

International Franchise Association  
53<sup>rd</sup> Annual Legal Symposium  
May 4-6, 2021  
Virtual

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# Regulatory Update

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# REGULATORY UPDATE<sup>1</sup>

## 1. Introduction

Those of us reading this paper in 2021 need not be reminded of the devastating effect COVID-19 has wrought on the business community. To provide context to this discussion, as well as to provide background for future generations who may not have witnessed it, or may have forgotten, we begin with a brief summary of the COVID-related events that transpired during the first quarter of 2020.

The United States celebrated the start of 2020 with enthusiasm, not knowing that, 10 days before the New Year, China had identified the first cluster of patients with “pneumonia of an unknown cause.” A month later, cases had been reported in Japan, South Korea, and Thailand. On January 21, 2020, the virus had made its way into the United States – Washington state had the first confirmed case, a man in his 30s who had recently traveled to Wuhan, China, developed symptoms. On January 31, 2020, the United States Health and Human Services Secretary declared a public health emergency for the entire United States to aid the nation’s healthcare community in responding to COVID-19.

As the United States was shutting down Mexican and Canadian borders, New York and California were the first states to take action.

On March 16, 2020, Governor Cuomo ordered bars and restaurants to cease operations, except for takeout and delivery,<sup>2</sup> and ordered the closure of all gyms, fitness centers, and movie theaters. On March 18, 2020, Governor Cuomo ordered the closure of all non-essential businesses, and for New Yorkers to refrain from large gatherings and remain indoors.<sup>3</sup> Essential businesses included health care operations, infrastructure, manufacturing, retail (including grocery stores and pharmacies), essential services (including trash collection, mail, and shipping services), news media, financial institutions, providers of basic necessities to economically disadvantaged populations, construction, vendors of services necessary to maintain the safety, sanitation, and essential operations of residences or other essential businesses, vendors that provide essential services such as logistics and technology support, child care services needed to ensure the continuing operation of government agencies and provide for the health, safety and welfare of the

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<sup>1</sup> The views expressed in this paper do not necessarily represent the views of the California Department of Financial Protection and Innovation, the Securities Division of the Maryland Attorney General’s Office, or the North American Securities Administrators Association, Inc.

<sup>2</sup> New York Executive Order 202.3 (available at <https://www.governor.ny.gov/news/no-2023-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency>) (last accessed February 28, 2021).

<sup>3</sup> New York Executive Order 202.6 (available at <https://www.governor.ny.gov/news/no-2026-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency>) (last accessed February 28, 2021).

public. On March 20, 2020, Governor Cuomo ordered the closure of all barbershops, hair salons, tattoo or piercing parlors, and ordered businesses to reduce their in-person workforce at any work locations by 75%.<sup>4</sup>

In California, similar directives were ordered by Governor Newsom. Other states followed, with varying restrictions. Consequently, by the end of March 2020, thousands of bars, restaurants, salons, fitness centers, and retail stores had shuttered across the country, or were operating in severely reduced fashion.

A year later, some forms of these directives are in lingering effect. Over the past 12 months, while government restrictions prevented restaurants, bars, salons, and fitness centers from providing in-person services, franchisors worked on improving and developing alternative channels of delivery. Restaurants and bars focused on technology to accommodate curb-side pick-up and third-party delivery. Schools and gyms focused on ways to deliver services through virtual classrooms and online streaming.

In the midst of all of this change and uncertainty, franchise regulators confronted three challenges: (1) updating their procedures to allow continued franchise registration compliance; (2) providing requested guidance to franchisors and their counsel regarding the current application of existing rules and laws; and (3) considering future regulatory changes that may be necessary to ensure that the objectives of franchise regulation are met. This paper explores key issues in each of these categories. While COVID-19 served as a catalyst for change for some of the topics addressed in this paper and are more fluid as circumstances continue to develop, other issues are long-standing but with new focus.

## **2. Changes to Franchise Registration/Filing Procedures**

### **a. COVID-Related Procedural Changes**

As a result of the COVID-19 pandemic and resulting government restrictions, franchise registration and filing procedures changed in some of the states. Generally, the changes can be summarized as follows:

- Filing deadlines were extended and/or late fees waived;
- Online filings were encouraged, where available;
- Notarization requirements were waived or modified;
- States increased their acceptance of documents signed using e-signature software (such as DocuSign); and
- Email communications replaced paper communications with state franchise examiners.

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<sup>4</sup> New York Executive Order 202.7, *available at* <https://www.governor.ny.gov/news/no-2027-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency> (last accessed February 28, 2021).

While filing deadlines have normalized, many of the other changes are here to stay.

## **b. Electronic Document Repository**

The state-by-state filing challenges presented by the COVID-19 pandemic served to highlight the need for a consistent method for the electronic submission of franchise filings. Luckily, the North American Securities Administrators Association (“NASAA”) had been working on expanding its universal securities filing system to accept franchise filings.

Launched in December 2014 as a tool for facilitating securities registrations and filings, the NASAA Electronic Filing Depository (“EFD”) was developed to allow *securities* filings to be submitted to multiple states at once. On June 10, 2020, NASAA announced that it has expanded its EFD to accept state franchise filings through a Universal Form Type Franchise filing portal. The goal of the new system was to allow franchise filers to:

- Submit multiple state franchise filings in one place;
- Upload multiple documents and select which states will receive each document;
- Submit different applications by state (e.g. initial registration applications, exemptions, renewals, advertising filings, etc.); and
- Make payments in a single transaction for those states that opted to accept payments through the system.

By May 2020, a number of states, including Hawaii, Maryland, Minnesota, North Dakota, Rhode Island, South Dakota, and Virginia, had already agreed to participate in the EFD system and accept filings. However, there were still some limits to the EFD’s utility for franchisors. For example, not all franchise registration states had agreed to participate, and there were some timing challenges. A NASAA press release detailed some of the timing considerations as follows:

The EFD system is now available Monday through Friday (except Federal holidays) from 6:00 a.m. – 11:00 p.m. ET. However, most states have a cut off time for timely filings. For example, Indiana requires that filings be submitted by 5:00 p.m. ET, and what is yet to be resolved is whether Indiana would consider a filing timely if the filing is submitted after 5:00 p.m. ET via the EFD system. Conversely, in Minnesota a filer has until 11:59 p.m. CT for a submission to be considered filed as of that day, but the EFD system will be unavailable after 10:00 p.m. CT. To further complicate things, the EFD system does not account for state holidays. Filers will need to wait for further clarification or proactively reach out to examiners for clarification on these timing issues.

### **c. EFD Expansion to Franchise Filings**

On April 13, 2021, NASAA announced that it had developed, with Software Consulting Service (SCS), a new online Franchise Filing Process designed to simplify filing franchise registrations with participating states. The new Franchise Electronic Depository, nicknamed “FRED,” will replace the Universal Form Type Franchise filing portal and significantly increase the information and review tools available to filers and regulators. FRED will be part of NASAA’s existing EFD and is a sophisticated system with management, compliance, and communication tools that should make the Franchise Filing Process more efficient for participating filers and states. FRED also will include a portal to allow the general public to search and view franchise disclosure documents that participating state franchise administrators have registered in their respective states.

As of this writing, NASAA announced that it expected the new FRED filing platform to launch on April 26, 2021. On April 19, 2021, NASAA and SCS conducted a recorded training session for potential franchise filers to explain the system, functionality, and benefits of filing franchise registrations through FRED.

## **3. New Impact of Existing Regulations**

Although the rules governing financial performance representations, financial statements, and accessibility have not fundamentally changed in the last year, there has been new guidance in these areas that requires new attention from franchisors and their counsel.

### **a. Financial Performance Representations in a Post-COVID World**

During the early part of the pandemic, it was suggested (and hoped) that the effects of COVID-19 caused just a “temporary aberration,” which would not rise to the level of a “material change” for purposes of triggering an amendment to a franchise disclosure document (“FDD”). As the situation persisted, however, it became apparent that the pandemic had altered consumer attitudes and materially changed the way some services are delivered. An historical (pre-COVID) financial performance representation (“FPR”) in the FDD’s Item 19, therefore, was arguably not as relevant to a person purchasing a franchise in a post-COVID environment.

