

## **BASICS TRACK: REGISTRATION & DISCLOSURE**

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## I. Overview of Franchise Regulation

The franchise business model has become an integral part of the U.S. economy. The projected number of U.S. franchise establishments for 2023 is 805,000 units, with franchising expected to add approximately 254,000 jobs to the U.S. workforce in 2023.<sup>1</sup> Additionally, total franchise output is expected to increase by 4.2%, from \$825.4 billion in 2022 to \$860.1 billion in 2023.<sup>2</sup>

Unlike most traditional business models where a company's growth depends on the owner's personal capital contributions and growth initiatives, the franchise business model allows companies to build their brand through a network of independent operators all using the same trademark and system. Given the significant investments of time and capital required by franchisees, state and federal laws have been enacted to protect franchisees from a variety of misleading sales tactics historically used by unscrupulous franchisors and their brokers.

This paper provides a broad overview of the laws that apply to franchise sales in the United States, including disclosure and registration requirements at both the state and federal level. Additionally, this paper identifies tips and best practices for franchise attorneys navigating the vast franchise regulatory framework.

### A. Federal Trade Commission's (FTC) Franchise Rule

As franchising grew in popularity across the United States, so did franchisors' use of deceptive trade practices (e.g., fraud and misrepresentations) occurring in connection with the offer and sale of franchises. By the 1970s, the federal government stepped in to regulate the industry, much as it did in connection with the sale of securities and stocks following the stock market crash in the 1930s. In 1979, the Federal Trade Commission ("FTC") adopted a trade regulation rule governing the offer and sale of franchises (the "1979 Franchise Rule" or "1979 Rule").<sup>3</sup>

The 1979 Rule required pre-sale disclosure and prohibited certain practices which the FTC deemed unfair or deceptive in nature. The purpose of the pre-sale disclosure requirement was to provide each franchisee with "at least the minimum information needed to make an informed decision whether to enter into the franchise relationship."<sup>4</sup> In developing and enacting the 1979 Franchise Rule, the

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<sup>1</sup> 2023 Franchising Economic Outlook by FRANdata, <https://www.franchise.org/sites/default/files/2023-03/2023-Franchising-Economic-Report.pdf>.

<sup>2</sup> *Id.*

<sup>3</sup> Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.1 (1978).

<sup>4</sup> Statement of Basis and Purpose 43 FR 59621 (Dec. 21, 1978).

FTC did not regulate the substantive business terms of the franchise relationship and no private right of action was made available to franchisees.

In 2007, the 1979 Franchise Rule was amended (the “Franchise Rule” or “Rule”) to address new developments in technology and the franchise industry itself, as well as to account for new state laws enacted since the Rule’s initial debut.<sup>5</sup> While many of the provisions (and purpose of the law) remained unchanged, the Franchise Rule also sought to mitigate concerns prospective franchisees had regarding the relationship franchisors have with their franchisees. For example, the Franchise Rule requires the disclosure of all franchisor-initiated litigation against franchisees, broadens the disclosure requirements relating to territory rights, requires the disclosure of confidentiality provisions in franchise agreements, and requires the disclosure of trademark-specific franchisee associations.<sup>6</sup>

Today, the Franchise Rule governs the pre-sale disclosure requirements applicable to the offer and sale of franchises throughout the United States, including the District of Columbia and all U.S. Territories.<sup>7</sup> Compliance with the Rule requires franchisors to make disclosures with respect to 23 different “Items” of information by furnishing prospective franchisees with a Franchise Disclosure Document (“FDD”). The central purpose of the FDD is to provide prospective franchisees with important background information about a particular franchisor and franchise offering, and to bring attention to some of the risks associated with investing in a franchised business.

Like the 1979 Rule, the Franchise Rule does not provide a private cause of action against franchisors who fail to comply with the Rule. This, among other things, motivated individual states to enact their own, separate legislation to combat deceptive practices used to sell franchises within their borders and to their residents.

## **B. State Franchise Laws**

Today, fifteen states currently impose state-specific disclosure regulations that supersede the federal Franchise Rule (“Disclosure States”).<sup>8</sup> Although most

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<sup>5</sup> See, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities; Final Rule, 72 Fed. Reg. 15444, 15478, n.350 (March 30, 2007).

<sup>6</sup> See, *Id.*

<sup>7</sup> 16 C.F.R. § 436.2.

<sup>8</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.*; *Oregon*

disclosure obligations under these state statutes simply parallel the Franchise Rule, certain state laws impose additional disclosure and registration requirements. For example, certain state franchise laws: (1) require franchisors to consent to the jurisdiction within their respective states; (2) require that their respective state laws govern the franchise agreement, regardless of the governing law provision included in the franchise agreement; (3) permit state agencies to conduct their own investigations and impose administrative and civil penalties for non-compliance; (4) empower state regulatory authorities to review FDDs to ensure compliance with applicable disclosure requirements; and (5) provide a private right of action for franchisees harmed by a franchisor's noncompliance.

Of the fifteen Disclosure States, fourteen states also impose registration requirements ("Registration States"), which make it unlawful for a franchisor to offer or sell franchises within the state without first registering its FDD with the state.<sup>9</sup> In many, but not all, Registration States, a state administrator will perform at least a cursory review of the FDD to confirm that the franchisor has complied with the requirements of the Franchise Rule and applicable state law. As described further in Section III.B below, the state administrator may respond to an FDD with questions, comments, or feedback for the Franchisor.

### **C. North American Securities Administration Association**

While each state differs in how it codifies and enforces its franchise sale law, the North American Securities Administration Association ( "NASAA" ) endeavors to align state and federal regulations by proposing uniform guidelines, rules, and laws. Although NASAA has no formal authority over the franchise industry, its recommendations and policy initiatives have helped substantially frame the enactment and interpretation of state franchise laws, and NASAA guidelines frequently lend support to franchisees' causes of action against franchisors. Additionally, NASAA's recommendations and policy initiatives traditionally have been given great weight by the states that regulate franchises and are sometimes incorporated by reference into state law.

Below, is a list of the key NASAA guidelines, policies and commentary addressing the franchise offer and sale process:

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*Franchise Transactions Law*, Oregon Revised Statutes, Title 50 Ch. 650, Section 650.005 *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.*; and *Wisconsin Franchise Investment Law*, *Wisconsin Stats.*, Ch. 553, Section 553.01 *et seq.*;

<sup>9</sup> The Oregon Franchise Transactions law does not require registration.

- 2008 Franchise Registration and Disclosure Guidelines<sup>10</sup>
- NASAA Commentary on 2008 Franchise Registration & Disclosure Guidelines<sup>11</sup>
- NASAA Franchise Multi Unit Commentary<sup>12</sup>
- NASAA Financial Performance Representation Commentary<sup>13</sup>
- NASAA New Franchise State Cover Sheets Instructions<sup>14</sup>
- Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgements<sup>15</sup>

Each state's standards and process is slightly different, so understanding the variations between each Registration State's process, as well as reviewing the guidelines and commentary published by NASAA prior to registering, is important.

## II. Franchise Disclosure Document Requirements

As noted in Section I above, franchisors are required to provide prospective franchisees with an FDD consisting of 23 "Items" prior to a franchise sale. In this Section, we provide high level summaries of the information that must be disclosed in each FDD Item and FDD drafting tips and resources. These summaries and tips are meant to be used in conjunction with the Franchise Rule, and do not include all of the Franchise Rule requirements.

### A. FDD Drafting Tips and Resources

#### i. Plain English

The FDD must disclose all required information clearly, concisely, and legibly in "plain English."<sup>16</sup> The term "plain English" is defined as "the organization of information and language usage understandable by a person unfamiliar with the franchise business. It incorporates short sentences; definite, concrete, everyday language; active voice; and tabular presentation of information, where possible. It

<sup>10</sup> NASAA, *NASAA 2008 Franchise Registration and Disclosure Guidelines*, <https://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf>.

<sup>11</sup> NASAA, *Commentary on 2008 Franchise Registration and Disclosure Guidelines*, [http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary\\_final.pdf](http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf).

<sup>12</sup> NASAA, *Multi-Unit Commentary*, <http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Set.-16-2014.pdf>.

<sup>13</sup> NASAA, *NASAA Franchise Commentary Financial Performance Representations*, <http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf>.

<sup>14</sup> NASAA, *NASAA New Franchise State Cover Sheets Instructions*, <https://www.nasaa.org/wp-content/uploads/2019/06/New-Franchise-State-Cover-Sheets-Instructions.pdf>

<sup>15</sup> NASAA, *NASAA Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgements*, <https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf>.

<sup>16</sup> 16 C.F.R. § 436.6(b); Compliance Guide at 121.

avoids legal jargon, highly technical business terms, and multiple negatives.”<sup>17</sup>

The FDD must be presented in a “single document” in a form that a prospective franchisee can “store, download, print, or otherwise maintain . . . for future reference.”<sup>18</sup> Each disclosure requirement under the Franchise Rule must be addressed in the FDD.<sup>19</sup> Even if a required disclosure does not apply to a franchise system, a negative statement or disclosure must still be included.<sup>20</sup> If the Franchise Rule indicates the use of specific language for certain disclosures, then that exact language must be used verbatim and cannot be modified.<sup>21</sup> Finally, the FDD must be limited to the specific disclosures required by the Franchise Rule or the states (as long as state imposed requirements are not inconsistent with the Franchise Rule).<sup>22</sup> Practically, this means that any information or language not directly responsive to specific disclosure requirements is not permitted in the FDD.<sup>23</sup>

## **ii. Purpose of the FDD and interplay with the Franchise Agreement**

When drafting an FDD, it can be helpful to keep in mind the purpose for which it is required – to prevent deceptive and unfair practices in the sale of franchises by requiring franchisors to disclose to prospective franchisees material information about their business operations and the contractual terms and conditions that will control the franchise business and relationship.<sup>24</sup> In large part, the FDD functionally summarizes and breaks down key terms and conditions of the franchise agreement, ostensibly into a more digestible format and language.<sup>25</sup>

## **iii. Resources**

We recommend becoming familiar with the following list of resources for drafting or updating an FDD:

- The Franchise Rule (and its Amended Statement of Basis and Purpose)<sup>26</sup>
- FTC Amended Rule FAQs<sup>27</sup>

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<sup>17</sup> 16 C.F.R. § 436.1(o); Compliance Guide at 121.

<sup>18</sup> 16 C.F.R. § 436.6(b); Compliance Guide at 121.

<sup>19</sup> 16 C.F.R. § 436.6(c); Compliance Guide at 121.

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

<sup>21</sup> Compliance Guide at 122.

<sup>22</sup> 16 C.F.R. § 436.6(d); Compliance Guide at 122.

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

<sup>24</sup> Statement of Basis and Purpose, 16 C.F.R. 15444, 15445 (March 30, 2007) (“Amended Statement”).

<sup>25</sup> 16 C.F.R. § 436.3(e)(2).

<sup>26</sup> 16 C.F.R. § 436; Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444 (March 30, 2007) or <https://www.ftc.gov/sites/default/files/070330franchiserulefrnotice.pdf>.

<sup>27</sup> <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs>.

- FTC Compliance Guide<sup>28</sup>
- FTC Informal Advisory Opinions<sup>29</sup>
- NASAA Guidelines<sup>30</sup>
- NASAA Multi-Unit Commentary<sup>31</sup>
- NASAA FPR Commentary<sup>32</sup>
- NASAA State Cover Sheets Instructions<sup>33</sup>
- NASAA Statement of Policy on Questionnaires and Acknowledgments<sup>34</sup>

## B. FDD Requirements

### i. Federal/FTC Cover Page

The FDD begins with a federal cover page (also referred to as the FTC cover page) to explain the purpose of the FDD to prospective franchisees and provide basic information about the franchise system, and certain mechanisms in place to protect franchisees.<sup>35</sup> The federal cover page must include specific language and other information in a required format and order.<sup>36</sup> The title – “**FRANCHISE DISCLOSURE DOCUMENT**” – must appear in capital letters and boldface type,<sup>37</sup> and must be followed by the franchisor’s name, type of business organization, principal business address, telephone number, email address, and web page.<sup>38</sup> The following requirements must appear next in order: a sample of the primary business trademark to be used by the franchisee,<sup>39</sup> a brief description of the franchised business,<sup>40</sup> and the following statements (note – bolded and italicized language is mandated formatting):

The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7]. This includes

<sup>28</sup> <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>.

<sup>29</sup> <https://www.ftc.gov/policy/advisory-opinions>.

<sup>30</sup> <https://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf>.

<sup>31</sup> <https://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf>

<sup>32</sup> <https://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary-12082017.pdf> and <https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf>.

<sup>33</sup> <https://www.nasaa.org/wp-content/uploads/2019/06/New-Franchise-State-Cover-Sheets-Instructions.pdf>

<sup>34</sup> <https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf>.

<sup>35</sup> 16 C.F.R. § 436.3.

<sup>36</sup> *Id.*

<sup>37</sup> 16 C.F.R. § 436.3(a).

<sup>38</sup> 16 C.F.R. § 436.3(b).

<sup>39</sup> 16 C.F.R. § 436.3(c).

<sup>40</sup> 16 C.F.R. § 436.3(d).

[the total amount in Item 5] that must be paid to the franchisor or affiliate.<sup>41</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>42</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>43</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>44</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>45</sup>

There may also be laws on franchising in your state. Ask your state agencies about them.<sup>46</sup>

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<sup>41</sup> 16 C.F.R. § 436.3(e)(1).

<sup>42</sup> 16 C.F.R. § 436.3(e)(2).

<sup>43</sup> 16 C.F.R. § 436.3(f).

<sup>44</sup> 16 C.F.R. § 436.3 (e)(3).

<sup>45</sup> 16 C.F.R. § 436.3 (e)(4).

<sup>46</sup> 16 C.F.R. § 436.3 (e)(5).

The federal cover page must also include the issuance date of the FDD, which can be any date upon which the franchisor finalizes the FDD for use.<sup>47</sup> The FDD issuance date differs from state “effective date(s)” which must be disclosed on a separate page at the end of the FDD before the acknowledgement of receipt pages – this is discussed below in Section II.B.xxv.<sup>48</sup>

## **ii. State Cover Pages**

Three state cover pages required by NASAA must directly follow the federal cover page. These three state cover pages have mandated specific language, must be in 13 point font size, and other required formatting. The purpose of the first two state cover pages – titled “How to Use this Franchise Disclosure Document” and “What You Need to Know About Franchising, Generally” are included to provide prospective franchisees with clear direction as how to use the FDD and general information about franchising and the franchise relationship. The third state cover page – titled “Special Risk(s) to Consider about This Franchise” – includes one standard risk factor relating to out-of-state dispute resolution and allows states to require additional risk factors on this page. However, if a particular state requires non-uniform risk factors, those may be included in a state addendum to the FDD, rather than on this cover sheet. Note that if that is the case, the following statement must be included at the end of the page: “Certain states may require other risks to be highlighted. If so, check the “State Specific Addenda” pages for your state.” Risk factors must be in lower case text as opposed to all capital letters, and bold or underlined text is not permitted unless specifically required by a state.<sup>49</sup>

## **iii. Item 1: The Franchisor and Any Parents, Predecessors and Affiliates**

Item 1 requires disclosure of specific background information about the franchisor, related entities, and the business the franchisee will operate.<sup>50</sup> This includes the names and principal business addresses of: the franchisor; all parents of the franchisor; any affiliates of the franchisor that offer franchises in any line of business or provide products or services to franchisees of the franchisor;<sup>51</sup> any predecessor of the franchisor within the prior 10-year period;<sup>52</sup> and the franchisor’s agents for service of process.<sup>53</sup> In practice, the franchisor’s agents for service of

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<sup>47</sup> 16 C.F.R. § 436.3 (e)(6); Compliance Guide at 26.

