—and are not selling on behalf of franchisor-- are not included in this definition
Amendments regarding brokers

- Third party brokers remain within definition of “franchise seller.”
- Amended rule changes disclosure obligations regarding brokers
- The business experience of third party broker or referral services are no longer required in Item 2
Who Must Receive Disclosure

• Applies only to prospective U.S. franchisees
  – Amended Rule does not apply to sales outside of the U.S.

• Prospective franchisee is anyone who approaches, or is approached by, a franchise seller to discuss the possible establishment of a franchise business relationship
Timing For Conversion

• Optional Compliance Started as of July 1, 2007
• Mandatory Compliance by July 1, 2008
• No “cherry picking”--all or nothing approach
  – E-disclosure is the only exception to “all or nothing” approach
Delivery Options

Amended Rule Permits E-Delivery
- By e-mail (pdf recommended)
- Website (password protected) and must provide directions on how to access
- Via CD-ROM or computer disc (first class mail at least 3 days before required disclosure date)
Issues Prior to Delivery

- Franchisor must disclose
  - Format in which FDD is available
  - Prerequisites to obtaining FDD in a particular format
  - Conditions to reviewing FDD in a particular format
E Receipt

- Set up system to record prospective franchisee’s receipt
- Signature can be by use of security code, password, or electronic signature
E Disclosure Requirements

- FDD must look like one document
- Financial statements must be included electronically
- Receipt must be part of FDD
  - It cannot be a separate document
- Copies of receipts must be saved for at least 3 years
E-Enhancements Prohibited

- May not use video or audio enhancements
- No pop-ups
- No external links
Timing of Delivery--FDD

-- FDD no longer must be delivered at first personal meeting

• Some states still require: Iowa, Maryland, New York, Oklahoma and Rhode Island

– 14 day requirement—must deliver 14 calendar days prior to signing binding agreement or making a payment to the franchisor or an affiliate

• Caveat-Iowa, Maryland, Michigan New York, Oklahoma, Rhode Island, Washington and Wisconsin
Timing for Delivery of Franchise Agreement

- 5 business day rule regarding “execution copy” eliminated
- Second waiting period required only where unilateral changes have been made by franchisor
- Then 7 calendar day rule becomes applicable
  - Fill in the blank provisions such as name, address and date do not trigger this obligation
  - Likewise negotiated changes do not trigger requirement
    - FTC is signaling acceptability of negotiated agreements
  - Any other changes would require re-delivery and additional waiting period
Financial Performance Representations---Item 19

- Name changes from “Earnings Claims”
- Definition--“Any representation . . . that states, expressly or by implication, a specific level or range of actual operational sales, income gross profits or net profits.”
Required Introduction

• Required Introduction states, “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 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.”
Cost information no longer considered an “earnings claim”

- Free to discuss cost only information
- Costs should be discussed in dollars
  - Not as a percentage of gross sales
  - Percentage of gross sales information would constitute a financial performance representation
- Registration states may still have problems with discussing “cost only” information
Subset information may be provided

- Subgroups may be created based upon
  - Geographic location
  - Type of location (such as free standing or in-line/shopping center)
  - Degree of market competition in the area
  - Length of time the outlets have operated
  - Services or goods sold
  - Services supplied by the franchisor
  - Whether the outlets are franchised or franchisor owned
Subset information

- Must disclose the number and percentage of outlets that attained or surpassed the stated results
- Must also disclose how performance results of subgroups were derived
Media and advertising generally exempt

- Disclosure of financial performance to general media, on websites, in SEC filings and in speeches not considered a financial performance representation
- Caveat—material cannot be incorporated in franchisor’s franchise advertising and promotional literature
Required Negative Disclosure

- Negative disclosure required if FDD does not include a financial performance representation
Negative Disclosure Text

- Required negative disclosure, “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 agencies.”
Financial Performance Reps

• Also, must affirmatively state that a franchisor is permitted to provide financial performance information if
  – There is a reasonable basis for the information, and
  – It is included in the disclosure document

• When furnishing an FDD, franchisor must notify franchisee of any material changes in the Financial Performance Representations
New Litigation Disclosure Obligations—Item 3