Consequently, in June 2020, in response to multiple industry requests, the NASAA Franchise Project Group issued guidance<sup>5</sup> on how a franchisor can comply with amendment filing requirements and state anti-fraud provisions when making an historic financial performance representation after COVID. According to the guidance, a franchisor should consider:

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<sup>5</sup> <https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf>.

- Whether the franchise business has been significantly impacted by the COVID-19 pandemic;
- The type of data the franchisor includes in the FPR;
- The reasonable inferences a prospective franchisee can draw from the FPR;
- When the franchisor estimates a prospective franchisee can expect to open for business after entering into a franchise agreement;
- Whether and how the franchisor adapts the franchise business to account for current market conditions resulting from the COVID-19 pandemic; and
- Whether and how the franchisor adapts the franchise business to account for future market conditions resulting from the COVID-19 pandemic.

While NASAA has not issued any subsequent guidance in 2021 relating to FPRs impacted by the COVID-19 pandemic, practitioners would be wise to continue to follow the Franchise Project Group's June 2020 guidance in order to satisfy examination requirements and minimize the comment process.

For franchise registrations filed in 2021, examiners will continue to comment on disclaimers that some franchisors include in Item 19. Although there can be a fine line between prohibited disclaimer language and non-prohibited explanatory information, when an FPR includes language that suggests that prospective franchisees cannot rely on the disclosures in Item 19, or that Item 19 may not necessarily reflect the financial performance that the prospective franchisee can expect, examiners will ask that the language be removed. While examiners likely will not object to factual statements in Item 19 that the results stated in an FPR reflect a period of time when outlets were shut down or had reduced operating hours, franchisors should not include additional disclaimer language about the effect of the pandemic.

Examiners also will be skeptical of any FPR made in 2021 that includes financial performance data from 2019 while excluding data from 2020. Some franchisors may choose to omit 2020 performance data if the franchise system has been negatively impacted by the pandemic because they may believe that the financial performance that year is not representative of future results. Omitting that data on that basis, however, conflicts with NASAA's June 2020 guidance. In addition, omitting negative results may expose the franchisor to future claims of misrepresentation or omissions of material facts regarding financial performance. One possible exception to this guidance might be when franchisors have determined that the financial performance reported in 2020 was *better* than in previous years *and* is not likely to be replicated in 2021 and beyond. For example, take-out restaurants and other businesses have thrived during the pandemic compared to other businesses precisely because of pandemic conditions that favored their business models. Those franchisors may consider omitting financial performance data in their FDDs if prospective franchisees cannot reasonably be expected to achieve comparable results. In that event, however, the franchisor should include an explanation in a cover letter to state examiners as part of a registration application with both the reasons for omitting the data and the actual financial data that is omitted.<sup>6</sup>

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<sup>6</sup> Hypotheticals discussed during the presentation are included in Exhibit A.

## **b. Revisiting ASC 606**

### **i. Implementation of ASC 606**

Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, changed the recognition rules for initial franchise fees. Under prior Generally Accepted Accounting Principles (“GAAP”) accounting guidance (codified under ASC 605, *Revenue from Contracts with Customers*), licensing revenue was recognized at the point in time when the customer could start using and benefiting from the licensed intellectual property. With respect to franchising, the rights to a trade name, market area, and proprietary know-how were considered a combined performance obligation, which was satisfied at the point in time that the customer obtained control of the rights. This meant that, generally, the initial franchise fee could be recognized when the franchisor’s performance obligations were completed and the franchisee was open for business.<sup>7</sup>

On May 28, 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. Under the new revenue recognition standard, franchises are considered a license of “symbolic IP,” contemplating performance obligations over the franchise term.<sup>8</sup> Under ASC 606, franchisors may recognize a portion of the initial franchise fee if it relates to distinct pre-opening performance obligations. Otherwise, the entire initial franchise fee must be recognized over the life of the franchise agreement.

Recognizing initial franchise fee revenue now follows a five-step process:

- Step 1 – Identifying the contract with the franchisee
- Step 2 – Identifying the performance obligation in the contract
- Step 3 – Determining the transaction price

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<sup>7</sup> Accounting Standards Update No 952-605, *Revenue from Contracts with Customers (Topic 605)*.

<sup>8</sup> The new guidance was scheduled to take effect, with respect to public entities, for annual reporting periods beginning after December 15, 2016 (including interim reporting periods within that reporting period) and, for nonpublic companies, for annual reporting periods beginning after December 15, 2017, and interim periods with annual periods beginning after December 15, 2018. In April 2014, FASB extended these dates for all entities by one year. In May 2020, FASB delayed the required implementation of ASC for all non-public entities that had not yet issued financial statements reflecting the adoption of ASC 606 to annual reporting periods beginning after December 15, 2019, and interim reporting periods within annual reporting periods beginning after December 15, 2020. As it currently stands, all franchisors must comply with the new revenue recognition standard for fiscal year ending on or after December 15, 2020. See Accounting Standards Update No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, which deferred the original effective date by one year, and Accounting Standards Update No. 2020-05, which deferred the effective date an additional year for nonpublic companies.

- Step 4 – Allocating the transaction price
- Step 5 – Recognizing revenue when or as the franchisor satisfies a performance obligation

When performing Step 2 of the exercise, ASC 606 now requires franchisors to separate those goods and services delivered to a franchisee as part of the franchise from the goods and services that are separate and distinct from the franchise. Delivery of a good or service promised to a customer is “distinct” from the franchise itself, for purposes of ASC 606, if both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

For example, implementing product improvements and marketing campaigns benefit the franchisee, but do not constitute distinct performance obligations because they do not directly transfer goods or services apart from the franchisor’s promise to convey intellectual property rights under the franchise agreement and because they directly affect the value of the franchise. On the other hand, the promise to sell equipment to the franchisee is distinct from the promise to grant the franchise because the franchisee benefits from both promises: the franchisee benefits from the franchise and from delivery of the equipment, and the equipment can either be used in the franchise or sold for material consideration.<sup>9</sup>

## ii. The Practical Expedient

Identifying separate pre-opening performance obligations in a franchise agreement, however, requires a complex analysis and the most conservative approach would most often weigh against early recognition. As a result, full compliance with ASC 606 for a franchisor that did not want to recognize the entire initial franchise fee over the life of the franchise agreement could be complicated and expensive. Fortunately, on February 21, 2021, FASB issued a practical expedient to account for a franchisor’s pre-opening services.<sup>10</sup> According to the practical expedient (which applies only to franchisors that are not public business entities), “when applying the guidance in Topic 606, a franchisor that enters into a franchise agreement may account for the following pre-opening services as distinct from the franchise license:

- Assistance in the selection of a site;

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<sup>9</sup> See ASU 2014-09 (Topic 606), *Revenue from Contracts with Customers*, subparagraphs 606-10-55-376 – 606-10-55-380 (Example 57 – Franchise Rights).

<sup>10</sup> ASU 2021-02 – *Franchisors – Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient*.

- Assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation;
- Training of the franchisee’s personnel or the franchisee;
- Preparation and distribution of manuals and similar materials concerning operations, administration, and record keeping;
- Bookkeeping, information technology, and advisory services, including setting up the franchisee’s records and advising the franchisee about income, real estate, and other taxes or about regulations affecting the franchisee’s business; and
- Inspection, testing, and other quality control programs.

Thus, non-public franchisors may allocate a portion of the initial franchise fee to each of the pre-opening obligations listed above, enabling them to recognize a significant portion of the initial franchise fee by the time the franchised business opens for business. The process still requires determination of the transaction price (i.e., the fair value of performance of the separate obligation).

### **iii. Method of Adoption**

When transitioning to the new recognition standard, Topic 606 requires retrospective application, and a franchisor may choose whether to use the full retrospective approach or the modified retrospective approach. Under the full retrospective approach, a franchisor’s revenue and expenses will be recast for all periods reported. Under the modified retrospective approach, the prior years’ data is not recast. Instead, there is a single adjustment made (usually in retained earnings) at the beginning of the initial year of application. On account of simplicity, franchisors generally favor the modified retrospective approach.