<sup>48</sup> Compliance Guide at 26; <https://www.nasaa.org/wp-content/uploads/2019/06/New-Franchise-State-Cover-Sheets-Instructions.pdf>.

<sup>49</sup> *Id.*

<sup>50</sup> 16 C.F.R. § 436.5(a).

<sup>51</sup> 16 C.F.R. § 436.5(a)(1); Compliance Guide at 29.

<sup>52</sup> 16 C.F.R. § 436.5(a)(2).

<sup>53</sup> 16 C.F.R. § 436.5(a)(4); Compliance Guide at 29.

process is often simply referenced in Item 1 and included as an exhibit to the FDD. A sample "Agents for Service of Process" document is attached as Exhibit A.

The franchisor must also disclose its type of entity and state of formation,<sup>54</sup> any names it intends to use to conduct business,<sup>55</sup> other and prior business activities, and whether it operates any businesses of the type being franchised. Additional information must be disclosed if the franchisor operates businesses of the type being franchised or if the franchisor, its predecessors or affiliates have offered franchises in any line of business or provide products or services to the franchisees, including length of time each have been offered or operated, a description of the other lines of businesses, and numbers of franchises sold.<sup>56</sup>

Item 1 also requires a description of: the general market for the franchise's goods or services – such as whether the market is developing, established, or seasonal; the competition franchisees may face; and a general description of any laws or regulations specific to the franchise industry.<sup>57</sup> The description of the laws does not require disclosure of laws that affect all businesses generally, only those that are specific to the type of business the franchisee will operate.<sup>58</sup>

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

Item 2 requires disclosure of the business experience of the franchisor's directors, principal officers, trustees, general partners, and individuals who will have "management responsibility" of the sale or operation of franchises for the 5 years immediately prior to the FDD's issuance date.<sup>59</sup> A longer lookback period is acceptable if that experience is "directly relevant" to the franchise offering.<sup>60</sup> For each person, Item 2 must list their name, and each employer name, title held, starting and ending month and year, and location of employment.<sup>61</sup>

The requirement to include individuals with "management responsibility" related to the sale or operation of the franchises does not require all managers be disclosed, nor is it limited to employees of the franchisor entity only.<sup>62</sup> If an individual's involvement is such that prospective franchisees will "rely on their expertise, formulation of policy, or control of the system in making an investment

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<sup>54</sup> 16 C.F.R. § 436.5(a)(5).

<sup>55</sup> 16 C.F.R. § 436.5(a)(3).

<sup>56</sup> 16 C.F.R. § 436.5(a)(6)-(7).

<sup>57</sup> 16 C.F.R. § 436.5(a)(6)(iv)-(vi); Compliance Guide at 31.

<sup>58</sup> Compliance Guide at 31.

<sup>59</sup> 16 C.F.R. § 436.5(b).

<sup>60</sup> Compliance Guide at 33.

<sup>61</sup> 16 C.F.R. § 436.5(b).

<sup>62</sup> Compliance Guide at 33.

decision,” then these sales managers or operational managers should be disclosed.<sup>63</sup>

#### **v. Item 3: Litigation**

Item 3 requires disclosure of specific case information relating to four categories of legal actions involving the franchisor, its predecessors, certain of its parents or affiliates, or any individual listed in Item 2 of the FDD (each a “Franchisor Entity”): (1) certain pending actions, (2) certain prior actions within the last 10 years, (3) current governmental actions, and (4) material actions involving the contractual franchise relationship within the last fiscal year.<sup>64</sup> The franchisor’s parents and affiliates that are required to disclose litigation under this item are limited to those who promise to financially back or otherwise guarantee the franchisor’s performance and to affiliates that sell franchises under the franchisor’s principal trademark or have offered or sold franchises in any line of business in the past 10 years.<sup>65</sup>

- Pending Actions

There are two kinds of pending actions that must be disclosed. The first is any pending administrative, criminal, or material action alleging a violation of franchise, antitrust, or securities law, fraud, unfair or deceptive practices, or similar action against any Franchisor Entity. A legal action is considered “material” if it is likely to affect a prospective franchisee’s decision to purchase a franchise.<sup>66</sup> The second is any pending civil action that is considered “material in the context” of the potential effect on “the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations.”<sup>67</sup>

- Prior Actions

All prior lawsuits within the 10-year period prior to the FDD issuance date must be disclosed if a Franchisor Entity was convicted of or plead nolo contendere to a felony or was held liable for any violations of franchise, antitrust, or securities law, fraud, unfair or deceptive practices, or similar allegations.<sup>68</sup> A party is considered to be “held liable” if they were required to make any kind of payment, reduce an indebtedness by the amount of a legal award, could not enforce its rights, or take some other action

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<sup>63</sup> *Id.*

<sup>64</sup> 16 C.F.R. § 436.5(c); Compliance Guide at 34.

<sup>65</sup> 16 C.F.R. § 436.5(c); Compliance Guide at 39-40.

<sup>66</sup> Compliance Guide at 35.

<sup>67</sup> 16 C.F.R. § 436.5(c)(1)(i)(B); Compliance Guide at 35.

<sup>68</sup> 16 C.F.R. § 436.5(c)(1)(iii)(A); Compliance Guide at 37.

adverse to its own interests.<sup>69</sup> Settlement of a dispute is considered being held liable and all material terms of the settlement must be disclosed.<sup>70</sup>

- **Governmental Actions**  
All currently effective injunctive or restrictive orders or decrees that resulted from an action brought by any governmental agency under a federal, state, or Canadian franchise, securities, antitrust, trade regulation, trade practice law, or otherwise relating to the franchise, must be disclosed.<sup>71</sup> These types of orders or decrees are considered currently effective unless: (1) vacated or rescinded by a court or the governmental agency; or (2) expired by its own terms.<sup>72</sup>
- **Franchise Relationship Actions:**  
Item 3 must also disclose any material civil action that involves the franchise relationship with in the last fiscal year.<sup>73</sup> This relates to disputes arising out of the contractual obligations between the franchisor and franchisee directly relating to the franchised business.<sup>74</sup> A legal action is considered “material” if it is likely to affect a prospective franchisee’s decision to purchase a franchise.<sup>75</sup>

#### **vi. Item 4: Bankruptcy**

Item 4 requires the franchisor to disclose all bankruptcies during the 10-year period preceding the date of the FDD involving the franchisor; any of its predecessors, parents, or affiliates; its officers, general partners, or any of the individuals disclosed in Item 2.<sup>76</sup> This must include any foreign bankruptcies and is not limited to certain affiliates or parents, bankruptcies of all affiliates and parents must be disclosed.<sup>77</sup> For each bankruptcy, Item 4 must include the name, address, and principal place of business of the debtor, relationship to the franchisor, date of filing, material facts – including court name, case name and number, and any discharge date.<sup>78</sup> If a franchisor has no reportable bankruptcies, the FDD must

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<sup>69</sup> 16 C.F.R. § 436.5(c)(1)(iii)(B); Compliance Guide at 38.

<sup>70</sup> Compliance Guide at 38.

<sup>71</sup> 16 C.F.R. § 436.5(c)(2)-(3); Compliance Guide at 38.

<sup>72</sup> Compliance Guide at 38.

<sup>73</sup> 16 C.F.R. § 436.5(c)(1)(ii); Compliance Guide at 37-38.

<sup>74</sup> *Id.*

<sup>75</sup> Compliance Guide at 35.

<sup>76</sup> 16 C.F.R. § 436.5(d).

<sup>77</sup> 16 C.F.R. § 436.5(d)(3); Compliance Guide at 42.

<sup>78</sup> 16 C.F.R. § 436.5(d)(2).

include the following negative disclosure statement “[N]o bankruptcy is required to be disclosed in this Item.”

**vii. Item 5: Initial Fees**

Item 5 requires the disclosure all initial fees, whether they are uniformly imposed on franchisees, whether each fee is refundable, and if so, under what circumstances.<sup>79</sup> The term “initial fees” refers to “all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee’s business opens, whether payable in lump sum or installments.”<sup>80</sup> Fees that must be paid directly to third parties before a franchisee’s business opens are not required to be disclosed in this Item. If an initial fee is not imposed uniformly on all prospective franchisees, then the range of each fee variance must be disclosed in Item 5. If any initial fees are structured as installment payments, disclosure of the payment terms must be made in Item 5 or Item 10, as appropriate.<sup>81</sup>

**viii. Item 6: Other Fees**

Item 6 requires disclosure of all fees (other than initial fees disclosed in Item 5) the franchisee pays to the franchisor or its affiliates, associated with operating the franchise. Item 6 must be laid out in a prescribed table format with columns that indicate the fee type, the fee amount, the due date, and any remarks (caveats, definitions, or other clarifications can be included in the remarks column or in footnotes to the table).<sup>82</sup> A sample Item 6 table is attached at Exhibit B.

The fees required to be disclosed in Item 6 include fees that recur such as royalties; marketing fees; fees that occur only under certain circumstances like renewal or transfer fees; and payments made to the franchisor for reimbursement if certain costs are incurred on behalf of franchisees.<sup>83</sup> Payment made directly to third parties are not disclosed in this Item, however, pass-through fees paid to or collected by the franchisor or its affiliates for fees imposed by third parties (for example, licensing fees for third-party software) must be disclosed.<sup>84</sup>

Item 6 must also disclose when any fee is subject to adjustment, and if so, the basis on which the fee may change.<sup>85</sup> For example, disclosure of a royalty fee calculated as a percentage of gross sales is acceptable if “gross sales” is defined

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<sup>79</sup> 16 C.F.R. § 436.5(e).

<sup>80</sup> *Id.*

<sup>81</sup> Compliance Guide at 42.

<sup>82</sup> 16 C.F.R. § 436.5(f).

<sup>83</sup> *Id.*

<sup>84</sup> Compliance Guide at 45.

<sup>85</sup> Compliance Guide at 46.

in Item 6.<sup>86</sup> Similar to Item 5, franchisors must also disclose whether the fees described in Item 6 are refundable (and if so, under what circumstances) and whether they are imposed uniformly on all franchisees and locations.<sup>87</sup>

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

Item 7 requires the franchisor to disclose all estimated initial investment expenses required by the franchise agreement and all other costs a franchisee can expect to incur to develop and open the franchised business during the “initial period”. This disclosure must be laid out in a prescribed table format with columns identifying each type of expenditure, amount, method of payment, when it is due, to whom payment is made and must include the additional funds required to operate the franchised business during the “initial period” of operations.<sup>88</sup> A sample Item 7 table is attached at Exhibit C. A reasonable “Initial period” is generally at least three months, unless a longer period is reasonable for the particular industry. These additional funds must indicate the specific initial period and the basis, factors, and experience used to determine the estimate.<sup>89</sup>

Expenditures listed in Item 7 are often paid to third parties and can vary vastly depending on the franchisor, system, and industry; but some typical categories of cost estimates are for initial franchise fees, initial training, real estate, construction, initial inventory, furniture, fixtures, and equipment, licensing fees, and any other specific expenses required to begin operations such as for travel, advertising, deposits, site selection fees, and insurance.<sup>90</sup> When the expenditure amount is unknown, a low-to-high range may be used based on the franchisor’s experience or research. For unknown real estate estimates, franchisors may instead describe the property by size, location, and type of building.<sup>91</sup>

The investment costs must be totaled at the bottom of the table, and any fees paid to the franchisor must match amounts disclosed in Items 5 and 6. If any expenditures are disclosed in low-to-high ranges, then the totals must also be reflected as a range.<sup>92</sup>

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

Item 8 requires the disclosure of information related to franchisor restrictions on the sources of products and services franchisees must use in the operation of the franchise, including any revenue the franchisor or its affiliates may earn from

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<sup>86</sup> *Id.*

<sup>87</sup> 16 C.F.R. § 436.5(f)(4); Compliance Guide at 46.

<sup>88</sup> 16 C.F.R. § 436.5(g).

<sup>89</sup> Compliance Guide at 48-49.

<sup>90</sup> 16 C.F.R. § 436.5(g).

<sup>91</sup> 16 C.F.R. § 436.5(g)(2); Compliance Guide at 48-49.

<sup>92</sup> 16 C.F.R. § 436.5(g)(6).

required suppliers, and other disclosures related to franchisee purchasing. This disclosure must include (1) all goods or services franchisees are required to purchase or lease; (2) whether the franchisor or its affiliates are approved suppliers (or the only approved supplier); (3) whether any officer of the franchisor owns an interest in any designated or approved supplier; (4) how the franchisor approves and revokes approval of alternative suppliers (including any fees, procedures, timing, and whether its approval criteria is available to franchisees); (5) whether the franchisor requires specifications and standards for each item, and if so how the standards are determined and modified; and (6) whether the franchisor or its affiliates will receive revenue or other consideration based on required franchisee purchases.<sup>93</sup>

If the franchisor or its affiliates receive payments or other benefits from suppliers based on required franchisee purchases, the “precise basis” by which such consideration will be derived must be disclosed, including the franchisor’s: (1) total revenue; (2) revenue from all required franchisee purchases and leases (and any affiliate revenue); and (3) percentage of total revenues that come from such required franchisee purchases or leases.<sup>94</sup>

Item 8 also requires disclosure of: (1) the estimated percentages of required franchisee purchases and leases compared to all purchases and leases in establishing and operating the franchised business; (2) the existence of any purchasing or distribution cooperatives; (3) whether the franchisor negotiates purchase prices or other terms with suppliers; and (4) whether the franchisor provides any material benefits to franchisees (such as the right to renew an agreement or the grant of additional franchises) in exchange for making required purchases of products or from certain suppliers.<sup>95</sup>

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

Item 9 requires disclosure of the franchisee’s primary contractual obligations in a prescribed table format titled “**FRANCHISEE’S OBLIGATIONS**” which cross-references corresponding sections of the franchise agreement or other related or ancillary agreements and the related FDD Item(s) that provides additional information about each obligation. The following statement must appear at the top of the table in bold font under the title: “**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>96</sup> A disclosure must be made for each obligation required by the Franchise Rule, which means if an obligation does not exist in a

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<sup>93</sup> 16 C.F.R. § 436.5(h).

<sup>94</sup> 16 C.F.R. § 436.5(h)(8); Compliance Guide at 53-55.

<sup>95</sup> 16 C.F.R. § 436.5(h)(7),(9)-(11); Compliance Guide at 53-55.

<sup>96</sup> 16 C.F.R. § 436.5(i).

particular franchise agreement, a negative disclosure such as “Not Applicable” must be included. Additional obligations applicable to particular franchise systems can be added to the end of the table. A sample Item 9 table is attached as Exhibit D.<sup>97</sup>

## xii. **Item 10: Financing**

Item 10 requires the disclosure of any financing offered by the franchisor, its affiliates or agent, to franchisees. For the purposes for this disclosure, financing can be direct or indirect, includes guaranties of franchisee loans and leases, as well as situations where the franchisor or its affiliate receive a benefit from the lender in exchange for each franchisee sale financed. If any such financing is offered, the material terms and conditions of the arrangements must be disclosed, including: (1) the interest rate, including any annual finance charges, (2) the number of payments, (3) any penalties upon default, (4) any consideration the franchisor receives for each franchisee being referred to a lender.<sup>98</sup> Any required finance agreements must be included in Item 22 of the FDD.<sup>99</sup> If no financing is offered by the franchisor, Item 10 should state the following negative disclosure: “We do not offer direct or indirect financing. We do not guarantee your note, lease, or obligation.”<sup>100</sup>

## xiii. **Item 11: Franchisor’s Assistance, Advertising, Computer Systems and Training**

Item 11 requires several lengthy disclosures including the franchisor’s contractual obligations to provide pre-opening and ongoing assistance, information related to the time it generally takes to open the franchised business, advertising, training programs, computer systems, and operating manuals – we describe each below:<sup>101</sup>

- Franchisor Obligations

At the beginning of Item 11, the following warning statement must be included in bold type: “**Except as listed below, [the franchisor] is not obligated to provide you with any assistance.**”<sup>102</sup> Next, the obligations of franchisor assistance must be organized as either pre-opening assistance or continuing assistance provided post franchise opening.<sup>103</sup> These must include

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<sup>97</sup> 16 C.F.R. § 436.5(i); Compliance Guide at 57.