- Must disclose franchisor initiated suits involving the franchise relationship
  - Suits directly related to the operation of the franchised business such as royalty payment and training obligations
- Disclosure should be in summary format
- Can list under summary headings such as “royalty collection suits”
  - Narrative not required
- Any suits filed within the last fiscal year to be included
Litigation Disclosure Obligation Extends to Parents and Affiliates

– Disclosure relates to any parent that guaranties franchisor’s financial performance
– Must disclose government litigation for affiliates who have offered or sold franchises in any line of business in the last 10 years
– Other litigation need be disclosed only for affiliates who franchise under the franchisor’s principal trademark
– Not simply limited to those affiliates offering franchises under the franchisor’s principal trademark
Renewal Rights—Item 17

- Franchisor must now disclose what “renewal” means in the franchisor’s system
- If applicable, franchisor must include a statement that “franchisees may be asked to sign a contract with materially different terms and conditions that their original contract,” if franchisee elects to renew.
Territory---Item 12

- Cautionary Statement if No Exclusive Territory
  - Must warn that franchisee may face competition from other franchisees, franchisor outlets, or other channels of distribution
Territory---Item 12

- Disclosures required regarding exceptions to exclusivity
  - Internet sales
  - Catalog sales
  - Telemarketing or direct marketing
- Any restrictions on franchisee’s sales outside the territory must be disclosed
- Disclose any current plans to acquire other operating systems
Outlets—Item 20—5 Tables

- System wide Summary—Includes both franchised and company-owned outlets as of the beginning of the period, and opened, closed and open at the end of the period
- Transfers of Outlets from Franchisees to new owners over the past 3 years (franchisor sales excluded)
- Status of Franchised Outlets—turnover rate for the past 3 years
- Status of Company-owned outlets—turnover rate for the past 3 years
- Projected Openings as of the last day of last fiscal year
Multiple Events-- Item 20

– Report the event that occurred last in time
– Use footnotes to describe multiple changes and locations where they occurred
Franchisee Contact Information

Item 20

- Limits former franchisee personal information
  - only business telephone number, or if unknown, last known home telephone number
- Warns franchisees that their contact information may be disclosed to other buyers after they leave the system
Disclosure Regarding Gag Rule--Item #20

- Must disclose whether confidentiality clauses signed during previous three fiscal years
- Required provision states, “In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees may be able to communicate with you.”
Item 11—Title been changed to “Franchisor Assistance, Advertising and Training”

– Computer Systems

• Amended rule eliminates requirement of technical description of systems
• General descriptions sufficient
• Start up franchisors may state that computer requirements are not yet known
Training—Item 11

- Training schedule does not require instructional material, but nevertheless must be described
- Where training is non-mandatory, must indicate the percentage of new franchisees that enrolled in the previous 12 months
Advertising Councils or Cooperatives—Item 11

- Disclose whether there is an advertising council of franchisees advising on advertising policies
- For advertising cooperatives indicate whether contribution to the fund is mandatory, whether franchisor owned locations must contribute and whether there are franchisees who contribute at different rates
Exemptions under the New Rule

- Large Franchisees—Must have been in business at least 5 years and have a net worth of at least $5 million
- Large Initial Investment—Individual initial investment of at least $1 million
  - Excludes financing received from franchisor and the cost of unimproved land
- Related party--applies if owner(s) having controlling ownership in franchise business have at least 2 years experience with the franchisor as an officer, owner or manager
Recent Judicial Decisions in the Sales Process
Randall v. Lady of America (D. Minn. July 2007)--Facts

- Disgruntled franchisees sue in connection with their purchase of franchises
- Attend “Discovery Day” in Florida intended to inform and promote potential franchisees
- Marketing Director makes representations regarding
  - Level of membership on franchise opening day
  - Quantities at which membership would grow weekly
  - Stated profits would be $22,000 per month
Randall v. Lady of America (D. Minn. July 2007)--Facts

– Plaintiffs shown financial statements of other franchisees
– Also toured franchisee locations and made representations regarding profits
Randall v. Lady of America -

Contractual disclaimers

- Earnings claim disclaimer stated that franchisor does not furnish financial information and disavowed any statements salespeople may have made and stating, “actual results may vary from franchise to franchise.”

- Other disclaimer, “I did not make any representations about the revenues of existing franchises. If you disagree, you must list such representation below. If you don’t list a representation, you cannot later sue me for making that representation.”