### **iv. Disclosure Requirements**

The new revenue recognition standard requires franchisors to disclose, in the period of adoption, adoption of ACS and the method used for retrospective application (i.e., full retrospective or modified retrospective),<sup>11</sup> and the use of any practical expedients, including the newly issued practical expedient for franchisors.<sup>12</sup>

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<sup>11</sup> In addition to accounting requirements, ASC 606 also imposes certain disclosure requirements “that enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.” See ASU 2014-09, *Revenue from Contracts with Customers*, Subparagraph 606-10-50 *et seq.* (Disclosure).

<sup>12</sup> See ASU 2021-02 – *Franchisors – Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient* subparagraph 952-606-50-2 (if an entity elects to use the practical expedient ..., the entity shall disclose that fact).

The franchisor or franchisor’s counsel should read the auditor’s notes and double check that the auditor included a note about Topic 606 that includes the method of adoption, any catch-up adjustments which should be presented in a table format and an analysis that includes the five steps to revenue recognition and whether the practical expedient was relied upon. Franchisors should also ensure that unrecognized initial fees are separated into current deferred revenue (revenue due to be recognized within the next year) and long-term deferred revenue (revenue to be recognized thereafter). Commonly, regulators will issue comment letters when the auditor makes a conclusory disclosure without showing the Topic 606 analysis, when the auditor uses GAAP Legacy language as that indicates the auditor is not familiar with Topic 606, or when the auditor fails to separate current and long-term deferred revenue. The Topic 606 disclosures should be detailed and demonstrate both an understanding of and compliance with Topic 606.

### **c. ADA Compliance**

For many years, several states have facilitated franchise registrations/filings through web-based portals. A few states also grant public access to the portals, allowing users to view and download the filings, which include franchise disclosure documents submitted for registration. The granting of public access to these documents has raised issues regarding the accessibility of the information to persons with disabilities.

#### **i. Background of the ADA’s Application to Websites**

Title II of the Americans with Disabilities Act (“ADA”) prohibits discrimination on the basis of disability in all services, programs, and activities provided to the public by state and local governments, except public transportation services. Federal agencies, government contractors, and programs that receive federal funding are also subject to Section 504 and Section 508 of the Rehabilitation Act of 1973. In addition, the ADA covers any business that regularly serves the public and employs 15 or more people for at least 20 or more calendar weeks in the year. Private clubs, federally-recognized Native American tribes or religious organizations are considered exempt.

In June 2003, the Department of Justice (“DOJ”) announced its position that the ADA (and, if a government entity receives federal funding, the Rehabilitation Act of 1973) generally requires that “State and local governments provide qualified individuals with disabilities equal access to their programs, services, or activities, unless doing so would fundamentally alter the nature of their programs, services, or activities or would impose an undue burden.”<sup>13</sup>

According to the DOJ’s publication, “[o]ne way to help meet these requirements is to ensure that government websites have accessible features for people with disabilities,

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<sup>13</sup> See U.S. Department of Justice, Civil Rights Division, Accessibility of State and Local Government Websites to People with Disabilities (June 2003), available at [https://www.ada.gov/websites2\\_scrn.pdf](https://www.ada.gov/websites2_scrn.pdf) (last accessed April 11, 2021).

using the simple steps described in this document.” Accessible features, at that time, included use of alt tags or long descriptions of images and graphics.<sup>14</sup> A more comprehensive resource “is the Web Content Accessibility Guidelines developed by the Web Accessibility Initiative (WCAG).”<sup>15</sup>

In its 2010 Advanced Notice of Proposed Rulemaking for websites, the DOJ identified the WCAG, and specifically sought comment as to whether the DOJ should adopt WCAG 2.0 (the most recent and updated version of the WCAG, published on December 2008) as its standard for website accessibility for entities covered by titles II and III of the ADA.<sup>16,17</sup>

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<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> 75 FR 43460-43467 (July 26, 2010).

<sup>17</sup> According to the Notice of Proposed Rulemaking, “the WCAG.20 contains 12 guidelines addressing Web accessibility. Each guideline contains testable criteria for objectively determining if Web content satisfies the guideline. In order for a Web page to conform to the WCAG 2.0, the Web page must satisfy the criteria for all 12 guidelines under one of three conformance levels: A, AA, or AAA. The three levels of conformance indicate a measure of accessibility and feasibility. Level A, which is the minimum level of conformance for access, contains criteria that provide basic Web accessibility and that are most feasible for Web content developers. Level AA, which is the intermediate level for access, contains enhanced criteria that provide more comprehensive Web accessibility and yet are still feasible for Web content developers. Level AAA, which is the maximum level of access, contains criteria that may be less feasible for Web content developers. In fact, WAI does not recommend that Level AAA conformance be required as a general policy for entire Web sites because it is not possible to satisfy all Level AAA criteria for some content.”

Although the DOJ never issued final regulations, up until 2017, a number of DOJ settlements and court filings referenced WCAG 2.0 Level AA standards as the applicable legal compliance standard.<sup>18</sup>

On September 25, 2018, in response to a letter sent by a group of 103 members of the House of Representatives, the DOJ reiterated its position that the ADA applies to websites, but it declined to adopt WCAG 2.0 as the legal standard in the absence of regulations. According to the letter:

Absent the adoption of specific technical requirements for websites through rulemaking, public accommodations have flexibility in how to comply with the ADA's general requirements of nondiscrimination and effective communication. **Accordingly, noncompliance with a voluntary technical standard for website accessibility does not necessarily indicate noncompliance with the ADA.**

(emphasis added).<sup>19</sup>

Meanwhile, the courts continue to consistently hold that websites must be accessible even though the ADA does not specify a particular set of standards to measure compliance. The *Domino's Pizza* case is a reminder that a court can order compliance

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<sup>18</sup> See, for example, Settlement Agreement between the United States of America and The Newseum, Inc. under Title III of the Americans with Disability Act (requiring that Newsom “ensure that the visual and audio contents of its website conform to the Level A and Level AA Success Criteria and Conformance Requirements of the WCAG 2.0) (December 6, 2013), available at <https://www.ada.gov/newseum/newseum-sa.htm> (last accessed April 11, 2021); Settlement Agreement between the United States of America and Ahold U.S.A., Inc. and Peapod, LLC under the Americans with Disabilities Act (requiring Peapod to ensure that its mobile applications and website conform to WCAG 2.0) (November 17, 2014), available at <https://www.justice.gov/file/163956/download> (last accessed April 11, 2021); Settlement Agreement between the United States of America and EDX Inc. under the Americans with Disabilities Act (requiring EDX to ensure that its website and mobile applications conform to WCAG 2.0) (April 1, 2015), available at [https://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/02/edx\\_settlement\\_agreement.pdf](https://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/02/edx_settlement_agreement.pdf) (last accessed April 11, 2021); Settlement Agreement between the United States of America and Carnival Corporation (Carnival must conform its mobile applications to WCAG.20) (July 23, 2015), available at [https://www.ada.gov/carnival/carnival\\_sa.html](https://www.ada.gov/carnival/carnival_sa.html) (last accessed April 11, 2021); *The United States of America v. Greyhound Lines, Inc.*, Consent Decree (stating that “for purposes of this Decree, websites and documents will be considered ‘accessible’ if they comply with the Level A and Level AA Success Criteria and Conformance Requirements of the Web Content Accessibility Guidelines 2.0”) (February 10, 2016), available at [https://www.ada.gov/greyhound/greyhound\\_cd.html](https://www.ada.gov/greyhound/greyhound_cd.html) (last accessed April 11, 2021).