<sup>98</sup> 16 C.F.R. § 436.5(j).

<sup>99</sup> Compliance Guide at 60.

<sup>100</sup> Compliance Guide at 59-63.

<sup>101</sup> 16 C.F.R. § 436.5(k); Compliance Guide at 63-64.

<sup>102</sup> *Id.*

<sup>103</sup> 16 C.F.R. § 436.5(k)(1).

specific disclosures relating to assistance in franchisees obtaining sites, property, leases, signage, furniture, fixtures, inventory, equipment, supplies, establishing prices, and hiring and training employees. Each must be listed as separate numbered paragraphs and must refer to the corresponding section of franchise agreement imposing the obligation.<sup>104</sup>

Franchisors sometimes disclose discretionary or optional assistance, but these must be “set out separately and clearly identified as assistance that is not required by the franchise agreement.”<sup>105</sup> However, because the FDD should only include required disclosures, certain state examiners will prohibit “optional” assistance disclosures in the FDD.

- Time to Open

Item 11 must include: the approximate length of time it typically takes a franchisee to open the franchised business from the time the franchise agreement is signed; any required deadlines related to site selection, obtaining a lease, construction, and development; and any factors that may affect the estimated time period.<sup>106</sup>

- Advertising Programs

Item 11 must disclose certain information on the franchisor’s advertising programs including: (1) whether the franchisor is required to conduct advertising; (2) the kinds of media that may be used for advertising (e.g., print, radio, television, internet); (3) the source of advertising materials; (4) whether the advertising is local, regional, or national; (5) whether a franchisor requires franchisees to contribute to marketing funds or to spend certain amounts on local advertising; and (6) specific information regarding any advertising councils or cooperatives.<sup>107</sup> If franchisees are required to contribute to a marketing fund, certain additional disclosures must be made, including who must contribute to the fund, amount of required contribution, whether the contribution is the same or different for franchisees and company owned units, who administers the fund, whether it is audited, whether financial statements are available to franchisees and how, and a statement on how the funds were spent during the last fiscal year.<sup>108</sup>

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<sup>104</sup> 16 C.F.R. § 436.5(k)(1); Compliance Guide at 64.

<sup>105</sup> Compliance Guide at 65.

<sup>106</sup> 16 C.F.R. § 436.5(k)(2).

<sup>107</sup> 16 C.F.R. § 436.5(k)(4).

<sup>108</sup> 16 C.F.R. § 436.5(k)(4)(v).

The disclosure on marketing fund spend must include percentages spent on production, media placement, administrative expenses, and descriptions of any other use.<sup>109</sup> The franchisor must disclose what will happen to any remaining unspent marketing fund amounts.<sup>110</sup> An additional disclosure must be made on whether any percentage of marketing funds are used to solicit new franchisees.<sup>111</sup>

- Computer Systems

Franchisors must provide a non-technical general description of the required computer system or electronic payment system (relating to both software and hardware). The costs related to the purchase or leasing of these systems must be disclosed in Item 11 and should match the amount included in Item 7. The costs and the contractual limitations of any required or optional ongoing maintenance, repairs, support, upgrades or updates must be disclosed in Item 11.<sup>112</sup> This item also requires disclosure of whether franchisor will have independent access to the franchisee's computer system to obtain data, and if so, whether there are any contractual limitations to such access.<sup>113</sup>

- Operating Manuals

Item 11 requires disclosure of the table of contents to the operation manual provided to franchisees, the total number of pages to the manual, and number of pages devoted to each section of the manual. The table of contents is usually included as an exhibit to the FDD. This disclosure is not required if the franchisor offers "a prospective franchisee the opportunity to review the manual before buying the franchise." If the franchisor allows prospective franchisees a chance to review the manual before the franchise sale, most will require each prospect to execute a confidentiality agreement, a form of which must be included as an exhibit to the FDD.<sup>114</sup>

- Training Programs

Item 11 must include certain disclosures regarding the franchisor's training program in a prescribed table format titled "TRAINING PROGRAM." This disclosure must provide the subject matter of

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<sup>109</sup> 16 C.F.R. § 436.5(k)(4)(v)(G).

<sup>110</sup> 16 C.F.R. § 436.5(k)(4)(vi).

<sup>111</sup> 16 C.F.R. § 436.5(k)(4)(vii).

<sup>112</sup> 16 C.F.R. § 436.5(k)(5).

<sup>113</sup> 16 C.F.R. § 436.5(k)(5)(v).

<sup>114</sup> 16 C.F.R. § 436.5(k)(6); Compliance Guide at 67-68.

each training, indicate whether it is conducted “on-the-job” or in a classroom setting, and the number of hours spent on each training category. This disclosure must also include: (1) which franchisee personnel must attend training; (2) whether all or some of the trainees must complete the training successfully; and (3) any costs associated with attending the training, including tuition and travel costs. Certain information must be disclosed about the franchisor staff conducting and administering the training, including their names and length of experience in the field of their expertise and working for the franchisor. Lastly, location and the timing of the training must also be disclosed.<sup>115</sup>

#### **xiv. Item 12: Territory**

Item 12 requires detailed disclosures concerning assigned territories and applicable sales restrictions. Two of the most important topics that must be covered in Item 12 include: (i) the conditions, if any, under which a franchisor will approve the relocation of the franchisee’s business and the franchisee’s establishment of additional outlets<sup>116</sup>; and (ii) any present plans on the part of the franchisor to operate a competing franchise system offering similar goods or services.<sup>117</sup> In addition, if franchisor does not offer an exclusive territory, Item 12 requires the franchisor to include a specified statement that emphasizes this point and provides a warning about the consequences of purchasing a non-exclusive territory. If the franchisor reserves such rights, the franchisor will include the following statement: “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>118</sup>

Item 12 also requires disclosures on several other topics relating to territories including the impact of technological innovation and new market developments. Specifically, Item 12 requires disclosure of information about the use of the Internet to achieve sales and the use of alternative channels for distribution of franchisor’s goods.<sup>119</sup> These disclosures are required regardless of whether the franchisor provides an exclusive territory.<sup>120</sup> A franchisor must disclose, whether, under the franchise agreement: (i) the franchisor itself can solicit or accept orders from consumers within a franchisee’s territory; (ii) the franchisor reserves the right to use alternative channels of distribution within a franchisee’s territory, including Internet, catalog, or telemarketing sales; and (iii) any

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<sup>115</sup> 16 C.F.R. § 436.5(k)(7); Compliance Guide at 68.

<sup>116</sup> 16 C.F.R. §436.5(l)(3).

<sup>117</sup> 16 C.F.R. §436.5(l)(6)(iii).

<sup>118</sup> 16 C.F.R. §436.5(l)(5)(i).

<sup>119</sup> 16 C.F.R. §436.5(l)(6)(i)(A).

<sup>120</sup> 16 C.F.R. §436.5(l)(6).

compensation a franchisor pays to a franchisee for soliciting or accepting orders from inside the franchisee's territory.<sup>121</sup>

Further, Item 12 requires the disclosure of similar information describing the extent to which a franchisee will be restricted from soliciting or accepting orders from outside his or her territory, including whether a franchisee has the right to distribute through alternative channels, such as the Internet, catalog sales, telemarketing, or other direct marketing.<sup>122</sup>

#### **xv. Item 13: Trademarks**

Item 13 requires franchisors to disclose whether each of its principal trademarks is registered with the United States Patent and Trademark Office ("PTO"), as well as application, renewal, and other related information.<sup>123</sup> A "principal trademark" is defined as the "primary trademarks, service marks, names, logos, and commercial symbols the franchisee will use to identify the franchised business. It may not include every trademark the franchisor owns."<sup>124</sup> If franchisor's principal trademarks are not registered with the PTO, Item 13 requires the following statement: "We do not have a federal registration for our principal trademark. Therefore, our trademark does not have many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses."<sup>125</sup> In addition, Item 13 requires the disclosure of other information, including: (i) the existence of any pending litigation, settlements, agreements, or superior rights that may limit a franchisee's use of the trademark<sup>126</sup>; and (ii) any contractual obligation of the franchisor to protect a franchisee's right to use the principal trademarks, and to protect the franchisee against claims of infringement or unfair competition.<sup>127</sup>

Item 13 permits a franchisor to include an attorney's opinion regarding the merits of any litigation or of a PTO or similar action if the attorney issuing the opinion consents to its use.<sup>128</sup> The text of the Item 13 disclosure may include a summary of the opinion if the full opinion is attached to Item 22 and the attorney issuing the opinion consents to the use of the summary.<sup>129</sup>

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<sup>121</sup> 16 C.F.R. §436.5(l)(6)(i).

<sup>122</sup> 16 C.F.R. §436.5(l)(6)(ii).

<sup>123</sup> 16 C.F.R. §436.5(m)(2).

<sup>124</sup> 16 C.F.R. §436.5(m)(1).

<sup>125</sup> 16 C.F.R. §436.5(m)(4).

<sup>126</sup> 16 C.F.R. §436.5(m)(6).

<sup>127</sup> 16 C.F.R. §436.5(m)(7).

<sup>128</sup> 16 C.F.R. §436.5(m)(6).

<sup>129</sup> *Id.*

**xvi. Item 14: Patents, Copyrights and Proprietary Information**

Item 14 requires the disclosure of information about intellectual property related to the franchise. Franchisors must disclose the types of intellectual property, their ownership rights or licenses in each, details about, and the duration of, their rights, and any legal proceedings, settlements, and restrictions that may impact the franchisee's ability to use such property.<sup>130</sup> Item 14 permits a franchisor to include an attorney's opinion regarding the merits of litigation or of a PTO or similar action if the attorney issuing the opinion consents to its use.<sup>131</sup> The text of the Item 14 disclosures may include a summary of the opinion if the full opinion is attached to Item 22 and the attorney issuing the opinion consents to the use of the summary.<sup>132</sup>

In addition, similar to Item 13 and franchisor's principal trademarks, a franchisor is required to disclose information regarding its obligation to protect the patent, patent application, or copyright and whether the franchisor is obligated to defend the franchisee against claims arising from franchisee's use of such items.<sup>133</sup> For example, the franchisor must disclose: (i) whether under the franchise agreement the franchisor must take affirmative action after being notified of an infringement; (ii) whether the franchisor or franchisee has the right to control any litigation; and (iii) whether the franchisor is obligated to participate in the defense of a franchisee or indemnify the franchisee against claims of infringement or unfair competition involving its use of a patent, patent application, or copyright licensed to the franchisee.<sup>134</sup>

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

Item 15 requires franchisors to disclose whether franchisees are required to participate personally in the direct operation of the franchise.<sup>135</sup> The franchisor must disclose any obligation for the franchisee to participate directly in the business that arises from the parties' franchise agreement, or from any other agreement, or from the franchisor's practice.<sup>136</sup> In addition, Item 15 requires disclosure regarding whether the franchisor recommends direct participation and if personal "on premises" supervision is not required, any limitations on whom the franchisee can hire as a supervisor, whether the supervisor must successfully complete training, and any restrictions (i.e., covenants not to compete or trade

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<sup>130</sup> 16 C.F.R. §436.5(n)(1).

<sup>131</sup> 16 C.F.R. §436.5(n)(3).

<sup>132</sup> *Id.*

<sup>133</sup> 16 C.F.R. §436.5(n)(5).

<sup>134</sup> *Id.*

<sup>135</sup> 16 C.F.R. §436.5(o).

<sup>136</sup> 16 C.F.R. §436.5(o)(1).

secrecy agreements) that the franchisee must place on his or her manager.<sup>137</sup> If the franchisee is not an individual but operates as a business entity (corporation or a partnership), Item 15 requires the franchisor to disclose the amount of equity interest, if any, that the on-premises supervisor must have in the franchise.<sup>138</sup>

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

Item 16 requires the disclosure of any restrictions relating to the goods or services a franchisee sells.<sup>139</sup> A franchisor must disclose any restriction allowing only sales of franchisor-approved goods or services and any restriction requiring a franchisee to sell all goods or services authorized by the franchisor.<sup>140</sup> In addition, Item 16 requires the disclosure of whether the franchisor has the right to change the types of authorized goods or services and whether there are any restrictions on the franchisor's right to make such changes.<sup>141</sup>

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

Item 17 requires franchisors to summarize, in the specified tabular format, common provisions of franchise agreements, including those provisions dealing with termination, renewal, and dispute resolution.<sup>142</sup> The Item 17 table must be titled with the following, in capital letters and boldface type: "**THE FRANCHISE RELATIONSHIP.**" If the franchise agreement is silent regarding one or more of the categories enumerated in the table, but the franchisor voluntarily offers to provide certain benefits or protections to franchisees as a matter of policy, then the franchisor may add a footnote to the table describing the policy and state whether the policy is subject to change.<sup>143</sup> For example, if the franchisor routinely offers to buy back a franchised outlet upon the death of the franchisee-owner, that policy may be added as a footnote to the line in the table for "Death or Disability of Franchisee." In addition, Item 17 requires franchisors to explain their renewal policy in the "Summary" column of the line in the table titled "Requirements for Franchisee to Renew or Extend."<sup>144</sup> For example, in many franchise systems, a right of renewal means that the franchisee, upon the expiration of the original term of the franchise agreement, has the right to enter into a new agreement according to the then-current terms and conditions. In other systems, the franchisee may have a simple right to extend the existing agreement under the same terms and

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<sup>137</sup> 16 C.F.R. §436.5(o)(2).

<sup>138</sup> 16 C.F.R. §436.5(o)(2)(iv).

<sup>139</sup> 16 C.F.R. §436.5(p).

<sup>140</sup> *Id.*

<sup>141</sup> 16 C.F.R. §436.5(p)(3).

<sup>142</sup> 16 C.F.R. §436.5(q).

<sup>143</sup> 16 C.F.R. §436.5(q)(2).

<sup>144</sup> 16 C.F.R. §436.5(q)(3).

conditions for an additional period of time. A sample Item 17 table is attached as Exhibit E.

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

Item 18 requires certain information about a public figure's involvement in the franchise system. This covers public figures who lend their name or image to the franchise, control or manage the franchisor, or invest in the franchisor.<sup>145</sup> A "public figure" means a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located.<sup>146</sup> Typical public figures include sports stars, actors, musicians, and similar celebrities. If a public figure's name is used as part of the franchisor's name, the public figure's image is used as a symbol associated with the franchise, or the public figure endorses or recommends the franchise to prospective franchisees, then the franchisor must disclose any compensation or other benefits given or promised to the public figure.<sup>147</sup> If a public figure is involved in the management or control of the franchisor, the franchisor must disclose the extent of that involvement, including the public figure's position in the franchisor and his or her duties in the business structure.<sup>148</sup> If a public figure invests in the franchisor, the franchisor must disclose the type and total amount of his or her investment.<sup>149</sup> The "type" of investment includes cash, stock, promissory notes, and any in-kind services performed or to be performed by the public figure.<sup>150</sup>

## **xxi. Item 19: Financial Performance Representations**

Item 19 permits but does not require franchisors to include representations about financial performance in their disclosure documents. "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>151</sup> A franchisor that decides to make such representations must include them in Item 19, not in a separate document.<sup>152</sup> A franchisor electing to make a financial performance representation must, among other things, have a reasonable basis and written substantiation for the

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<sup>145</sup> 16 C.F.R. §436.5(r).