- Franchisee acknowledge that they conducted their own investigation and disclaimed any reliance on representations by the franchisor

- Contract contained integration clause barring reliance on prior representations
Randall--Franchisees sue for Fraud and Violations of Minnesota Franchise Act

– Denies summary judgment to Franchisor
– Anti waiver provisions of Minnesota Act applied
  • Unlawful to make misrepresentations
  • Act contains anti waiver provisions
  • Franchisor could not waive the “legal effect” of those provisions precluding fraud
Randall—Court holds false statement made in any event

- Even if the financial information furnished were correct, statement in UFOC that financial information not furnished was false
- And, of course, if financial information false: a violation of Act
- Actionable in either event
Emfore Corp. v. Blimpie Assocs. (N.Y. 2007)

- Blimpie franchisee sued for fraud based on alleged franchisor earnings representations and promises of co-branding opportunity with Chock Full ‘O Nuts
- Blimpie salesperson was alleged to have fraudulently represented that the average Blimpie store showed sales of $33,000 per month, that an existing store in the vicinity had revenues of $20,000 per week, and that another store with “someone just like you guys” had revenues of $12,000 per week.
Blimpie--UFOC had a disclaimer of any earnings claims.

- Additionally, franchisee signed a letter, requested as part of Blimpie’s compliance program, acknowledging that there were no earnings claims.
- A questionnaire was also signed in which the franchisee acknowledged that they had not relied on any representations regarding sales.
- Store failed to perform in accordance to franchisee’s expectations and franchisee closed it within 6 months of opening.
Blimpie--Court holding contrasts with Lady of America

– Court held that statements regarding the potential profitability of the perspective store constituted mere "puffing" or opinions as to future events and could not serve as a predicate of a fraud claim.

– Disclaimers in contract sufficient to bar common law fraud claims. The court noted that the offering circular disclaimed the projected sales, and that the franchisees signed questionnaires disclaiming any representations.

– The disclaimers, however, would not bar NY Franchise Act fraud claims.
Lessons of these decisions

- Important to develop good internal sales practices
- Negative disclaimer may not bar claims
Dealing with the Registration States

- The Amended FTC Rule continues the policy of limited federal preemption
- Registration states can continue to legislate in this area, but only if their laws offer equal or greater protection, such as more extensive disclosure requirements
NASAA has adopted Amended Rule as successor to UFOC Guidelines

- NASAA has issued an Interim Policy Statement adopting the Amended Rule, with minimal additional requirements, as the successor to UFOC Guidelines.
- NASAA recommends that registration states require the addition of a state cover page with risk factors and other information.
- Registration states have adopted, or are about to adopt, these recommendations.
Effect on Timing of Disclosure

- Amended Rule eliminates obligation to delivery FDD at “first personal meeting.”
  - The following states have “first personal meeting” rules which must be complied with Iowa, Maryland, New York, Oklahoma and Rhode Island.
Effect on Calendar Day rule

- New rule requires delivery within 14 calendar days
- State laws with lesser timing will be preempted
- Ten business days sometimes are less than 14 calendar days—must comply with 14 day rule
- States with 10 business day rule: Iowa, Maryland, Michigan, New York, Oklahoma, Rhode Island, Washington, and Wisconsin
State registration states with electronic discourse

- Only California and Virginia have adopted
- Others will likely adopt during the year
General Prohibitions Under New Rule

– Failing to furnish an FDD earlier than the established time frames upon the request of a prospective franchisee

– Failing to provide a prospective franchisee who already has received an FDD with a copy of the most recent FDD and any quarterly updates upon reasonable request (before signing the franchise agreement)

– Making financial representations without a reasonable basis and written substantiation, and includes the information in Item 19

– Failing to provide a prospective franchisee with written substantiation of the financial representation in Item 19, upon reasonable request
General Prohibitions Under New Rule

- Making a claim or representation that contradicts the information required to be disclosed
- Presenting a prospective franchisee with an agreement containing unilateral changes from FDD, less than 7 days before signing
- Failing to refund deposits or fees identified as refundable in the FDD
- Requiring a franchise to waive reliance on any representation made in the FDD
- Using shills to vouch for the franchisor or system