<sup>19</sup> Letter from U.S. Department of Justice to the Honorable Charles E. Grassley (October 2018) (responding to Senator Grassley’s letter dated September 4, 2018).

with WCAG 2.0 as an equitable remedy if, after discovery, the website and app fail to satisfy the ADA.<sup>20</sup> Liability exists for failure to comply with Section 12182 of the ADA rather than failure to comply WCAG 2.0. This distinction does not shield against lawsuits related to accessibility. Essentially, the only safe harbor for online ADA compliance is WCAG 2.0.

## ii. California's Approach to Accessibility

States and individual businesses have taken various approaches to ensuring accessibility. However, California has been particularly attuned to this issue.

In California, the Department of Financial Protection and Innovation, like other state agencies, must certify that its website is in compliance with the accessibility requirements of California Government Code Section 11546.7, originating from AB 434 (2017-18).<sup>21</sup> While California has made great progress ensuring physical accessibility in providing state services, the state of California recognizes people with disabilities still face barriers in the digital realm. AB 434 recognizes all Californians should be able to navigate state websites to find information, file forms, or apply for services.

One of the most important components of accessibility is ensuring that communication with persons with disabilities is as effective as communications with others. This means that disabled persons visiting the Department's website should not encounter obstacles in accessing non-compliant documents in the DocQNet database. Franchise disclosure documents, therefore, cannot be made available through open, online access unless and until a reader for a visually impaired person can read the document – under WCAG 2.0. guidelines – to ensure effective communications with all persons, regardless of a disability.

More than a decade ago, California became the first state to provide online document access for franchise-related filings. This gave users the ability to search and download, without charge, all franchise disclosure documents registered in the state. In subsequent years, other states – notably Minnesota, Wisconsin, and more recently Indiana – also elected to provide online access to franchise filings or documents.

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<sup>20</sup> *Robles v. Domino's Pizza, LLC*, 913 F.3d 898 (9th Cir. 2019) (reversing district court's grant of summary judgment to Domino's and remanding case).

<sup>21</sup> Assembly Bill No. 434 requires California state agency and entity websites to maintain full accessibility compliance with WCAG 2.0 Level AA success criteria. Each agency must post on the home page of their website a signed certification from the state agency's or state entity's director and chief information officer that they have determined that the website is in compliance with California law and WCAG 2.0, or a subsequent version. CA Gov. Code 11546.7 (2018).

In early 2020, however, California's Department of Financial Protection and Innovation (formerly Department of Business Oversight) announced that it was discontinuing such access, citing accessibility concerns.<sup>22</sup>

This announcement was met with a significant outcry from franchise practitioners, many of whom had come to view the California database as an invaluable resource. As a result of industry feedback, the Department decided not to amend the DocQNet portal and is instead remediating historical documents that will be available online. However, to ensure that it is meeting its accessibility goals, the state will likely require franchisors to file WCAG 2.0 compliant documents online only in the near future. California's decision follows many years of state regulatory and enforcement activity, making clear that ADA requirements apply to website accessibility.

#### **4. Reconsidering Certain Franchise Sales Practices**

##### **a. The Use of Franchise Brokers**

Franchisors, particularly emerging franchisors, may find the use of franchise brokers as an attractive way to grow without the cost of using their own sales team. In addition to avoiding salaries and overhead for an internal sales team, franchisors like the ability to outsource sales services to third parties who often are experienced and can expand the franchisors' geographic reach. Given that most franchise brokers work with multiple brands, and may advertise themselves as helping prospective franchisees find the right fit rather than as representing an individual franchisor, they also have a larger network than an individual franchisor could reach by itself, thus increasing access to potential candidates.

While there may be positive reasons to use a broker, the franchisor loses some control in the sales process when third parties are involved. This can mean candidates

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<sup>22</sup> The state's announcement read as follows:

The Department of Business Oversight is committed to providing a Self-Service Portal that is accessible to all users regardless of physical ability. In furtherance of this goal, the DBO Self-Service Portal will be modified to display search results in an index format only starting June 26, 2020. This means that users will no longer be able to view copies of the actual document. The DBO Self-Service Portal will display search results with the following parameters:

- Date range for searchable public records will be limited to the past 10 years
- Search results will no longer be hyperlinked to viewable documents

If a user wishes to view a copy of a document indexed in the DBO Self-Service Portal, they may submit a Public Records Act request through the Department's website at <https://docqnet.dbo.ca.gov/create-pra/>. Questions about accessibility may be sent to [Webmaster@dbo.ca.gov](mailto:Webmaster@dbo.ca.gov). Any questions or comments about this change may be directed to [ASK.DBO@dbo.ca.gov](mailto:ASK.DBO@dbo.ca.gov).

are not vetted as well as a franchisor itself would do if it was performing the screening. Because brokers typically work for multiple brands, they may not be as robust with their sales efforts as an internal sales force, and they lack the long-term connection to the brand and its culture that an employee may have. Brokers are often paid solely by commissions on initial fees, which means the monetary incentives encourage a higher volume of sales over finding candidates that are most likely to succeed as franchisees. In addition, franchise brokers can make misrepresentations about the franchise to candidates, increasing the likelihood that the franchisor will be held liable for their actions. For franchisees, working with a franchise broker can be helpful because of their potential to introduce them to multiple brands and ability to act as a liaison with the franchisor, but the broker is being paid by the franchisor, not the prospect, for sales so their allegiance may not be aligned with the prospective franchisee.

### **i. Registration of Franchise Brokers**

The amended Federal Trade Commission (“FTC”) Rule, effective in 2008, defines a “franchise seller” as “a person that offers for sale, sells or arrange for the sale of a franchise.”<sup>23</sup> It includes “the franchisor and the franchisor’s employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities.”<sup>24</sup> The FTC Rule does not define “third-party brokers.” However, the Statement of Basis and Purpose,<sup>25</sup> which provides clarification and additional guidance to the FTC Rule, states that the FTC “intends that the term broker in the ‘franchise seller’ definition to mean a person who (1) is under contract with the franchisor relating to the sale of franchises; (2) receives compensation from the franchisor related to the sale of franchises; and (3) arranges franchise sales by assisting prospective franchisees in the sales process.”<sup>26</sup> The Commission specifically rejected the suggestion that the term “broker” was limited to those persons who negotiate contract terms or sign franchise agreements and accept payments on behalf of a franchisor.<sup>27</sup>

New York and Washington require that sales agents/brokers be registered.<sup>28</sup> The California Consumer Financial Protection Law created a Supervision and Registration

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<sup>23</sup> 16 C.F.R. § 436.1(j).

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

<sup>25</sup> 72 Fed. Reg. 15,444, 2007 WL 932206 (March 30, 2007).

<sup>26</sup> 72 Fed. Reg. at 15460-15462.

<sup>27</sup> 72 Fed. Reg. at 15461.

<sup>28</sup> N.Y. Comp. Codes R. & Regs. Tit. 13 § 200.11 (applies to “franchise sales agents,” who are defined in the New York Franchise Sales Act as “a person who directly or indirectly engages in the offer or sale of any franchise on behalf of another. Franchisors, subfranchisors, and their employees are not to be considered sales agents.” N.Y. Gen. Bus. L. § 681.8); Wash. Rev. Code § 19.100.140 (applies to “franchise brokers,” defined in § 19.100.010(7) as “a person who directly or indirectly engages in the business of the offer or sale of franchises. The term does not include a franchisor, subfranchisor, or their officers, directors, or employees.”).