<sup>146</sup> 16 C.F.R. §436.5(r)(4).

<sup>147</sup> 16 C.F.R. §436.5(r)(1).

<sup>148</sup> 16 C.F.R. §436.5(r)(2).

<sup>149</sup> 16 C.F.R. §436.5(r)(3).

<sup>150</sup> *Id.*

<sup>151</sup> 16 C.F.R. §436.1(e).

<sup>152</sup> 16 C.F.R. §436.5(s)(3).

representation at the time it is made, and disclose the bases and assumptions underlying the representation in Item 19.<sup>153</sup>

All Item 19 disclosures must begin with a prescribed preamble that informs prospective franchisees about the law of financial performance representations:

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.<sup>154</sup>

The preamble must be included word-for-word as set out above, with no modification in language or punctuation.

If a franchisor elects not to make a financial performance representation, then the franchisor's disclosure document must include in Item 19 not only the universal preamble set out above, but also this additional preamble:

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.<sup>155</sup>

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<sup>153</sup> *Id.*

<sup>154</sup> 16 C.F.R. §436.5(s)(1).

<sup>155</sup> 16 C.F.R. §436.5(s)(2).

Like the universal preamble, this preamble for those not making financial performance representations must be included word-for-word as set out above, with no modification in language or punctuation.

The requirements of Item 19 vary depending upon whether a franchisor makes historical representations (how much existing franchisees have, in fact, earned in the past) or projections (how much an individual prospective franchisee is likely to earn in the future). In fact, Item 19 requires franchisors to state expressly whether any financial performance representation: (i) pertains to historic performance of all or a subset of existing franchised outlets; or (ii) is a forecast of future potential performance.<sup>156</sup> A franchisor making a historical financial performance representation must state the material facts underlying the representation.<sup>157</sup> The Franchise Rule specifies six separate elements comprising the material bases for such a representation, each of which must be expressly addressed.

As is the case with historical financial performance representations, financial performance projections must have a reasonable basis, and must disclose the material bases and assumptions upon which the projection is based.<sup>158</sup> The Franchise Rule does not enumerate specific factors that must be addressed in describing the bases for a projected financial performance representation. Nevertheless, if a franchisor makes a performance projection, its Item 19 disclosures must include sufficient facts to enable a prospective franchisee to make an independent judgment as to the validity of the projection.<sup>159</sup> The Item 19 disclosures should include a description of the material information on which the franchisor relied in making the representation. This may include market studies, statistical analyses, franchisee profit-and-loss statements, as well as other types of information that prudent persons customarily rely on in making business decisions.<sup>160</sup>

Item 19 requires a clear and conspicuous admonition that a new franchisee's individual financial results may differ from the results stated in the Item 19 disclosure.<sup>161</sup> If a franchisor elects to make a financial performance representation in Item 19, then it must also include a statement that written substantiation for the representation will be made available to the prospective franchisee upon reasonable request.<sup>162</sup> In this context, the term "reasonable" pertains to time and location. A request is reasonable when the prospective franchisee gives the

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<sup>156</sup> 16 C.F.R. §436.5(s)(3)(i).

<sup>157</sup> 16 C.F.R. §436.5(s)(3)(ii).

<sup>158</sup> 16 C.F.R. §436.5(s)(3)(iii).

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> 16 C.F.R. §436.5(s)(3)(iv).

<sup>162</sup> 16 C.F.R. §436.5(s)(3)(v).

franchisor sufficient time to produce the substantiation at a convenient location, possibly at company headquarters or where the substantiation is stored if it contains confidential information or is voluminous. For example, franchisors are not expected to bring substantiation with them to a trade show. Accordingly, a request by a trade show attendee for substantiation that afternoon at the trade show would likely be deemed unreasonable.

A franchisor not wishing to make financial performance representations may nonetheless offer to show a prospective franchisee the actual operating results of a specific outlet being offered for sale.<sup>163</sup> Such information, however, may only be furnished to potential purchasers of that outlet and no others.<sup>164</sup> If a franchisor has furnished an Item 19 disclosure, it may furnish a prospective franchisee with a supplemental financial performance representation pertaining to a particular location or pertaining to a particular variation (e.g., a kiosk, as opposed to a standard free-standing restaurant).<sup>165</sup> Any such supplemental representation must be in writing, explain the departure from the financial performance representation set forth in the Item 19 disclosures, and be prepared according to the standards for financial performance claims.<sup>166</sup>

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

Item 20 requires the disclosure of statistical information on the number of franchised outlets and company-owned outlets for the preceding three-year period.<sup>167</sup> Item 20 requires five tables. The first table provides a systemwide summary of outlets, detailing the net changes in the number of outlets – both franchised and company-owned – over the last three fiscal years.<sup>168</sup> The second tracks transfers of outlets, state by state, over the last three fiscal years.<sup>169</sup> The third shows, state by state, changes in the status of franchised outlets over the last three fiscal years.<sup>170</sup> Similarly, the fourth table displays, state by state, changes in the status of company-owned outlets over the last three fiscal years.<sup>171</sup> Finally, the fifth table projects new outlet openings in each state.<sup>172</sup> It also shows the number of franchise agreements that have been signed but have not yet resulted in the opening of an outlet.<sup>173</sup>

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<sup>163</sup> 16 C.F.R. §436.5(s)(4).

<sup>164</sup> *Id.*

<sup>165</sup> 16 C.F.R. §436.5(s)(5).

<sup>166</sup> *Id.*

<sup>167</sup> 16 C.F.R. §436.5(t)(1).

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

<sup>169</sup> 16 C.F.R. §436.5(t)(2).

<sup>170</sup> 16 C.F.R. §436.5(t)(2)(ii).

<sup>171</sup> 16 C.F.R. §436.5(t)(2)(iii).

<sup>172</sup> 16 C.F.R. §436.5(t)(3).

<sup>173</sup> 16 C.F.R. §436.5(t)(3)(ii).

The Item 20 tables are designed to capture outlet and ownership status changes. In some instances, there may be multiple changes in the status of a particular outlet over the course of a fiscal year. For example, during a single fiscal year, a franchisee may cease operations and the franchisor may respond by terminating the franchisee's franchise agreement. Where there are multiple events such as these affecting a particular outlet, the Franchise Rule provides that only the last event for that specific outlet need be reported.<sup>174</sup> In the example above, since termination was the last event, the change in status should be reported only as a termination. Franchisors are permitted to add a footnote to the chart to explain the series of status changes, but except in the case of multiple franchise owners, as discussed below, are not required to do so.<sup>175</sup>

Table No. 1 of Item 20 presents the total number of all outlets nationwide – both company owned and franchised – operating at the beginning and at the end of each of the franchisor's last fiscal years.<sup>176</sup> This chart should include all outlets that are substantially similar to those being offered for sale to prospective franchisees.<sup>177</sup> The table is intended to show the net change – positive or negative – in the number of operating franchised and company-owned outlets over time.<sup>178</sup>

Table No. 2 of Item 20 shows the number of transfers in each state occurring over the last three fiscal years.<sup>179</sup> Transfers occur for a variety of reasons. An existing franchisee may wish to sell his or her outlet in order to retire, because of ill health, or due to a pending move to another state. However, because a transfer to a new owner generally does not change the total number of operating outlets in a system, transfers are reported separately from other changes in ownership.

Table No. 3 of Item 20 shows changes in the status of franchisee-owned outlets in each state over the last three fiscal years.<sup>180</sup> It begins with a baseline, using the number of franchise outlets at the start of the fiscal year. Added to the baseline are any new franchise outlets opened during that fiscal year and any existing company-owned outlets that are sold to a franchisee.<sup>181</sup> Subtracted from the baseline are any outlets that changed status for one of four reasons: (i) termination; (ii) non-renewal; (iii) reacquisition by the franchisor; or (iv) cessation

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<sup>174</sup> 16 C.F.R. §436.5(t)(2).

<sup>175</sup> *Id.*

<sup>176</sup> 16 C.F.R. §436.5(t)(1).

<sup>177</sup> *Id.*

<sup>178</sup> 16 C.F.R. §436.5(t)(1)(v).

<sup>179</sup> 16 C.F.R. §436.5(t)(2)(i).

<sup>180</sup> 16 C.F.R. §436.5(t)(2)(ii).

<sup>181</sup> 16 C.F.R. §436.5(t)(2)(ii)(D).

of operations/other reasons.<sup>182</sup> Finally, Table No. 3 shows the outlets remaining at the end of the year.<sup>183</sup>

During the course of a single fiscal year, multiple changes in an outlet's ownership may occur. For example, on February 1, 2022, a franchisor may reacquire an outlet from a franchisee and then resell it on March 1, 2022, to a new franchisee owner. Subsequently, on December 1, 2022, the new franchisee owner may cease operations. The last of such series of events should be reported in Table 3 in the "ceased operations" column, because that was the last change in ownership for that specific franchise outlet during the fiscal year. However, for clarity and full disclosure, the Franchise Rule requires a footnote in this table describing such multiple events involving multiple owners, and the order in which they occurred.<sup>184</sup>

Table No. 4 of Item 20 shows changes in the status of company-owned outlets in each state over the last three fiscal years.<sup>185</sup> It also begins with a baseline, using the number of company-owned outlets at the start of the fiscal year.<sup>186</sup> Added to the baseline are any new company-owned outlets opened during that fiscal year and any outlets reacquired from franchisees during the year.<sup>187</sup> Subtracted from the baseline are outlets that were closed, sold to a franchisee, or otherwise ceased to operate under the franchisor's trademark.<sup>188</sup> The resulting number reflects the company-owned outlets remaining at the end of the year.<sup>189</sup>

Table No. 5 of Item 20 addresses two issues: (i) franchise agreements signed but outlets not opened; and (ii) projected new franchised and company-owned outlets.<sup>190</sup> Franchisors are required to report, for each state, the total number of franchise agreements that were signed, but where the outlet had not opened as of the end of the last fiscal year.<sup>191</sup> For example, a franchisor may have signed five agreements with franchisees in Illinois over the last three years. Of the five agreements, three have yet to be opened. Accordingly, the franchisor would report that in Illinois three agreements have been signed but none of the three outlets has opened. In addition, Item 20 requires franchisors to report, state by state, the projected number of new franchised and company-owned outlets for the next fiscal year.<sup>192</sup> The Franchise Rule does not provide specific instructions on

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<sup>182</sup> 16 C.F.R. §436.5(t)(2)(ii)(E)-(H).

<sup>183</sup> 16 C.F.R. §436.5(t)(2)(ii)(I).

<sup>184</sup> 16 C.F.R. §436.5(t)(2).

<sup>185</sup> 16 C.F.R. §436.5(t)(2)(iii).

<sup>186</sup> 16 C.F.R. §436.5(t)(2)(iii)(C).

<sup>187</sup> 16 C.F.R. §436.5(t)(2)(iii)(D).

<sup>188</sup> 16 C.F.R. §436.5(t)(2)(iii)(E)-(G).

<sup>189</sup> 16 C.F.R. §436.5(t)(2)(iii)(H).

<sup>190</sup> 16 C.F.R. §436.5(t)(3).

<sup>191</sup> 16 C.F.R. §436.5(t)(3)(ii).

<sup>192</sup> 16 C.F.R. §436.5(t)(3)(iv).

how to make these projections. However, such projections must have a reasonable basis.

Item 20 requires the disclosure of contact information for current franchisees.<sup>193</sup> Franchisors may provide contact information for all current franchisees, for all franchisees in the state where they are offering to sell franchises, if there are 100 or more franchises in the state.<sup>194</sup> If not, contact information must be provided for franchisees in contiguous states, and then the next closest states, until contact information for at least 100 franchised outlets can be listed.<sup>195</sup> If a franchisor has fewer than 100 current franchisees, contact information must be provided for all of them.<sup>196</sup> To protect franchisee privacy, only the name of the franchisee and the address, and telephone number of his or her outlet must be disclosed.<sup>197</sup> In the case of a franchise that may be operated from the franchisee's home, such as an Internet franchise, franchisor may substitute a post office box or current email address for the home address for the same reasons. In that situation, franchisors should list only the telephone number of the franchisee's business, if there is a separate line for the business. If not, a listing of a valid email address will suffice.

Item 20 requires the disclosure of contact information for every franchisee who: (i) has had an outlet terminated, canceled, not renewed, or otherwise voluntarily or involuntarily ceased to do business under the franchise agreement during the most recently completed fiscal year; or (ii) has not communicated with the franchisor within 10 weeks of the disclosure document issuance date.<sup>198</sup> In order to protect the privacy of former franchisees, the Franchise Rule calls for the disclosure of only limited contact information. Specifically, franchisors should disclose only the name, city and state, and current business telephone number of a former franchisee.<sup>199</sup> Only if the current business telephone number is unknown should the last known home telephone number of former franchisees be disclosed. Before disclosing the former franchisee's home telephone number, however, franchisors should first attempt to disclose any current business telephone number for the former franchisee. Finally, to ensure that prospective franchisees are aware that contact information will be disclosed once they leave the system, franchisors must include the following statement, verbatim, in the Item 20 disclosure: "If you

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<sup>193</sup> 16 C.F.R. §436.5(t)(4).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.*

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> 16 C.F.R. §436.5(t)(5).

<sup>199</sup> *Id.*

buy this franchise, your contact information may be disclosed to other buyers when you leave the franchise system.”<sup>200</sup>

The Franchise Rule requires franchisors to provide certain information if they are selling a specific outlet under their control that was previously owned by a franchisee.<sup>201</sup> Franchisors are not required to make this disclosure, however, if they do not currently own and offer such an outlet for sale. A franchisor also is not obligated to make this disclosure if it assists a current franchisee in selling his or her outlet. Nor does a franchisor have an obligation to make this disclosure if it is selling a unit that has always been a company-owned outlet. If the franchisor is selling a previously owned franchised outlet now under its control it must disclose the following information for the last five fiscal years: (i) the name, city and state, current business telephone number, or if unknown, last known home telephone number of each previous owner of the outlet; (ii) the time period when each previous owner controlled the outlet; (iii) the reason for each previous ownership change; and (iv) the time period(s) when the franchisor retained control of the outlet.<sup>202</sup> If multiple units with previous franchisee ownership are being sold, the franchisor must provide the required information separately for each one.

In some instances, Item 20 requires the franchisor to disclose if franchisees have signed a confidentiality agreement with the franchisor during the last three fiscal years.<sup>203</sup> If so, franchisors must include the following prescribed statement:

“In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees will be able to communicate with you.”

The term “confidentiality agreement” encompasses “any contract, order, or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor’s system with any prospective franchisee.”<sup>204</sup> A confidentiality agreement typically arises as part of the resolution of a dispute between the franchisor and franchisee. The requirement to disclose confidentiality agreements is narrow. As noted, it specifically is limited to agreements that restrict a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor’s system. Thus, for example, if a franchisee is also employed by the franchisor as a manager, a confidentiality agreement prohibiting the franchisee

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<sup>200</sup> *Id.*

<sup>201</sup> 16 C.F.R. §436.5(t)(6).

<sup>202</sup> 16 C.F.R. §436.5(t)(6)(i)-(iv).

<sup>203</sup> 16 C.F.R. §436.5(t)(7).

<sup>204</sup> 16 C.F.R. §436.1(c).

from discussing her experience as a manager (as opposed to a franchisee) would not trigger this disclosure. Further, a confidentiality agreement that would bar a franchisee from speaking with individuals other than a prospective franchisee – such as competitors or trade press – would not trigger this disclosure obligation. This obligation would also not be triggered if a franchisee is restricted from discussing only the specific terms of a settlement, but is otherwise free to discuss his or her experience – including having a dispute with the franchisor.

The Franchise Rule requires franchisors to disclose contact information for trademark-specific franchisee associations.<sup>205</sup> This disclosure requirement pertains solely to associations of franchisees of the franchise brand being offered for sale.<sup>206</sup> It does not pertain to associations of franchisees whose membership is opened to franchisees of many franchise systems, such as “The Texas Association of Restaurant Franchisees.” The disclosure requirements pertaining to franchisee associations differ depending on whether the franchisee association is created, sponsored, or endorsed by the franchisor, or whether the trademark-specific franchisee association is independent of the franchisor.<sup>207</sup> If the franchisor creates, sponsors, or endorses a trademark-specific franchisee association, it must disclose in Item 20 the name, address, telephone number, email address, and Web address of the association.<sup>208</sup> It also must disclose the specific relationship between the franchisor and the association (*i.e.*, that it was created, sponsored, or endorsed by the franchisor).<sup>209</sup> A franchisor has no obligation to disclose contact information for an organized independent association unless the association has asked to be included in the franchisor’s disclosure document for the next fiscal year.<sup>210</sup> To be included in the disclosure document, the association must request inclusion no later than 60 days after the close of the franchisor’s fiscal year.<sup>211</sup>

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

Item 21 requires franchisors to include copies of their financial statements audited in accordance with generally accepted accounting principles (“GAAP”) for the most recent three fiscal years to show the financial condition of the franchisor.<sup>212</sup> The financial statements of franchisors that own a direct or beneficial controlling financial interest in one or more subsidiaries must also reflect the financial condition of the subsidiaries.<sup>213</sup> Financial disclosures must be in tabular

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<sup>205</sup> 16 C.F.R. §436.5(t)(8).

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> 16 C.F.R. §436.5(t)(8)(i).

<sup>209</sup> *Id.*

<sup>210</sup> 16 C.F.R. §436.5(t)(8)(ii).

<sup>211</sup> *Id.*

<sup>212</sup> 16 C.F.R. §436.5(u)(1).

<sup>213</sup> 16 C.F.R. §436.5(u)(1)(iv).

format that compares at least two fiscal years.<sup>214</sup> This provides prospective franchisees with information with which to assess financial trends in a franchise system. The Franchise Rule requires franchisors to prepare financial statements according to “United States generally accepted accounting principles, as revised by any future government mandated accounting principles, or as permitted by the Securities and Exchange Commission.”<sup>215</sup> The Franchise Rule recognizes that what currently complies with “GAAP” may change as a result of federal government oversight of the accounting profession. Accordingly, it provides that franchisors must use GAAP, as revised by any future government mandated accounting principles.

Item 21 provides that a franchisor must also disclose the financial statements of any parent corporation in two circumstances: (1) when the parent commits to perform post-sale obligations for the franchisor; or (2) when the parent guarantees the obligations of the franchisor.<sup>216</sup> In such circumstances, prospective franchisees may reasonably consider the parent’s financial status in their investment decision-making. Accordingly, the parent’s financial status is material. Also note that where a parent guarantees a franchisor’s performance, Item 21 requires the franchisor to include a copy of the guarantee in the attachments to the disclosure document in Item 22.<sup>217</sup> Franchisor is also permitted to substitute the financial statements of an affiliate for its own financial statements if the affiliate’s statements meet the requirements for audited financial statements and the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor to the franchisee under the franchise agreement.<sup>218</sup> A copy of the guarantee, which need not extend to third parties, must be included in the attachments to the disclosure document in Item 22.<sup>219</sup>

The Franchise Rule requires the disclosure of financial information of any subfranchisor.<sup>220</sup> The term “subfranchisor” is limited by the definition in Section 436.1(k) of the Franchise Rule to circumstances where the subfranchisor steps into the shoes of the franchisor by engaging in pre-sale activities and performing post-sale obligations.<sup>221</sup> It does not include those individuals who may be called “subfranchisors,” but who act like brokers or salespersons, having no post-sale commitments to franchisees. Where a person engages in pre-sale activities and commits to perform under the franchise agreement, his or her financial information

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<sup>214</sup> 16 C.F.R. §436.5(u)(1).

<sup>215</sup> *Id.*

<sup>216</sup> 16 C.F.R. §436.5(u)(1)(v).

<sup>217</sup> *Id.*

<sup>218</sup> 16 C.F.R. §436.5(u)(1)(iii).

<sup>219</sup> *Id.*

<sup>220</sup> 16 C.F.R. §436.5(u)(1)(v).

<sup>221</sup> 16 C.F.R. §436.1(k).

becomes material in order to provide prospective franchisees with the opportunity to assess that person's financial condition.

Item 21 permits franchisors to phase-in the use of audited financial statements over the course of three years.<sup>222</sup> The phase-in applies only to companies that are new to franchising and that do not yet have audited financial statements.<sup>223</sup> If an existing company has prepared audited financial statements in the ordinary course of business before embarking on franchise sales it may not use the phase-in option. Moreover, the phase-in option is not available to spin-offs, affiliates, or subsidiaries of existing franchisors that have prepared audited financial statements in the past. In short, an existing franchise system cannot avoid the obligation to provide full audited financial statements by forming a spin-off company.

#### **xxiv. Item 22: Contracts**

Item 22 requires franchisors to attach a copy of all proposed agreements relating to the franchise offering that the franchisor provides or for which the franchisor makes arrangements.<sup>224</sup> These include not only the franchise agreement, but leases, options, financing agreements, and purchase agreements.<sup>225</sup> These agreements are part of the disclosure document. Typically, the attached agreements should be the same as those listed in the Table of Contents and in the Receipt.

#### **xxv. Item 23: Receipts and State Effective Dates Page**

Franchisors are required to obtain a signed receipt for the disclosure document furnished to each prospective franchisee.<sup>226</sup> When preparing the receipt, franchisors must follow the form of the receipt set forth in Item 23. In addition, Item 23 adopts the current industry practice of including two copies of the receipt at the end of the disclosure document: one that the franchisee retains as part of the disclosure document, and the other that the franchisee must return to the franchisor.<sup>227</sup> Franchisors are required to name and provide contact information (principal business address and telephone number) for each specific seller offering the franchise.<sup>228</sup> This includes any company salespersons, subfranchisors, or independent franchise brokers who may deal with a prospective franchisee. Because this information may vary with each franchise offered for sale, a franchisor can comply with this provision either by leaving a blank space in the

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<sup>222</sup> 16 C.F.R. §436.5(u)(2).

<sup>223</sup> *Id.*

<sup>224</sup> 16 C.F.R. §436.5(v).

<sup>225</sup> *Id.*

<sup>226</sup> 16 C.F.R. §436.5(w).

<sup>227</sup> *Id.*

<sup>228</sup> 16 C.F.R. §436.5(w)(2).

standard disclosure document that can be filled in by the seller of by including names(s) and contact information in an attachment to Item 22, which is then referenced in the Item 23 receipt.

The receipt must include the issuance date of the disclosure document.<sup>229</sup> The “issuance” date is the date upon which the franchisor finalizes the current version of the disclosure document for use. States that require registration, however, may use the term “effective date,” to mean the date upon which the state formally approves registration of the disclosure document. Where a franchisor seeks registration in one or more registration states, the franchisor may use, in lieu of an issuance date, an “effective” date to comply with state law. Franchisors obtaining an effective date from a registration state may also use the term “effective date” in non-registration states. Franchisors that register in one or more of the Registration States must include a state effective dates page before the Item 23 receipt. As each Registration State approves the FDD for use in the state, franchisor must add the applicable state “effective date” to the state effective dates page.

The Item 23 receipt requirement is flexible, permitting electronic acknowledgements of receipt. The term “signature” includes not only written signatures, but electronic signatures, passwords, security codes, and other methods that enable a prospective franchisee easily to acknowledge receipt, authenticate his or her identity, and submit the receipt information to the franchisor.<sup>230</sup> Franchisors may include specific instructions on how prospective franchisees should submit the receipt, such as via facsimile or email attachment.<sup>231</sup> Further, the means required for transmitting the receipt need not be the same as the means for transmitting the disclosure document. For example, a franchisor may wish to furnish disclosure documents online, but require a prospective franchisee to print out, sign, and fax back the signed receipt. In short, Item 23 enables the parties to determine for themselves the most efficient and cost-effective way for the prospective franchisee to transmit the receipt.

### **C. State-Specific Disclosures & Requirements**

The Franchise Rule prescribes the minimum disclosure requirements that apply to all franchise offerings in the United States. Certain Registration States, however, impose additional state-specific disclosure requirements, with which a franchisor must comply before offering or selling franchises in that state. Typically, state-specific disclosures are included in the state addenda attached to the FDD as a separate exhibit.

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<sup>229</sup> 16 C.F.R. §436.5(w)(3).

<sup>230</sup> 16 C.F.R. §436.1(u).

<sup>231</sup> 16 C.F.R. §436.5(w)(8).

## **i. Examples of Additional Disclosure Requirements**

This Section summarizes some of the common additional state-specific disclosures.

### **a. Item 1: Laws & Regulations**

Under the Franchise Rule, franchisors are required to summarize in Item 1 of the FDD, any laws and regulations applicable to the franchised business. Franchisors will often include a number of federal laws that apply to businesses generally in their Item 1 disclosures. However, 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 to prospective franchisees. For example, certain industries such as the hair salon industry is subject to additional state licensing requirements and regulations that may need to be summarized in Item 1 of the FDD. Further, and with the insurgence of state privacy regulation across the U.S., a franchisor may find it necessary to reference applicable state privacy regulations in Item 1.

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

Under the Franchise Rule, Franchisors are required to disclose bankruptcy and related proceedings that have occurred in the previous 10 years in Item 4 of the FDD. Under Minnesota law, however, the bankruptcy disclosure has a 15-year look-back period.<sup>232</sup> If a franchisor deletes a bankruptcy disclosure after ten years, it opens itself up to potential liability related to the offer and sale of franchises in Minnesota during that five-year period.

### **c. Item 8: Rebates**

The Franchise Rule requires franchisors to make certain disclosures related to obligatory purchases, sourcing restrictions, and supplier rebates. Maryland, however, requires franchisors to provide potential franchisees with additional details. Specifically, the Maryland regulations require franchisors to disclose: (1) the affiliation between the franchisor and the sources of supply, if any, (2) if the source is affiliated with the franchisor, 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 the 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>233</sup>

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<sup>232</sup> Minn. R. 2860.3500(4)(D).

<sup>233</sup> Md. Code Regs. 02.02.08.16(J)(2).

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

In addition to the Item 11 advertising fund disclosures required by the Franchise Rule, Maryland also requires franchisors to disclose the manner in which: (1) fees related to advertising are to be raised or spent; and (2) a franchisee may obtain an accounting of the advertising expenditures.<sup>234</sup>

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

In Item 21 disclosures, the Franchise Rule permits new franchisors to “phase in” the use of audited financial statements over a three-year period. Under the Franchise Rule, franchisors may use an unaudited opening balance sheet for their first disclosure year. Minnesota, New York, and Virginia, however, require franchisors to have their opening balance sheet audited by a certified public accountant.<sup>235</sup>

##### **ii. State Cover Page and Risk Factors**

As discussed previously, certain state laws and/or administrators may require franchisors to make additional disclosures in their FDDs. These supplementary disclosures can be presented in the body of the FDD itself or in state-specific addenda attached to the FDD.<sup>236</sup>

State administrators often ask franchisors to include certain state-specific risk factors on a “state cover page” that is included immediately after the federal cover page required by the Franchise Rule.

The particular risk factors that need to be disclosed on the state cover page depends on (1) the state in which the franchise is being offered, (2) the dispute resolution provision provided for in the franchise agreement, (3) the existence of minimum performance obligations, (4) whether any conditions are imposed on the owner’s spouse, and (5) the financial wherewithal and experience of the franchisor.

##### **iii. State Addenda**

As described above, franchisors are required to comply with the specific disclosure requirements of every state in which the franchisor intends to offer and sell franchises. However, there is no need for a franchisor to prepare an entirely separate FDD to address each state’s unique requirements. Instead, franchisors have the option to attach state-specific addenda to their FDDs in order to address: (1) disclosures needed to advise prospective franchisees of the state’s limited

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<sup>234</sup> Md. Code Regs. 02.02.08.16(G).

<sup>235</sup> Minn. Stat. Ann. § 80C.04; N.Y. Comp. Codes R. & Regs. tit. 13, § 200.2; 21 Va. Admin. Code 5-110-55.

<sup>236</sup> Compliance Guide at 26.

review of the FDD; and (2) modifications to the FDD (and to related agreements) that are necessary to (a) notify the franchisee of its rights under that state's franchise relationship laws, such as state law related to termination and non-renewal, (b) preserve the franchisee's rights under state law from waiver or modification by the terms of the franchise or other agreement, and (c) disclose any financial assurances the franchisor is required to provide as a condition of registration, typically when the franchisor's financial condition and/or years of franchising experience is limited.

Some states may also require that franchise agreements executed within the state be amended to reflect the same disclosures that are included in the state-specific addenda. State-specific amendments that modify the terms of the franchise agreement are typically included in Item 22.

#### **iv. NASAA Closing Addendum**

On September 18, 2022, NASAA adopted a Statement of Policy ("SOP") restricting a franchisor's ability to use a closing addendum – i.e., an acknowledgment and/or compliance questionnaire given to prospective franchisees amid the finalization of the sales process. The SOP went into effect on January 1, 2023, and is summarized in the remainder of this section.<sup>237</sup>

For decades, franchisors have been free to include language in their franchise agreements and/or FDDs that could later be used to disclaim potential liability to franchisees alleging that fraud or other misrepresentations were made during the sales process. This typically occurs immediately prior to the execution of the franchise agreement, at which point the potential franchisee would be provided a list of questions and/or acknowledgements regarding what occurred or did not occur during the sales process.

These closing addenda often include questions or statements regarding whether a prospective franchisee received any financial performance information outside of or different from the franchisor's Item 19 disclosures, as well as other representations regarding a prospective franchisee's understanding of the franchise business and its due diligence. For instance, virtually all closing addenda contain, among other acknowledgements, some variation of the following:

- Except as contained in Item 19 of the FDD, I have not been given by [Franchisor] or by any of its employees, agents or representatives, and I have not relied upon, any oral or written statement or promises, representations or assurances or any actual, projected or

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<sup>237</sup> See <https://www.nasaa.org/wp-content/uploads/2022/11/sop-franchise-questionnaires.pdf>

pro-forma sales, profits, earnings or break-even point for this franchise or any other franchise(s).

- I/We have conducted an independent investigation of this franchise opportunity and the merits and risks of owning and operating a franchise.

In adopting the SOP, NASAA acknowledged that by the time a prospective franchisee receives a Closing Addendum, he or she is already emotionally and financially invested in buying the franchise.