Office for New Covered Persons.<sup>29</sup> Under this law, franchise brokers are considered new covered persons and will begin registering in California once regulations are promulgated through standard rulemaking procedures. A franchise broker is included in the definition of someone who provides a financial product or service by directly or indirectly brokering the offer or sale of a franchise in this state on behalf of another.<sup>30</sup>

## ii. Enforcement Activity

State regulators have instituted enforcement actions against those who are acting in third-party franchise sales broker roles. In 2014 and 2015, the California Commissioner of the Department of Business Oversight (which changed its name effective September 2020 to the Department of Financial Protection and Innovation), which is responsible for administering and enforcing the California Franchise Investment Law, took action against Christopher Conner and his company, Conner and Associates, LLC d/b/a Franchise Marketing Systems, in connection with their role in selling franchises for two franchisors.<sup>31</sup> The Department issued citations, including desist and refrain orders, assessment of administrative penalties, and an order for recovery of the Department's attorneys' fees. Among other things, the Department alleged that Connor engaged in the offer or sale of unregistered or non-exempt franchises and made false statements, including oral and written financial performance projections that were not disclosed in a franchise disclosure document.<sup>32</sup> He also was not disclosed as a person who would assist the franchisor in offering and selling franchises, as the Department requires, and appeared to outsiders to be an officer or employee of the franchisor, using an email signature that identified him as the franchisor's "Franchise Director."<sup>33</sup> During the midst of the state regulatory action, an Ohio franchisee filed a lawsuit against the franchisor, Conner and his company, alleging violations of the Ohio Business Opportunity Purchasers Protection Act that

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<sup>29</sup> Cal Fin. Code Sec. 90000 *et. seq.* (added by Stat. 2020 ch. 157 (AB 1864), s 7, eff. Jan. 1, 2021).

<sup>30</sup> Cal. Fin. Code Sec. 90005(k)(11).

<sup>31</sup> See *In the Matter of The California Commissioner of Business Oversight v. RedRhino, Inc., Conner and Associates, LLC, d/b/a Franchise Marketing Systems, Michael Kenealy and Christopher Conner*, available at, <https://dfpi.ca.gov/wp-content/uploads/sites/337/2013/08/RedRhino-Inc-Assessment-and-Claim-for-Ancillary-dr.pdf>; *In the Matter of The Commissioner of Business Oversight v. Guanghuo Chen, Tomii Franchising, Inc., Christopher Conner, and Conner and Associates, LLC, d/b/a Franchise Marketing Systems*, available at, <https://dfpi.ca.gov/wp-content/uploads/sites/337/2014/01/Tomii-Franchising-Inc.-Citation-DR-Assessment-and-Claim-for-Ancillary.pdf>; *In the Matter of the Citation against Christopher Conner and Conner and Associates, LLC, d/b/a Franchise Marketing Systems*, available at <https://dfpi.ca.gov/wp-content/uploads/sites/337/2012/03/Conner-Christopher-Stipulation-to-Citation.pdf>.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

related to the Department's citation and forming the basis of fraud and other claims. The parties settled the case and the court dismissed it with prejudice.<sup>34</sup>

Maryland regulators have also taken action against a sales agent. In an October 5, 2020 Summary Order to Cease and Desist, the Securities Commissioner found that broker Dennis Kenneth Mason used an assumed name to sell a franchise in Maryland for a bagel restaurant despite being the subject of a 2015 Final Order of the Securities Commissioner to permanently cease and desist offering or selling franchises in Maryland in violation of the Maryland Franchise Law.<sup>35</sup> Under the 2020 Summary Order, the Securities Commissioner found, among other things, that the broker violated the Maryland Franchise Law by advertising, offering, and selling a franchise to a Maryland resident without registering the franchise or giving the prospective franchise a copy of the Maryland disclosure document, and by making material misrepresentations or omissions of facts. The Securities Commissioner noted that other states had issued enforcement actions against the same bagel restaurant franchisor and the broker, but those enforcement actions were not disclosed to the prospective Maryland franchisee, and neither was the Securities Commissioner's 2015 Final Order.<sup>36</sup>

### **iii. Lawsuits Against Franchise Brokers Directly**

Until 2019, published case law was sparse addressing the issue of whether

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<sup>34</sup> *Zyznar v. Redrhino: The Epoxy Flooring Company, Inc.*, Case No. 4:15-cv-749 (N.D. Ohio).

<sup>35</sup> See

[https://www.marylandattorneygeneral.gov/Securities%20Actions/2020/SMSFranchise\\_summary\\_cd\\_final\\_100520.pdf](https://www.marylandattorneygeneral.gov/Securities%20Actions/2020/SMSFranchise_summary_cd_final_100520.pdf).

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

franchise brokers could be held liable for their involvement in franchise sales.<sup>37</sup> Although franchisees had previously filed lawsuits against franchise brokers and those serving in similar roles,<sup>38</sup> a recent series of cases against one franchise broker firm and its consultants demonstrates the circumstances when franchise brokers and their representatives may be liable under state franchise acts or other state laws, separately and apart from the franchisor.

In 2019, franchisees filed more than a dozen cases in Minnesota (most of them in federal court) against franchise broker FranChoice and individual FranChoice brokers arising from sales of iLoveKickboxing.com (ILKB) franchises, which are fitness facilities

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<sup>37</sup> See, e.g., *Exciting Brand Holdings LLC v. FranChoice, Inc.*, Case No. 1:17-cv-6972-JGK (S.D.N.Y.) (alleging violations of the New York Franchise Sales Act, fraud and negligent misrepresentation) (Order of Discontinuance entered Nov. 1, 2018 due to settlement); *Hanley v. Doctors Exp. Franchising, LLC*, Case No. ELH-12-795, 2013 WL 690521, at \*\*35-36 (D. Md. 2013) (finding franchise broker could be liable under the Maryland Franchise Registration and Disclosure Law as “a person who sells or grants a franchise,” noting legislature’s intent to create a broad scope of liability, and rejecting broker’s argument that its lack of knowledge of the falsity of the representations at issue failed because the burden is shifted under the Maryland act such that a defendant’s lack of scienter is an affirmative defense rather than an element of plaintiff’s claim); *Salkeld v. V.R. Business Brokers*, 548 N.E.2d 1151, 1157, 1159-1160 (Ill. Ct. App. 1989) (affirming directed verdict on common law fraud and Illinois Consumer Fraud Act claims in favor of broker who met with franchisee but finding plaintiff failed to present a *prima facie* case of fraud where there was no evidence broker made any of the alleged misrepresentations and concluding that broker had no independent duty to substantiate the seller’s representations absent evidence that the representations were untrue or that broker had reason to believe they were false, but reversing and remanding on the Illinois Franchise Disclosure Act claim after finding the agreement created a franchise and plaintiff had presented a *prima facie* case), *appeal after remand*, 596 N.E.2d 1325 (Ill. Ct. App. 1992) (reversing and remanding after trial court improperly dismissed broker from Franchise Act claim); *Adams v. North American Business Brokers, Inc.*, 168 Ga. App. 342, 342-344 (Ga. Ct. App. 1983) (affirming judgment in favor of broker and franchisor and finding that although they did assist the franchisee in trying to find a location and builder for his site, the franchise agreement was clear that franchisee bore the risk of finding a location).

<sup>38</sup> See, e.g., *Bower v. Zounds Hearing Franchising, LLC*, Case No. 2:17-cv-728-NVW (D. Ariz.) (naming defendants Frannet LLC and FranChoice, Inc. for their alleged role in the sale of franchises).

dedicated to kickboxing.<sup>39</sup> The cases spawned additional litigation in New York in 2020 and 2021 against FranChoice and/or ILKB. FranChoice is a franchise broker that assists prospective franchisees in identifying, investigating, selecting, and acquiring franchises. It is a corporation formed under the laws of Minnesota, with its principal place of business in Minnesota.