The Franchise Rule includes a limited ban on disclaimers made in the FDD and its exhibits or attachments, but the Franchise Rule does not specifically address a franchisor's use of closing addenda and has yet to address whether closing addenda violate the ban on disclaimers.

There are several key parts of the SOP. First, it requires that a copy or script of any closing addenda be attached as an exhibit to the FDD and specifically referenced in Item 22.

Second, the SOP prohibits the use of closing addenda that requires prospective franchisees to make or agree to any statement that: (1) would cause a reasonable prospective franchisee to surrender or believe they have surrendered rights to which they are entitled under the law; (2) would have the effect of shifting the franchisor's disclosure duties under the law to the prospective franchisee; or (3) are otherwise prohibited under the SOP or that are similar to the prohibited statements.

Third, NASAA enumerates a non-exhaustive list of the kind of questions and acknowledgments that are prohibited, including the following:

- That the prospective franchisee has read or understands the FDD or any attachments thereto, including the franchise or other agreement.
- That the prospective franchisee is qualified or suited to own and operate the franchise.
- That neither the franchisor nor the franchise seller has made any representation, including any financial performance representation, outside of or different from the FDD and attachments thereto.
- That the success or failure of the franchise is dependent solely or primarily on Franchisee.

- That the Franchisor bears no liability or responsibility for Franchisee's success or failure.

Finally, the SOP requires that if the franchisor uses a questionnaire or acknowledgement, the franchisor must include a specific provision in its FDD, franchise agreement, or applicable state-specific addenda that such a questionnaire or acknowledgement is not effective to waive claims under any applicable state franchise law, or to disclaim reliance on any statement made by the franchisor, franchise seller, or other person acting on behalf of the franchisor.

## **D. In-House Tips and Best Practices**

### **i. Company involvement and responsibility**

While the FDD is a legal document, its creation requires input from virtually every department in the franchise organization. To facilitate the creation or renewal of an FDD, in-house attorneys must have a strong appreciation of not only the legal requirements for preparing a FDD but a deep understanding of the franchisor and franchised business operations. Counsel cannot prepare the FDD in isolation. Understanding which business units own or can help provide FDD disclosure information, and which departments have the vendor relationships necessary to fulfill disclosure obligations is critical. Accordingly, in-house attorneys who are responsible for drafting and/or renewing the FDD need to understand more than just the laws pertaining to franchise sales. To facilitate the creation of an accurate FDD, and efficient FDD process, in-house attorneys also need to understand the business and the corporate structure of the franchised company.

### **ii. Tips for gathering information**

Whether an attorney is renewing the FDD or building it out for the first time, working with other departments across the organization is critical. A good first step is to identify which business units have responsibility for, or input in, each piece of information that must be included in the FDD. After making that determination, in-house counsel can provide each business unit with their own copy of the current FDD, assuming one exists, highlighting the information for which each business unit is responsible.

Counsel should ask each business unit for information related to any new fees, changes in fees, new programs, and copies of any new or existing contracts franchisees are required to sign. Each department should also consider, and provide, any information, whether new or old, that is not yet disclosed in the FDD, but may be of interest to a prospective franchisee. While it is incumbent on each business unit to ensure the accuracy of their own information, counsel must review

the information carefully and follow up with any inconsistencies or clarifications, as needed.

As summarized further in Section II.B above, Items 2, 3 and 4 of the FDD require specific disclosures relating to certain of the franchisor's internal business personnel. To ensure the disclosures contained in Items 2, 3 and 4 are accurate and up to date, best practice includes circulating a questionnaire to all the individuals who will be disclosed in Item 2. The questionnaire should contain specific questions related to anything that may need to be disclosed in Items 2, 3 and 4 of the FDD. A sample questionnaire to aid in the collection of this information is attached as Exhibit F.

Finally, and since they typically spend the most time with prospective franchisees, it is recommended that in-house counsel work closely with the development team to obtain updates and information for the FDD. Understanding what information in the FDD generates the most questions from prospective franchisees is important, and getting feedback from the development team on potential clarifications or rephrasing can go a long way in ensuring the final document is clear, accurate, and easy for a potential franchisee to understand.

### **iii. Reverse disclosures**

After assigning each part of the FDD to the appropriate business unit, it should become apparent that there are significant portions of the FDD that do not necessarily require new or updated information and, thus, do not get assigned to another business unit to review (significant portions of Item 1, for instance). It is then incumbent on the legal department to review that information to ensure a complete and thorough review of the entire document every year.

### **iv. Remember disclosure timing**

Section VI.B below outlines the annual federal and state franchise renewal requirements. To ensure a smooth and efficient renewal process, in-house counsel should identify a target issuance date and work backwards to set internal deadlines. Key deadlines to consider include: (1) release of the audited (or unaudited) financial statements, (2) providing sufficient time for auditor review of the FDD, (3) final executive review, and (4) any franchisee association review period.

In practice the FDD needs to be complete, or substantially complete, weeks before the actual filing deadline. Fortunately, and aside from the few disclosures requiring precise fiscal year end data, the information required for a substantial number of the updated disclosure items are often known well in advance of the fiscal year end, and the updating process can begin prior to the fiscal year end.

When creating the timeline for the FDD also remember to account for an inevitable “blackout period” and communicate this timing to your development team. Because of the minimum required waiting period between initial disclosure and execution of the franchise agreement, it is important to account for and communicate to all necessary business units, the potential blackout period to manage expectations with prospective franchisees and business units.

Once the FDD has been updated and filed with the necessary states, it is important to have a good process for tracking any state registrations that remain pending and regularly communicating registration status to the franchise sellers. A good practice here is to keep an updated list of “hold states,” where the approval process is still pending, and “go states,” where registration is either not required or already effective. Every time a state moves from the “hold” list to the “go” list, an announcement should be made to all franchise sellers within the company, and the list should be updated to reflect the change.

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

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

##### **i. Electronic filing**

In the past, a franchisor was required to submit its franchise registration application via hard copy. Today, many states require the filing to be submitted online via the Electronic Filing Depository (EFD), a website developed by NASAA. The EFD allows the electronic filing of certain states securities filing material. The site also has search capabilities allowing individuals to search certain filings that have been made with state securities regulators.

##### **ii. State filing forms**

Registration states have different requirements as it relates to the required registration materials submitted by the franchisor. Specifically, states can require various forms in accordance with NASAA and state law. These forms can include: (i) a franchise registration application facing page which includes basic information and specifies the type of filing; (ii) a certification page certifying the information is true and accurate; (iii) a consent to service of process authorizing a state agency to provide service with franchise issues; (iv) franchise seller disclosure forms which provide information about the individuals who will offer and sell franchises on franchisor’s behalf; (v) franchisor’s costs and source of funds which provides an estimate of the cost to open each franchised location; and (vi) an auditor’s consent letter allowing franchisor to include the audited financial statements in the FDD. In addition, some states may require the franchisor to submit information regarding

sales activity during the last fiscal year, certification that all applicable taxes have been paid, or registration for franchise sellers.

### **iii. Maintaining and tracking state registration**

In addition, it is important to keep an updated record of a franchisor's status in each registration state. This includes recording the effective and expiration dates so that franchise sellers know whether they can offer or sell franchises to prospective franchisees in a certain state. Such a record can also be helpful in remembering required financial assurance conditions or if a state specific FDD is to be used in that state. A sample state tracking form is attached at Exhibit G.

## **B. State Examiner Review Process**

Once a franchise registration application is submitted and received by the state franchise regulators, it is assigned to a franchise examiner who is responsible for reviewing franchise and securities registration applications. Once the franchise examiner is assigned an application, all subsequent filings by the franchisor typically will also be assigned to that same examiner. The franchise examiner will review the registration application and then will either issue an order of effectiveness or prepare a comment or deficiency letter describing the deficiencies that must be addressed. If franchisor receives a "comment letter," franchisor must respond by either providing clarification, making corrections, or providing additional information. The comments provided by state examiners generally relate to failures to comply with applicable disclosure requirements but can also be the result of a failure to submit required documents such as the correct financial statements. It is important to note that each state implements a varying degree of review as it pertains to franchise disclosure documents. Some states may review the registration application checking only that the required documentation has been included while other states conduct a more thorough review of the disclosure document itself for compliance with federal and state franchise law.

There are several states, commonly referred to as "notice filing" states, in which the registration will be made effective immediately upon franchisor's submission of the application. The notice filing states include Indiana, Michigan, South Dakota, and Wisconsin. Although these "notice" states may conduct a review of the application materials, there is generally a very limited review or no review of the FDD itself. In addition, there are business opportunity laws in certain states that allow franchisors to obtain an exemption in that state by submitting a notice filing confirming the franchisor's compliance with the Franchise Rule, and providing a fee (if applicable). The business opportunity states include Florida, Kentucky, Nebraska, Texas, and Utah. In Kentucky, Nebraska, and Texas, only a one-time filing is required while Florida and Utah require an annual renewal of the exemption.

In so called “registration states,” a franchisor must receive an approval or order of effectiveness prior to offering or selling in that state. Registration states include California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia, and Washington. Examiners in these states will conduct a full review of all materials submitted in conjunction with the registration application. As mentioned above, if any deficiencies are found, the state examiner will issue a comment letter stating the deficiencies that must be addressed prior to franchisor being issued an order of effectiveness. If the deficiencies are not properly addressed in franchisor’s response to the comment letter, the state examiner may issue subsequent comments letters until franchisor has adequately addressed all of the state examiner’s comments.

#### **IV. Franchise Disclosure Requirements**

##### **A. FDD Timing and Delivery Requirements**

###### **i. FTC Requirements**

Under the Franchise Rule, a franchisor is required to furnish its FDD to a prospective franchisee “at least 14 calendar-days” prior to executing the franchise agreement or accepting any sort of compensation from the franchisee (including a deposit).<sup>238</sup> The fourteen day period does not include the day the FDD is received by the prospective franchisee or the date the franchise agreement is actually executed – accordingly, the wait time may be more accurately stated as a 16 day period.

In the event the franchisor unilaterally makes a material change to the franchise agreement attached to the FDD during the 14-day waiting period, or specifies material terms in the franchise agreement (e.g., identifies the territory), the franchisor must provide the prospective franchisee with the ready-to-execute version of the franchise agreement at least seven calendar days before the franchisee can sign the franchise agreement. The additional 7-day waiting period does not apply in the event of a franchisee-initiated change.

###### **ii. State Requirements**

There are a handful of states that impose timing requirements that differ from what is prescribed in the Franchise Rule: Connecticut, Iowa, Michigan, and New York. Prior to a franchise sale, Connecticut and Michigan require franchisors to provide the disclosure document to prospective franchisees at least 10 business days before executing the franchise agreement or paying consideration to the franchisor or an affiliate.<sup>239</sup> New York requires franchisors to provide the disclosure

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<sup>238</sup> 16 C.F.R. § 436.2(a)

<sup>239</sup> Conn. Gen. Statutes, § 36B-63(a); Mich. Comp. Laws Ann. §445.1508.

document to prospective franchisees at the earlier of the first personal meeting or 10 business days before executing the franchise agreement or paying consideration to the franchisor or an affiliate.<sup>240</sup> Iowa requires franchisors to provide the disclosure document to prospective franchisees at the earlier of the first personal meeting or 14 days before executing the franchise agreement or paying consideration to the franchisor or an affiliate.<sup>241</sup>

Franchisors need to comply with whichever wait period is longer between the Franchise Rule or the applicable state waiting period.

## **B. Disclosure Compliance**

### **i. Yearly training**

Shortly after filing the FDD, it is recommended that legal counsel provide a training to all employees involved in the franchise sales process to review the relevant changes to the FDD and review state and federal laws governing the franchise sales process. Further, continuing education on the definition of a “financial performance representation” and the importance of understanding what is actually disclosed in Item 19, if anything, is strongly recommended.

In addition to the fact that it is beneficial to maintain a well-trained sales staff from a liability standpoint, the frequency in which a franchisor conducts compliance training is often one of the first items of due diligence during a merger or acquisition of the franchisor. Whether a franchisor conducts legal training shortly after the issuance or renewal of the FDD each year is a frequent consideration for M&A transactions.

### **ii. Navigating jurisdictional requirements**

Different states have different definitions as to whether a franchisee is “located” within the state, and, thus, whether the FDD needs to be filed or registered within the state. It is common for the laws of multiple states to apply to a single offer or sale of a franchise. Although the laws differ from state to state, the events listed below are commonly considered key factors in making this determination:

- If meetings between the franchisor and prospective franchisee at which the parties have substantive communications about the franchise opportunity occurred within the state.

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<sup>240</sup> N.Y. Gen. Bus. Law § 683(8)(a).

<sup>241</sup> Iowa Code Ann. § 551A.4.

- If the offer to sell a franchise originates in the state (e.g., from the franchisor's headquarters in the state).
- If 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.
- If the prospective franchisee accepts the offer to buy the franchise in the state.
- If the offer or sale is made to a franchisee who is *domiciled* in the state and/or whether the potential franchisees will operate the franchised business in the state.
- If the offer or sale is made to a franchisee who *resides* in the state and/or whether the potential franchisees will operate the franchised business in the state.
- If the franchised business will be operated in the state or if any portion of the franchise territory is in the state.
- If the franchise contemplates or requires the franchisee to establish or maintain a place of business in the state.

In addition to complying with the state-specific disclosure requirements, a franchisor must be careful to conduct its sales activities in a manner that does not inadvertently cause state franchise laws to apply in a state where the franchisor is not registered. Given the wide variance between different state laws, and the severity of the consequences for failing to comply with them, it is important to have a plan for navigating jurisdictional requirements. Franchisors are well-served by taking a conservative approach to these jurisdictional issues by registering in all states, and adhering to all state laws that could potentially apply to a potential franchisee.

## **V. Navigating Franchise Exemptions**

If a business relationship meets the elements of a franchise under applicable law, franchisors must provide disclosure pursuant to the Franchise Rule and otherwise comply with the state and federal laws describe above in Section II.A and II.B, unless exemptions to these laws apply. Because the Franchise Rule requires disclosure only (and not federal registration), an exemption from the Franchise Rule eliminates the requirement for pre-sale disclosure of the FDD. Exemptions available under federal law differ from those available under various state laws, and exemptions available in one state may not exist in another. Because the Registration States require both disclosure and registration, it is

important to understand the scope of the different franchise state law exemptions – specifically, whether the exemption eliminates the requirement for both state franchise registration and disclosure, or just one of these requirements. Anytime a franchisor wishes to rely on exemptions from franchise laws, a complete analysis of the facts and circumstances must be conducted at both the state level and federal level to determine if any exemptions apply.<sup>242</sup>

## **A. Federal Exemptions**

As noted above, the Franchise Rule is a disclosure rule (there is no registration requirement at the federal level). This means that any applicable federal exemption eliminates the requirement for a franchisor to provide an FDD prior to a franchise sale. Below we provide a summary of commonly used federal exemptions from the Franchise Rule.

### **i. Fractional Franchise Exemption**

A “fractional franchise” often arises under certain circumstances when an existing business adds the offering of a new product or service at the existing business and meets two criteria: (1) the franchisee must have more than two years of experience in the same type of business as the additional franchise being offered or sold; and (2) there is a reasonable basis for the parties to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee’s total dollar sales volume during the first year of operation.<sup>243</sup>

The experience element can be satisfied by any of the current directors or officers of the franchisor, its parent, or its affiliate. The term “same type of business” means that which sells competitive goods or one that would ordinarily be expected to sell the type of goods to be offered by the franchised business. Some examples are an ice cream store that wants to start selling franchised ice cream cake or a café that wants to start selling a certain type of franchised coffee. To confirm the second element of the exemption applies, an analysis must be conducted to determine the sales attributable to the new product or service in proportion to the franchisee’s total sales volume. When considering the “total sales volume,” sales from all similar businesses owned and operated by the franchisee can be included.<sup>244</sup>

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<sup>242</sup> For a comprehensive explanation of exemptions and exclusions, see *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws*, (Leslie D. Curran and Beata Krakus, eds., 2017).

<sup>243</sup> 16 C.F.R. § 436.8(a)(2); 16 C.F.R. § 436.1(g); Compliance Guide at 7.

<sup>244</sup> Compliance Guide at 8-9.

## **ii. Minimum Payment Exemption**

The minimum payment exemption applies if the total required payment made by the franchisee “from any time before to within the first six months” after the franchisee commences business operations is less than \$615.<sup>245</sup> “A franchisee commences operation when it first makes goods or services available for sale.”<sup>246</sup> The \$615 threshold, and all other monetary thresholds related to exemptions can be adjusted every four years due to inflation, based on the U.S. Department of Labor’s Consumer Price Index.<sup>247</sup>

## **iii. Large Franchisee Exemption**

The large franchisee exemption applies if a franchisee has a net worth at least \$6,165,500 and at least five years of business experience in the same or similar industry as the franchised business.<sup>248</sup> The net worth and experience of the franchisee’s affiliates and parents can be used to meet these criteria.<sup>249</sup> The net worth threshold can be adjusted every four years due to inflation.<sup>250</sup>

## **iv. Large Investment Exemption**

The large investment exemption applies if (1) a franchisee is required to make an initial investment that equals or exceeds \$1,233,000 (excluding the cost of unimproved land or any financing received from the franchisor or its affiliate), and (2) the prospective franchisee signs a prescribed acknowledgment verifying the amount of the investment.<sup>251</sup> The required acknowledgment to be signed must read as follows:

“The franchise sale is for more than \$1,233,000 – 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>252</sup>

The initial investment is limited to the types of expenses disclosed in Item 7. Future costs incurred during the term of the franchise like royalties fees do not

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<sup>245</sup> 16 CFR 436.2(a)(3)(iii); Compliance Guide at 8.

<sup>246</sup> Compliance Guide at 7.

<sup>247</sup> 16 CFR 436.8(b); Compliance Guide at 7.

<sup>248</sup> 16 C.F.R. § 436.8(a)(5)(ii).

<sup>249</sup> Compliance Guide at 13.

<sup>250</sup> 16 CFR 436.8(b); Compliance Guide at 7.

<sup>251</sup> 16 CFR 436.8(a)(5)(i); Compliance Guide at 10-12.

<sup>252</sup> *Id.*

count towards meeting the investment threshold.<sup>253</sup> The initial investment threshold can be adjusted every four years due to inflation.<sup>254</sup>

## **v. Other Federal Exemptions**

Other exemptions available under the Franchise Rule include: (1) leased departments,<sup>255</sup> (2) insider exemption,<sup>256</sup> (3) franchise relationships covered by the Petroleum Marketing Practice Act,<sup>257</sup> and (4) oral franchises.<sup>258</sup> These exemptions are not as commonly applicable, so a careful legal analysis must be conducted before a franchisor relies on one.

## **B. State Exemptions**

In Registration States, there must be both an applicable federal exemption and a state exemption in order to avoid registration and disclosure requirements for a particular transaction. The types of exemptions available at the state and federal levels differ, and each state's requirements for similar exemptions can vary between states, so careful analysis must be conducted for each state's exemption criteria in every case. Also critical in the analysis is to determine the scope of each state exemption – exemption from registration, exemption from disclosure, or both. Finally, unlike the federal exemptions, which do not require filings, some states require certain filings be made with the state (and sometimes must also be approved by the state) before an exemption can be claimed or relied on.

### **i. Large Franchisor Exemption**

Nine registration states (California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, Virginia and Washington), exempt “large or seasoned franchisors” that meet certain net worth and experience requirements from registration.<sup>259</sup> This exemption does not eliminate the disclosure requirement, so franchisors must still prepare and disclose an FDD when relying on this exemption for a transaction. The exemption criteria vary by state, but generally a franchisor (or a parent entity) must meet certain net worth thresholds (ranging from \$5 million to \$15 million) and have at least 5 years of experience in offering or selling franchises or operating the type of business that is the subject of the franchise.

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<sup>253</sup> Compliance Guide at 10.

<sup>254</sup> 16 CFR 436.8(b); Compliance Guide at 7.

<sup>255</sup> 16 CFR 436.8(a)(3).

<sup>256</sup> 16 CFR 436.8(a)(6).

<sup>257</sup> 16 CFR 436.8(a)(4).

<sup>258</sup> 16 CFR 436.8(a)(7).

<sup>259</sup> Cal. Corp. Code § 31101; Ill. Admin. Code Tit. 14, § 200.202(E); Ind. Code § 23-2-2.5-3(A) - (B); Md. Code Regs. 02.02.08.10(D); N.Y. Gen. Bus. Law § 684(2); N.D. Cent. Code § 51-19-04(1); R.I. Gen. Laws § 19-28.1-6; 21 Va. Admin. Code § 5-110-75(4); Wash. Rev. Code § 19.100.030(4)(B).

Certain states also require that a franchisor have a minimum of 25 franchisees for the entire 5 year period preceding the claim of the exemption.

## **ii. Large Franchisee Exemption**

Five registration states (California, Illinois, Rhode Island, South Dakota, and Washington) have exemptions for “large franchisees” that meet certain net worth and experience.<sup>260</sup> The criteria for this exemption varies by state law but in general, the prospective franchisee (or its parent or affiliate) must have a certain net worth (often this threshold is \$5 million) and the prospective franchisee (or its owners) must have certain experience in operating the same or similar businesses as the subject of the franchise. In California, South Dakota, and Washington this exemption eliminates both the registration and disclosure requirement; but in Illinois and Rhode Island this exemption only eliminates the registration requirement.

## **iii. Fractional Franchise Exemption**

Ten registration states (California, Illinois, Indiana, Michigan, Minnesota, New York, Rhode Island, South Dakota, Virginia, and Wisconsin) have exemptions similar to the federal fractional franchise exemption.<sup>261</sup> The required criteria varies by state but in general (1) the prospective franchisee must have at least two years of experience in the same type of business and (2) the parties reasonably expect that the sales from the fractional franchise will not exceed 20% of the franchisee’s total sales. In all ten states, a fractional franchise is exempt from both registration and disclosure requirements.

## **iv. Other State Exemptions**

Other available state law exemptions to consider are: (1) large investment exemption, (2) insider exemption, (3) institutional franchisee exemption, (4) isolated sale exemption, (5) minimal payment/nominal fee exemption, (6) sale by judicial officer exemption, (7) sale/transfer by existing franchisee exemption, (8) sales to existing franchisee, (9) exemption by order, (10) leased department exemption, (11) securities exemption, (12) out-of-state exemption, and (13) exemption for renewal, extension, amendment, or modification of agreement.

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<sup>260</sup> Cal. Corp. Code § 31106(a)(1) and 31106(b); Cal. Corp.Code §31109; 815 Ill. Comp. Stat. 705/8(a)(2); R.I. Gen. Laws §19-28:1-6(4); S.D. Codified Laws § 37-5B-13(2); Wash. Rev. Code §19.100.030(5).

<sup>261</sup> Cal. Corp. Code § 31108; 815 Ill. Comp. Stat. 705/3; Ind. Code § 23-2-2.5-1(A)(3); Mich. Comp. Laws § 445.1506(1)(H); Minn. Stat. §80c.03(F) and Minn. Stat. § 80c.01, Subdiv. 18; N.Y. Comp. Codes R. & Regs. Tit. 13, § 200.10(2); R.I. Code R. 11-7-2:5; S.D. Codified Laws § 37-5b-12(3); Va. Code § 13.1-559; Wis. Stat. § 553.22.

## **VI. Amending and Renewing Requirements & Best Practices**

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

Within a reasonable time after the close of each quarter of the fiscal year, a franchisor must prepare and include in Item 22 an attachment to its disclosure document to reflect any material changes to the information the document contains.<sup>262</sup> Material changes include such events as the recent filing of a bankruptcy petition or the filing against the franchisor of a legal action that may have a negative effect on its financial condition. Note, however, that several of the disclosure requirements require only annual updating. For example, the franchisor-initiated litigation disclosures in Item 3 need be updated only once a year. Similarly, the statistical information about franchised outlets (such as changes in ownership over the course of a fiscal year) required by Item 20 need be revised on an annual basis, as is the case for the disclosure of trademark-specific franchisee associations.

In addition, any financial information required to be audited need not be re-audited for a quarterly update.<sup>263</sup> If there is a material change affecting previously audited financial information, a franchisor may furnish unaudited information in the quarterly update, provided that franchisor states in the update, in immediate conjunction with the financial information, the fact that the updated financial information has not been audited.<sup>264</sup> Franchisors are always free to update their disclosure documents more frequently than the Franchise Rule requires. For example, if a franchisor furnishes its disclosure document on a website, it could update the disclosure document frequently – e.g., monthly – to ensure accuracy. This is not required, but it is permitted if a franchisor wishes to do so. In addition, franchisors may update more frequently if state law requires it. For example, some state laws require immediate updating when a material change occurs.

### **B. Annual Renewal Requirements**

#### **i. Federal Requirements**

Franchisors must ensure that their disclosure documents are accurate and up to date. To that end, the Franchise Rule imposes three basic requirements: (1) annual updates; (2) quarterly updates; and (3) notification of changes in financial performance information.<sup>265</sup> After the close of each fiscal year, a franchisor must update its disclosure document to ensure that the document is current.<sup>266</sup> These

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<sup>262</sup> 16 C.F.R. §436.7(b).

<sup>263</sup> 16 C.F.R. §436.7(e).

<sup>264</sup> *Id.*

<sup>265</sup> 16 C.F.R. §436.7.

<sup>266</sup> 16 C.F.R. §436.7(a).

annual updates, including updated audited financial information, must be prepared within 120 days of the close of the fiscal year.<sup>267</sup> After the 120-day period, the franchisor may use only the updated disclosure document and no other.<sup>268</sup> Each prospective franchisee should receive, at a minimum, the current basic disclosure document and any prior quarterly updates available when the disclosure is made. For example, a prospective franchise that receives disclosures in August 2023 should receive not only the franchisor's annually updated 2023 disclosure document, but also any quarterly updates for the quarters ending March 31, 2023, and June 30, 2023.

## **ii. State Requirements**

As with the Franchise Rule, franchisors are required to submit a registration renewal application on an annual basis in the registration states. The timing for renewal can vary, but generally must be made within 90 or 120 days of franchisor's fiscal year end or the one-year anniversary of the effective date of the previous registration. The expiration date of the registration will generally be provided to the franchisor in the order of effectiveness. Other registration states require a franchisor to submit its renewal filing a specific amount of time prior to the expiration of its current registration. If a franchisor fails to file a renewal application in accordance with the state's timing requirements, it may result in the franchisor being unable to offer and sell franchises in that state and franchisor having to re-file an initial application. This can also result in a longer review of the franchise disclosure document.

## **iii. Managing the renewal process**

In preparation for updating and renewing the FDD, it is important to begin requesting and gathering information early. It is important to know and understand the deadlines to ensure that the FDD is completed on time. Missing the deadline will result in a violation of federal and state franchise laws and franchisor being unable to offer or sell franchises in that state. An in depth review of the FDD and franchise agreement should be conducted to address current updates to the law, legal issues, and best practices. Such review should include looking at recent court decisions, any changes in federal or state law, and updates regarding the FTC or NASAA. In addition, a franchisor should initiate early communication with its auditor. Many deadlines are missed as the result of late audits. Franchisors not making significant changes to the FDD should still be putting together information in the FDD requiring annual updates. For example, the franchisor will need to update: (1) the number of outlets operated; (2) initial fees paid by franchisee, other fees; (3) trademark information; (4) percentage breakdown of advertising fees; (5)

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<sup>267</sup> *Id.*

<sup>268</sup> *Id.*

annual rebate disclosures, and (6) current and former franchisees. Finally, if the franchisor makes an Item 19 financial performance representation, this should be reviewed and updated for accuracy.

## **VII. Advertising Registration Requirements**

Certain registration states also require franchisors to submit advertising materials that will be used for offering the sale of franchises in that state. These states include California, Maryland, Minnesota, New York, North Dakota, and Washington. Franchisors may be required to include in their advertising such things as the name and address of the person sponsoring the advertisement or making the offer or the registration or file number. After submission to the state of the advertising materials, they will be deemed approved unless franchisor receives a comment letter. Most internet-based franchise offers and sales are exempt from these registration 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.

## **VIII. Conclusion**

The laws and regulations that govern the offer and sale of franchises in the United States, at both the federal and state level, are complex. This paper is intended to provide a high-level overview of these laws and regulations and is not meant to be exhaustive. A franchisor (and its counsel) must understand these laws and regulations and the details of the various aspects of the franchised business to ensure that the franchisor complies with all applicable disclosure and registration requirements.

**Exhibit A**

**Sample Agents for Service of Process**

## LIST OF STATE ADMINISTRATORS

We intend to register this disclosure document as a “franchise” in some or all of the following states, if required by the applicable state laws. If and when we pursue franchise registration (or otherwise comply with the franchise investment laws) in these states, the following are the state administrators responsible for the review, registration, and oversight of franchises in these states:

<p><b>CALIFORNIA</b>          Commissioner of Financial Protection and Innovation          Department of Financial Protection and Innovation          320 West Fourth Street, Suite 750          Los Angeles, California 90013-2344          (213) 576-7500          Toll Free: (866) 275-2677</p>	<p><b>NEW YORK</b>          NYS Department of Law          Investor Protection Bureau          28 Liberty St. 21st Fl          New York, NY 10005          (212) 416-8222</p>
<p><b>HAWAII</b>          Commissioner of Securities          Department of Commerce &amp; Consumer Affairs          Business Registration Division          Securities Compliance Branch          335 Merchant Street, Room 203          Honolulu, Hawaii 96813          (808) 586-2722</p>	<p><b>NORTH DAKOTA</b>          North Dakota Securities Department          State Capitol          Department 414          600 East Boulevard Avenue, Fourteenth Floor          Bismarck, North Dakota 58505-0510          (701) 328-4712</p>
<p><b>ILLINOIS</b>          Illinois Office of the Attorney General          Franchise Bureau          500 South Second Street          Springfield, Illinois 62706          (217) 782-4465</p>	<p><b>RHODE ISLAND</b>          Department of Business Regulation          Securities Division, Building 69, First Floor          John O. Pastore Center          1511 Pontiac Avenue          Cranston, Rhode Island 02920          (401) 462-9527</p>
<p><b>INDIANA</b>          Secretary of State          Franchise Section          302 West Washington, Room E-111          Indianapolis, Indiana 46204          (317) 232-6681</p>	<p><b>SOUTH DAKOTA</b>          Division of Insurance          Securities Regulation          124 South Euclid Avenue, 2<sup>nd</sup> Floor          Pierre, South Dakota 57501          (605) 773-3563</p>
<p><b>MARYLAND</b>          Office of the Attorney General          Securities Division          200 St. Paul Place          Baltimore, Maryland 21202-2020          (410) 576-6360</p>	<p><b>VIRGINIA</b>          State Corporation Commission          Division of Securities and Retail Franchising          1300 East Main Street, 9th Floor          Richmond, Virginia 23219          (804) 371-9051</p>
<p><b>MICHIGAN</b>          Michigan Attorney General's Office          Corporate Oversight Division, Franchise Section          525 West Ottawa Street          G. Mennen Williams Building, 1<sup>st</sup> Floor          Lansing, Michigan 48913          (517) 335-7567</p>	<p><b>WASHINGTON</b>          Department of Financial Institutions          Securities Division – 3<sup>rd</sup> Floor          150 Israel Road, Southwest          Tumwater, Washington 98501          (360) 902-8760</p>
<p><b>MINNESOTA</b>          Minnesota Department of Commerce          85 7<sup>th</sup> Place East, Suite 280          St. Paul, Minnesota 55101          (651) 539-1600</p>	<p><b>WISCONSIN</b>          Division of Securities          4822 Madison Yards Way, North Tower          Madison, Wisconsin 53705          (608) 266-2139</p>

**AGENTS FOR SERVICE OF PROCESS**

We intend to register this disclosure document as a “franchise” in some or all of the following states, if required by the applicable state law. If and when we pursue franchise registration (or otherwise comply with the franchise investment laws) in these states, we will designate the following state offices or officials as our agents for service of process in these states. There may be states in addition to those listed below in which we have appointed an agent for service of process. There may also be additional agents in some of the states listed.