According to the lawsuits' allegations, FranChoice advertised on its website that it directed prospective franchisees to "high quality franchise businesses that match your requirements" and that it would match "entrepreneurs like you with the perfect franchise business." It also stressed that potential franchisees could "avoid the confusion of researching" franchise opportunities and could focus on those franchises that FranChoice had "selected...as franchise businesses matching [their] requirements." FranChoice also represented that "[t]hey will be by your side coaching you and making sure you are getting the information you need in order to make the best decision for you."<sup>40</sup> FranChoice individual brokers allegedly stressed their experience in franchising, that they were franchise experts across multiple industries, that they helped thousands of people achieve their business ownership goals, and that they would "coach" prospects through the "due diligence" process of evaluating the franchise.<sup>41</sup>

Plaintiffs alleged that FranChoice and its brokers made misrepresentations to prospective franchisees to induce them into purchasing franchises, usually multiple locations, in which they invested franchise fees and incurred costs in building out sites, taking out loans and assuming lease obligations. Franchisees alleged that the broker defendants made misrepresentations related to, among other things, financial performance and investment, such as the franchise would be profitable in three to six months, owners could expect to make \$4,000 to \$15,000 a month in net profit, for

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<sup>39</sup> *Dolphin Kickboxing Co. v. FranChoice, Inc.*, Case No. 19-cv-1477 (MJD/ECW) (D. Minn.); *Rise Above Fitness, Inc. v. FranChoice, Inc.*, Case No. 19-cv-1435 (MJD/ECW) (D. Minn.); *Hamilton v. FranChoice, Inc.*, Case No. 19-cv-1426 (MDJ-ECW) (D. Minn.); *Johnson v. FranChoice, Inc.*, Case No. 19-cv-1417 (MJD/ECW) (D. Minn.); *Saders v. FranChoice, Inc.*, Case No. 19-cv-1414 (MJD/ECW) (D. Minn.); *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJC-ECW) (D. Minn.); *ILKB of CNY, LLL v. FranChoice, Inc.*, Case No. 19-cv-1064 (MJD/ECW) (D. Minn.); *Wagner v. FranChoice, Inc.*, Case No. 19-cv-940 (MJD/ECW) (D. Minn.); *JTKB, LLC v. FranChoice, Inc.*, Case No. 19-cv-919 (MJD/ECW) (D. Minn.); *Hasko v. FranChoice, Inc.*, Case No. 19-cv-702 (MJD/ECW) (D. Minn.); *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW) (D. Minn.); *Golden Polar Bear, LLC v. FranChoice, Inc.*, Case No. 19-cv-484 (MJD/ECW) (D. Minn.); *Mount Holly Kickboxing, LLC v. FranChoice, Inc.*, Case No. 19-300 (MJD/ECW) (D. Minn.); *Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.); *Johnson-Delgado v. FranChoice, Inc.*, 27-CV-19-4045 (Hennepin County, Minn. Dist. Ct.).

<sup>40</sup> See, e.g., *Golden Polar Bear, LLC v. FranChoice, Inc.*, Case No. 19-cv-484 (MJD/ECW), 2019 WL 7598650, at \*1 (D. Minn. Dec. 19, 2019).

<sup>41</sup> See, e.g., *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW), at \*1 (D. Minn. Dec. 19, 2019).

\$100,000 in “mailbox money” for a semi-absentee owner, and the total investment to open a unit was \$120,000 to \$309,000. They also alleged that FranChoice made misrepresentations regarding the due diligence that FranChoice performed on the franchisor.<sup>42</sup> Plaintiffs brought a variety of claims, generally based on state unfair and deceptive trade practices acts, common law claims of fraud and negligent misrepresentation, plus claims under the New York Franchise Sales Act and the Minnesota Franchise Act, among other state franchise laws. Defendants denied the allegations, arguing that plaintiffs did not allege that they were in the business of selling franchises or that they sold a franchise – and that it was the franchisor that offered and sold the franchises.<sup>43</sup>

Plaintiffs did not name the franchisor, ILKB, LLC, as a defendant in these cases, apparently because its franchise agreements contained a mandatory arbitration clause.<sup>44</sup> However, at least three of the plaintiffs in the Minnesota cases filed lawsuits against ILKB

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<sup>42</sup> *Id.* at \*2.

<sup>43</sup> See, e.g., *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJD/ECW), 2019 WL 7598656, at \*6 (D. Minn. Dec. 19, 2019),

<sup>44</sup> See December 28, 2020 Letter to United States Magistrate Judge Elizabeth Cowan Wright, District of Minnesota, from Ryan O. Vettleson, Doc. 75, filed in *Golden Polar Bear, LLC v. FranChoice, Inc.*, Case No. 19-cv-484 (D. Minn.) (“As the Court knows, ILKB is not a party to any of these cases; pursuant to their Franchise Agreements, Plaintiffs were required to arbitrate any franchise disputes with the franchise seller, ILKB.”); *Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-CV-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order on Defendants’ Motion for Partial Dismissal at 3) (“The Franchisor is not a party to this suit but, pursuant to the arbitration clauses in the franchise agreements, is evidently a respondent in a separate arbitration proceeding involving the same plaintiffs.”).

in New York federal courts, alleging that ILKB breached the franchise agreement by refusing to pay its allotted arbitration fees, entitling them to proceed with litigation.<sup>45</sup>

The ILKB franchise is a New York limited liability company with its headquarters in the state of New York. In many cases, plaintiffs brought claims against the FranChoice defendants under the New York Franchise Sales Act. The FranChoice defendants argued in some cases that plaintiffs had not alleged that defendants or plaintiffs had any connections with New York or that any of the interactions between plaintiffs and defendants occurred in New York.<sup>46</sup> However, the court found that plaintiffs had alleged that ILKB offered and sold franchises only *in and from* New York, which was sufficient to state a claim under the New York Act even though the franchisor was not a defendant.<sup>47</sup>

For those plaintiffs who asserted claims under the New York Franchise Sales Act, the magistrate judge handling all of the FranChoice federal court cases issued Reports and Recommendations (subsequently adopted by the district court judge) that broadly

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<sup>45</sup> See *Gould v. ILKB LLC*, Case No. 2:20-cv-5154-DRH-ST (E.D.N.Y.); *Johnson v. ILKB LLC*, Case No. 2:20-cv-3901-JMA-AKT (E.D.N.Y.); *Callen v. ILKB LLC*, Case No. 2:20-cv-3345-DRH-ST (E.D.N.Y.). See also *McDowall v. ILKB, LCC and FranChoice, Inc.*, C.A. No. 2:20-cv-4240-JMA-ST (E.D.N.Y.) (alleging violations of New York Franchise Sales Act and common law claims against franchisor and broker and voluntarily dismissing without prejudice on Oct. 13, 2020 after removal from state court); *McDowall v. ILKB LLC*, C.A. No. 2:20-cv-6171-GRB-AKT (E.D.N.Y.) (alleging violation of the New York Franchise Sales Act, breach of contract, common law fraud, and negligent misrepresentation); *Cortina v. FranChoice, Inc.*, C.A. No. 6:21-cv-6195 (W.D.N.Y.) (removed from state court and alleging FranChoice made misrepresentations about ILKB that induced plaintiff to buy a franchise); *West Valley KB Venture, LLC v. ILKB LLC*, Case No. 2:19-cv-702-JS-AYS (E.D.N.Y.) (alleging claims for violation of the New York Franchise Sales Act, common law fraud, negligent misrepresentation and breach of contract); *ILKB, LLC v. Whitworth*, Case No. 1:20-cv-4900-WFK-LB (E.D.N.Y.) (counterclaims for breach of contract, fraud and negligent misrepresentation); *ILKB, LLC v. Singh*, Case No. 1:20-cv-4201-ARB-SJB (E.D.N.Y.) (counterclaims for breach of contract, fraud and negligent misrepresentation).

<sup>46</sup> See, e.g., *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJD/ECW), 2019 WL 7598656, at \*7 (D. Minn. Dec. 19, 2019) (noting that plaintiff alleged that ILKB accepted plaintiff's offer in New York and the communications at issue allegedly induced plaintiff to ultimately make an offer to purchase a franchise in New York).

<sup>47</sup> In one case, the Amended Complaint also alleged that the communications at issue allegedly induced plaintiffs to make an offer to buy a franchise in New York, although the franchise at issue was not in New York. *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW), 2019 WL 7598653 at \*7 (D. Minn. Dec. 19, 2019). See also *Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order at 7-8) (finding allegation that ILKB accepted plaintiffs' offer to purchase ILKB franchise within the state of New York by signing the franchise agreements after plaintiffs had signed them was sufficient to trigger application of the New York Act).

interpreted the New York Act's definition to conclude that the FranChoice defendants were "persons" who had solicited an "offer" to buy a franchise, even though the ultimate transaction involving the sale of the franchise was between the franchisor and plaintiffs.<sup>48</sup> The court found that "the word 'solicit' does not confine itself to a franchisor and the ultimate act of the offer and acceptance, especially here where it is alleged that Defendants had a financial incentive to convince Plaintiffs to purchase an ILKB franchise."<sup>49</sup> Defendants' arguments under the New York Act focused on the fact that a franchise broker unrelated to a franchisor is not enough to establish liability and that the plaintiffs did not allege that they were in the business of selling franchises or that they sold a franchise. The court found that had the New York Legislature only wanted liability to attach to franchisors, it would have defined a "person" under the Act as a Franchisor,

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<sup>48</sup> *Golden Polar Bear, LLC v. Franchoice, Inc.*, Case No. 19-cv-484 (MJD-ECW), 2019 WL 7598650, at \*\*4-7 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264145 (D. Minn. Jan. 17, 2020); *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW), 2019 WL 7598653, at \*\*4-7 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264294 (D. Minn. Jan. 17, 2020); *Hasko v. FranChoice, Inc.*, Case No. 19-cv-702 (MJD/ECW), 2019 WL 7598654, at \*\*4-7 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264262 (D. Minn. Jan. 17, 2020); *ILKB of CNY, LLC v. FranChoice, Inc.*, Case No. 19-cv-1064 (MJD/ECW), Doc. 51 at \*\*8-16 (D. Minn. Dec. 19, 2019), *report and recommendation adopted as modified on other grounds*, 2020 WL 635266 (D. Minn. Feb. 11, 2020); *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJD/ECW), 2019 WL 7598656, at \*\*3-6 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264273 (D. Minn. Jan. 17, 2020); *Johnson v. FranChoice, Inc.*, Case No. 19-cv-1417 (MJD/ECW), 2019 WL 7598623 at \*\*3-6 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264268 (D. Minn. Jan. 17, 2020); *Hamilton v. FranChoice, Inc.*, Case No. 19-cv-1426 (MJD/ECW), 2019 WL 7598651 at \*\*4-6 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264148 (D. Minn. Jan. 17, 2020); *Rise Above Fitness, Inc. v. FranChoice, Inc.*, Case No. 19-cv-1435 (MJD/ECW), 2019 WL 7598652 (Dec. 19, 2019), at \*\*3-6 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 2020 WL 264657 (D. Minn. Jan. 17, 2020); *ILKB of CNY, LLC v. FranChoice, Inc.*, Case No. 19-cv-1064 (MJD/ECW), Doc. 51 at \*\*8-16 (D. Minn. Dec. 19, 2019), *report and recommendation adopted as modified on other grounds*, 2020 WL 635266 (D. Minn. Feb. 11, 2020).

<sup>49</sup> See, e.g., *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW), 2019 WL 7598653, at \*\*5-7 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264294 (D. Minn. Jan. 17, 2020). According to the evidence, ILKB paid FranChoice a referral fee of \$30,000 for a single territory, \$50,000 for three territories, and more for more territories. *Mt. Holly Kickboxing v. FranChoice, Inc.*, Case No. 19-300 (MJD/ECW), 2021 WL 1117968, at \*# (D. Minn. Mar. 24, 2021).

which was defined in the Act. Instead, the Legislature defined “person” expansively. The state court had concluded the same earlier that same month.<sup>50</sup>

On the other hand, the court granted defendants’ motions to dismiss Minnesota Franchise Act claims where there were no plausible factual allegations suggesting the operative solicitations at issue originated from Minnesota.<sup>51</sup> The court refused to interpret the Minnesota Act so broadly that it would apply to a Minnesota company (FranChoice), even through a theory of respondent superior or agency, if none of the illegal acts complained of originated from Minnesota.<sup>52</sup> A Minnesota state court had earlier concluded the same.<sup>53</sup>

Of note for future cases, the court noted that the claims under the Minnesota Franchise Act “would be a closer question if the Complaint alleged that someone from within [FranChoice] in Minnesota directed [the individual broker defendant] to make the specific alleged solicitations to Plaintiffs. However, that is not the case here.”<sup>54</sup> Plaintiffs asked whether, if the court found that the amended complaints did not state a claim under the Minnesota Franchise Act, the court would give them leave to amend on the basis of an independent Consultant Agreement between FranChoice and its consultants providing that a consultant may not sell any franchises of franchisors with which FranChoice has a relationship, such as ILKB, because without FranChoice, the consultant never could have sold an ILKB franchise to plaintiffs. Plaintiffs argued that this agreement meant that the offer “originated” from FranChoice in Minnesota, “whether or not” the consultant was in Minnesota. The court noted that, even if there was such an agreement, it does not mean that the representation originated in Minnesota, as it does not change the fact that it was alleged that the consultant made the operative allegedly fraudulent solicitations at issue from outside of Minnesota.<sup>55</sup>

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<sup>50</sup> *Johnson-Delgado v. FranChoice, Inc.*, Case No. 27-CV-19-4045 (Hennepin County, Minn. Dist. Ct.) (Oct. 18, 2019 Memorandum and Order at 3-7); *Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order at 5-8).

<sup>51</sup> See, e.g., *Hamilton v. FranChoice, Inc.*, Case No. 19-cv-1426 (MDJ/ECW), 2019 WL 7598651, at \*10 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264148 (D. Minn. Jan. 17, 2020).

<sup>52</sup> *Id.* at \*11.

<sup>53</sup> *Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order at 13-17).

<sup>54</sup> See, e.g., *Hamilton v. FranChoice, Inc.*, Case No. 19-cv-1426 (MDJ/ECW), 2019 WL 7598651, at \*10 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264148 (D. Minn. Jan. 17, 2020).

<sup>55</sup> See, e.g., *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJC/ECW), 2019 WL 7598656, at \*13 n.7 (D. Minn. Dec. 19, 2019).

The court also found plaintiffs (depending on their citizenship) stated claims under the Arizona Consumer Fraud Act,<sup>56</sup> the Illinois Franchise Disclosure Act,<sup>57</sup> the Michigan Franchise Investment Law,<sup>58</sup> the New Jersey Consumer Fraud Act (finding a broad definition of “merchandise”),<sup>59</sup> and the Connecticut Business Opportunity Act.<sup>60</sup> Minnesota state courts had earlier concluded that plaintiffs stated claims against FranChoice under the California Franchise Investment Law<sup>61</sup> and the Massachusetts Consumer Protection Act.<sup>62</sup>

The court dismissed a claim under the Mississippi Franchise Law, finding that, based on the statutory language, it only applies to “franchise companies” that enter into

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<sup>56</sup> *Dolphin Kickboxing Co. v. FranChoice, Inc.*, Case No. 19-cv-1477 (MJD/ECW), 2019 WL 7598649 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264657 (D. Minn. Jan. 17, 2020).

<sup>57</sup> *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJC/ECW), 2019 WL 7598656 (D. Minn. Dec. 19, 2019) (finding Iowa plaintiff with Illinois franchise stated claim under Illinois Franchise Disclosure Act because the Act applies to the offer or sale of any franchise by “any person, directly or indirectly”), *report and recommendation adopted*, 2020 WL 264273 (D. Minn. Jan. 17, 2020); *see also Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order at 8).

<sup>58</sup> *Johnson v. FranChoice, Inc.*, Case No. 19-cv-1417 (MJD/ECW), 2019 WL 7598623 (D. Minn. Dec. 19, 2019), *report and recommendation adopted by*, 2020 WL 264268 (D. Minn. Jan. 17, 2020).

<sup>59</sup> *Hasko v. FranChoice, Inc.*, Case No. 19-cv-702 (MJD/ECW), 2019 WL 7598654 (D. Minn. Dec. 19, 2020); *report and recommendation adopted by*, 2020 WL 264262 (D. Minn. Jan. 17, 2020); *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW), 2019 WL 7598653, at \*10 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264294 (D. Minn. Jan. 17, 2020); *Saders v. FranChoice, Inc.*, Case No. 19-cv-1414 (MJD/ECW), 2019 WL 7598665, at \*\*3-7 (Dec. 19, 2019), *report and recommendation adopted*, 2020 WL264326 (Jan. 17, 2020); *see also Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order at 8-13) (finding that defendants’ “matchmaking” services between plaintiffs and franchisor were “merchandise” within meaning of the Act).