<p><b>CALIFORNIA</b>          Commissioner of Financial Protection and Innovation          Department of Financial Protection and Innovation          320 West Fourth Street, Suite 750          Los Angeles, California 90013-2344          (213) 576-7500          Toll Free: (866) 275-2677</p>	<p><b>NEW YORK</b>          New York Secretary of State          One Commerce Plaza          99 Washington Avenue          Albany, NY 12231          (518) 473-2492</p>
<p><b>HAWAII</b>          Commissioner of Securities          Department of Commerce &amp; Consumer Affairs          Business Registration Division          Securities Compliance Branch          335 Merchant Street, Room 203          Honolulu, Hawaii 96813          (808) 586-2722</p>	<p><b>NORTH DAKOTA</b>          North Dakota Securities Commissioner          State Capitol          Department 414          600 East Boulevard Avenue, Fourteenth Floor          Bismarck, North Dakota 58505-0510          (701) 328-4712</p>
<p><b>ILLINOIS</b>          Illinois Attorney General          500 South Second Street          Springfield, Illinois 62706          (217) 782-4465</p>	<p><b>RHODE ISLAND</b>          Director of Department of Business Regulation          Department of Business Regulation          Securities Division, Building 69, First Floor          John O. Pastore Center          1511 Pontiac Avenue          Cranston, Rhode Island 02920          (401) 462-9527</p>
<p><b>INDIANA</b>          Secretary of State          Franchise Section          302 West Washington, Room E-111          Indianapolis, Indiana 46204          (317) 232-6681</p>	<p><b>SOUTH DAKOTA</b>          Division of Insurance          Director of the Securities Regulation          124 South Euclid Avenue, 2<sup>nd</sup> Floor          Pierre, South Dakota 57501          (605) 773-3563</p>
<p><b>MARYLAND</b>          Maryland Securities Commissioner          200 St. Paul Place          Baltimore, Maryland 21202-2020          (410) 576-6360</p>	<p><b>VIRGINIA</b>          Clerk of the State Corporation Commission          1300 East Main Street, 1<sup>st</sup> Floor          Richmond, Virginia 23219          (804) 371-9733</p>
<p><b>MICHIGAN</b>          Michigan Attorney General's Office          Corporate Oversight Division, Franchise Section          525 West Ottawa Street          G. Mennen Williams Building, 1<sup>st</sup> Floor          Lansing, Michigan 48913          (517) 335-7567</p>	<p><b>WASHINGTON</b>          Director of Department of Financial Institutions          Securities Division – 3<sup>rd</sup> Floor          150 Israel Road, Southwest          Tumwater, Washington 98501          (360) 902-8760</p>
<p><b>MINNESOTA</b>          Commissioner of Commerce          Minnesota Department of Commerce          85 7<sup>th</sup> Place East, Suite 280          St. Paul, Minnesota 55101          (651) 539-1600</p>	<p><b>WISCONSIN</b>          Division of Securities          4822 Madison Yards Way, North Tower          Madison, Wisconsin 53705          (608) 266-2139</p>





## Exhibit D

### Sample Item 9 Table

#### FRANCHISEE'S OBLIGATIONS

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.

Obligation		Section in Agreement	Disclosure Document Item
a.	Site selection and acquisition/lease		
b.	Pre-opening purchases/leases		
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 E

### Sample Item 17 Table

#### 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.

Provision	Section In Franchise Agreement	Summary
a. Length of the franchise term		
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– curable defaults		
h. "Cause" defined – non-curable defaults		
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		
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 F**

**Sample Item 2 Disclosure Questionnaire**

**DUE DILIGENCE QUESTIONNAIRE  
FOR  
[                    ]  
(THE "FRANCHISOR")**

THIS QUESTIONNAIRE IS TO BE COMPLETED BY ALL DIRECTORS, TRUSTEES, GENERAL PARTNERS, AND OFFICERS OF THE FRANCHISOR, AND ANY OTHER INDIVIDUALS WHO WILL HAVE MANAGEMENT RESPONSIBILITY RELATING TO THE SALE OR OPERATION OF FRANCHISES.

**I. GENERAL INFORMATION**

1. Name: \_\_\_\_\_
2. Business Address: \_\_\_\_\_
3. Business Telephone Number: (         ) \_\_\_\_\_
4. Are you completing this as (check all that apply):
  - \_\_\_\_\_ the Franchisor?
  - \_\_\_\_\_ a director of the Franchisor?
  - \_\_\_\_\_ an officer of the Franchisor?
  - \_\_\_\_\_ an executive of the Franchisor with management responsibilities?
  - \_\_\_\_\_ a salesperson employed by the Franchisor?
  - \_\_\_\_\_ a franchise broker of the Franchisor?
  - \_\_\_\_\_ a salesperson employed by the franchise broker?
5. Please provide the following information:
  - a. Current principal occupation or employment by title and description:  
\_\_\_\_\_
  - b. Current Employer: \_\_\_\_\_
  - c. Beginning date (by month and year) of your current position or employment:  
\_\_\_\_\_, \_\_\_\_\_
  - d. Current Employer's address:  
\_\_\_\_\_
  - e. Will you engage in franchise sales for the Franchisor?..... Yes \_\_\_ No \_\_\_
  - f. If the answer to 5(e) is "Yes," will you engage in franchise sales in all states?..... Yes \_\_\_ No \_\_\_

g. If the answer to 5(f) is "No," please list the states in which you will engage in franchise sales for the Franchisor:

\_\_\_\_\_

6. If a corporation will serve as a franchise broker, then each officer and director of that corporation must complete this Questionnaire. In addition, please provide the following for the corporation:

a. State of incorporation: \_\_\_\_\_

b. Date of incorporation: \_\_\_\_\_

7. Please provide the following information for the employment or position which you held immediately preceding your current principal occupation:

a. Employer: \_\_\_\_\_

(1) Principal occupation or employment by title or description:

\_\_\_\_\_

(2) Beginning and ending dates by month and year) of this position or employment:

\_\_\_\_\_, \_\_\_\_\_ to \_\_\_\_\_, \_\_\_\_\_

(3) Previous Employer's address:

\_\_\_\_\_

8. Please provide the following information for each principal occupation which you have held during the preceding five full years, in chronological order:

a. Employer: \_\_\_\_\_

(1) Principal occupation or employment by title or description:

\_\_\_\_\_

(2) Beginning and ending dates by month and year) of this position or employment:

\_\_\_\_\_, \_\_\_\_\_ to \_\_\_\_\_, \_\_\_\_\_

(3) Previous Employer's address:

\_\_\_\_\_

b. Employer: \_\_\_\_\_

(1) Principal occupation or employment by title or description:

\_\_\_\_\_

(2) Beginning and ending dates by month and year) of this position or employment:

\_\_\_\_\_, \_\_\_\_\_ to \_\_\_\_\_, \_\_\_\_\_

(3) Previous Employer's address:

\_\_\_\_\_

c. Employer: \_\_\_\_\_

(1) Principal occupation or employment by title or description:

\_\_\_\_\_

(2) Beginning and ending dates by month and year) of this position or employment:

\_\_\_\_\_, \_\_\_\_\_ to \_\_\_\_\_, \_\_\_\_\_

(3) Previous Employer's address:

\_\_\_\_\_

d. Employer: \_\_\_\_\_

(1) Principal occupation or employment by title or description:

\_\_\_\_\_

(2) Beginning and ending dates by month and year) of this position or employment:

\_\_\_\_\_, \_\_\_\_\_ to \_\_\_\_\_, \_\_\_\_\_

(3) Previous Employer's address:

\_\_\_\_\_

=====

**II. LITIGATION HISTORY**

1. Pending Litigation

- a. Are you, at the present time, a defendant in a pending criminal action? ..... Yes \_\_\_ No \_\_\_
- b. Are you, at the present time, a defendant, or defendant to a counterclaim, in any pending civil matter?..... Yes \_\_\_ No \_\_\_
- c. Are you, at the present time, a party to a pending administrative action?..... Yes \_\_\_ No \_\_\_

2. Do any of the above (under Section II.1) allege a violation of:

- a. Any franchise law? ..... Yes \_\_\_ No \_\_\_
- b. Any antitrust law? ..... Yes \_\_\_ No \_\_\_
- c. Any securities law?..... Yes \_\_\_ No \_\_\_
- d. Unfair or deceptive practices? ..... Yes \_\_\_ No \_\_\_
- e. Fraud? ..... Yes \_\_\_ No \_\_\_
- f. Comparable allegations?..... Yes \_\_\_ No \_\_\_

3. Concluded Litigation

- a. Have you ever been convicted of a felony? ..... Yes \_\_\_ No \_\_\_
- b. Have you ever pleaded nolo contendere to a felony? ..... Yes \_\_\_ No \_\_\_
- c. Within the preceding 10 years, have you:
  - (1) Been convicted of a misdemeanor? ..... Yes \_\_\_ No \_\_\_
  - (2) Pleaded nolo contendere to a misdemeanor? ..... Yes \_\_\_ No \_\_\_
  - (3) Been held liable in a civil action by a final judgment? ..... Yes \_\_\_ No \_\_\_
  - (4) Been the named party or the subject of a complaint? ..... Yes \_\_\_ No \_\_\_
  - (5) Been the subject of other legal proceedings? ..... Yes \_\_\_ No \_\_\_
- d. Did any of the above (under Section II.3.) involve a violation of:
  - (1) Any franchise law? ..... Yes \_\_\_ No \_\_\_
  - (2) Any antitrust law? ..... Yes \_\_\_ No \_\_\_
  - (3) Any securities law? ..... Yes \_\_\_ No \_\_\_
  - (4) Fraud? ..... Yes \_\_\_ No \_\_\_

(5) Unfair or deceptive practices? ..... Yes \_\_\_ No \_\_\_

(6) Comparable allegations? ..... Yes \_\_\_ No \_\_\_

If the answer to any of the questions in 1, 2, or 3 above is "Yes," please provide the following information:

a. Court or arbitration office in which action filed:

\_\_\_\_\_

b. Date of filing: \_\_\_\_\_

c. Docket number: \_\_\_\_\_

d. General nature of claims asserted: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

e. Relationship to defendant or party bringing the action (e.g., former franchisee, supplier, etc.):

\_\_\_\_\_

\_\_\_\_\_

f. For pending actions, describe current status: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

g. For actions no longer pending, please provide the disposition of the case, including the terms of settlement.

\_\_\_\_\_

\_\_\_\_\_

Note: You may be asked to provide copies of the pleadings.

h. Please provide the following information regarding arbitration proceedings which are either pending or have been concluded within the past 10 years:

(1) The number of such pending and/or concluded arbitration proceedings: \_\_\_\_\_

(2) The number of arbitration proceedings initiated by the franchisor: \_\_\_\_\_

(3) The number of arbitration proceedings initiated by franchisees: \_\_\_\_\_

4. Currently Effective Administrative Orders

a. Are you, at the present time:

- (1) Subject to any currently effective injunctive or restrictive order or decree relating to franchises? ..... Yes \_\_\_ No \_\_\_
- (2) Subject to any currently effective injunctive or restrictive order or decree 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? ..... Yes \_\_\_ No \_\_\_
- (3) 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 you from membership in such association or exchange? ..... Yes \_\_\_ No \_\_\_

b. If the answer to any question in Section II.4.a. is "Yes," please provide us with the following

(1) The public agency or court:

\_\_\_\_\_

(2) A summary of the allegations or facts found by the court or agency:

\_\_\_\_\_  
 \_\_\_\_\_

(3) The date of the order or decree: \_\_\_\_\_

(4) Nature, terms and conditions of the order or decree:

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

**III. BANKRUPTCY HISTORY**

1. Within the past 10 years, were you:

a. Adjudged bankrupt? ..... Yes \_\_\_ No \_\_\_

b. Reorganized due to insolvency? ..... Yes \_\_\_ No \_\_\_

c. A principal officer of any company or a general partner in any partnership which was adjudged bankrupt or reorganized due to insolvency during or within one year before or after you held such position?..... Yes \_\_\_ No \_\_\_

2. Are you presently subject to any pending bankruptcy or reorganization proceedings? ..... Yes \_\_\_ No \_\_\_

3. If the answer to III.1. or 2. is "Yes," please provide the following information:

- a. The name of the proceeding: \_\_\_\_\_  
\_\_\_\_\_
- b. Date of filing (if pending): \_\_\_\_\_
- c. Date of judgment (if discharged): \_\_\_\_\_
- d. Court: \_\_\_\_\_
- e. Docket or case number: \_\_\_\_\_
- f. Any other material facts or circumstances: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

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**IV. SUPPLIER INTERESTS**

1. If you are an officer of the Franchisor, do you own an interest in any of the Franchisor's approved suppliers? (See attached list of approved suppliers) ..... Yes \_\_\_ No \_\_\_

PLEASE NOTE: In responding to this question, you may exclude interests which:

- (1) Are held indirectly through a mutual fund, 401(k) plan or similar mechanism by which you do not have the ability to manage the ownership of individual company stock or other interests; or
- (2) Represent fewer than 1,000 units or shares of a supplier entity and less than 1% of the total outstanding equity interest in such supplier.

If yes, please describe:

<u>Name of Supplier</u>	<u>Type of Interest Held</u>

**Exhibit G**

**Sample State Registration Tracking Form**

State	Status	Note	Effective Date	Expires Date	Type of Filing	Addenda**
California						
Connecticut						
Florida						
Hawaii						
Illinois						
Indiana						
Kentucky						
Maryland						
Michigan						
Minnesota						
Nebraska						
New York						
North Dakota						
Rhode Island						
South Dakota						
Texas						
Utah						
Virginia						
Washington						
Wisconsin						

\* FYE – \_\_\_\_\_. In all states not listed, the FDD was effective on \_\_\_\_\_, 2023 and expires on \_\_\_\_\_, 2023. In 2023, in order for \_\_\_\_\_ not to “go dark,” the FDD should be updated by \_\_\_\_\_, 2024.

\*\* Addenda: FDD= Franchise Disclosure Document; DA = Development Rights Agreement; FA = Franchise Agreement

Notes

- 1 This exemption applies as long as the company “substantially complies” with the FTC Rule in each transaction.
- 2 As a condition of franchise registration, \_\_\_\_ [franchisor] \_\_\_\_\_ must defer fees in \_\_\_\_ [state] \_\_\_\_.