<sup>60</sup> *JTKB, LLC v. FranChoice, Inc.*, Case No. 19-cv-919 (MJD/ECW), 2019 WL 7598663 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264261 (D. Minn. Jan. 17, 2020).

<sup>61</sup> *Johnson-Delgado v. FranChoice, Inc.*, Case No. 27-CV-19-4045 (Hennepin County, Minn. Dist. Ct.) (Oct. 18, 2019 Memorandum and Order at 7-9) (finding that restricting the CFIL to franchisors or their direct employees “would allow intervening third parties to engage in the exact conduct the legislature sought to prohibit without subjecting those third parties to consequent liability”).

<sup>62</sup> *Cobalt Franchise Group, Inc. v. FranChoice, Inc.*, Case No. 27-19-11308 (Hennepin County, Minn. Dist. Ct.) (Nov. 12, 2019 Memorandum and Order at 17-19).

franchise agreements.<sup>63</sup> The court also dismissed a claim under the South Carolina Unfair Trade Practices Act, finding that although plaintiff had signed a franchise agreement to open a location in South Carolina, it was a purely private dispute with no harm to the citizens at large as required by case law.<sup>64</sup> The court also dismissed a claim under the Colorado Consumer Protection Act, finding that there were no allegations that the alleged misrepresentations were made to the public at large.<sup>65</sup>

The court later allowed plaintiffs to add a claim for punitive damages based on some allegations that went to the financial viability of the franchise.<sup>66</sup>

As of March and April 2021, the parties have resolved nearly all of the cases in federal court. On March 24, 2021, the court granted summary judgment to FranChoice on all claims. In *Mount Holly Kickboxing, LLC v. FranChoice, Inc.*, Case No. 19-300 (MJD/ECW), 2021 WL 1117968 (D. Minn. Mar. 24, 2021), the court held that all but one of the statements on which plaintiffs based their claims were not actionable, and plaintiff could not establish the element of reasonable reliance for the remaining statement. Plaintiff had asserted claims under the New York Franchise Sales Act, the North Carolina Unfair and Deceptive Trade Practices Act, fraud and negligent misrepresentation. The court concluded that several of the statements that the broker made were puffery or predictions of future events that plaintiff failed to show did not reflect past or present circumstances (such as it would cost \$275,000 to start the franchise), while plaintiff failed to show that other statements were false when made (such as the franchise was suitable for absentee or semi-absentee ownership). For example, as for the alleged misrepresentation that other franchisees made monthly profits ranging from \$10,000 to \$20,000 and the plaintiff should make that much in monthly profit, the court found that the first part of the statement was a statement of fact and the second part was a prediction of future events, but that neither was actionable because plaintiffs failed to point to any evidence that, at the time the statements were made, other franchisees did not make monthly profits ranging from \$10,000 to \$20,000. The only actionable statement was that no ILKB franchises had ever closed, but the court found that plaintiff could not have reasonably relied on the statement because it was contradicted by the FDD.

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<sup>63</sup> *Hamilton v. FranChoice, Inc.*, Case No. 19-cv-1426 (MDJ/ECW), 2019 WL 7598651, at \*\*10-12 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264148 (D. Minn. Jan. 17, 2020).

<sup>64</sup> *Rise Above Fitness, Inc. v. FranChoice, Inc.*, Case No. 19-cv-1435 (MJD/ECW), 2019 WL 7598652, at \*11-14 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 2020 WL 264657 (D. Minn. Jan. 17, 2020).

<sup>65</sup> *Golden Polar Bear, LLC v. Franchoice, Inc.*, Case No. 19-cv-484 (MJD-ECW), 2019 WL 7598650, at \*\*10-13 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264145 (D. Minn. Jan. 17, 2020).

<sup>66</sup> *See, e.g., ILKB of CNY, LLC v. FranChoice, Inc.*, Case No. 19-cv-1064 (MJD/ECW), 2020 WL 2192346 (D. Minn. May 6, 2020).

After the summary judgment ruling, the parties stipulated to dismissal of nine of the other cases, with each party bearing their own costs and attorneys' fees.<sup>67</sup> The court dismissed another case in February 2021 after plaintiff, the sole owner of the franchisee entity, died and no party was substituted as plaintiff.<sup>68</sup> The parties previously entered into a stipulation to dismiss another one.<sup>69</sup> One case remains pending in federal court in Minnesota.<sup>70</sup>

California's Franchise Investment Law ("CFIL") provides franchisees more protection from unscrupulous franchise sellers. In California, it is unlawful for any person to effect or attempt to effect a sale of a franchise unless the franchise seller is identified in a franchise application or is a licensed real estate broker or salesperson or a license broker-dealer or agent.<sup>71</sup> Moreover, the CFIL provides franchisees with civil remedies against any person who offers or sells a franchise in violation of the CFIL disclosure or fraud provisions.<sup>72</sup>

### **b. Use of Franchisee Acknowledgment/Compliance Questionnaires**

One of the more controversial practices in franchising involves the use of franchisee questionnaires which, among other things, protect a franchisor from statements that may have been made outside the four corners of the franchise agreement. For decades, franchisors have relied on contractual exculpatory representations<sup>73</sup> which, coupled with the integration clause, serve to defeat statutory and common law fraud claims.

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<sup>67</sup> *The Orange Rabbit, Inc. v. FranChoice, Inc.*, Case No. 19-cv-687 (MJD/ECW) (D. Minn.); *JTKB, LLC v. FranChoice, Inc.*, Case No. 19-cv-919 (MJD/ECW) (D. Minn.); *Wagner v. FranChoice, Inc.*, Case No. 19-cv-940 (MJD/ECW) (D. Minn.); *Hasko v. FranChoice, Inc.*, Case No. 19-cv-702 (MJD/ECW) (D. Minn.); *ILKB of CNY, LLL v. FranChoice, Inc.*, Case No. 19-cv-1064 (MJD/ECW) (D. Minn.); *Li v. FranChoice, Inc.*, Case No. 19-cv-1267 (MJC-ECW) (D. Minn.); *Saders v. FranChoice, Inc.*, Case No. 19-cv-1414 (MJD/ECW) (D. Minn.); *Johnson v. FranChoice, Inc.*, Case No. 19-cv-1417 (MJD/ECW) (D. Minn.); *Hamilton v. FranChoice, Inc.*, Case No. 19-cv-1426 (MDJ-ECW) (D. Minn.); *Rise Above Fitness, Inc. v. FranChoice, Inc.*, Case No. 19-cv-1435 (MJD/ECW) (D. Minn.).

<sup>68</sup> *Hasko v. FranChoice, Inc.*, Case No. 19-cv-702 (MJD/ECW) (D. Minn.).

<sup>69</sup> *Dolphin Kickboxing Co. v. FranChoice, Inc.*, Case No. 19-cv-1477 (MJD/ECW) (dismissed on Feb. 4, 2021).

<sup>70</sup> *Golden Polar Bear, LLC v. Franchoice, Inc.*, Case No. 19-cv-484 (MJD-ECW).

<sup>71</sup> Cal. Corp § 31210.

<sup>72</sup> Cal. Corp § 31303, 31301, 31302, 31406, 31408.

<sup>73</sup> A typical provision reads as follows: "Franchisee represents and warrants that it did not rely on, and Franchisor and Franchisor's representatives have not made, any promises, representations, warranties or agreements relating to franchising the System, except as expressly contained in this Agreement and in the Franchise Disclosure Document."

While the practice may succeed in defeating common law fraud claims (either by triggering application of the parol evidence rule and barring introduction of outside testimony or by negating the “reasonable reliance” element of common law fraud), state franchise laws are remedial in nature, designed to “favor franchisees over franchisors.”<sup>74</sup> Thus, exculpatory representations coupled with integration clauses likely violate the anti-waiver and/or anti-fraud provisions found in many state franchise laws.<sup>75</sup> Consequently, franchisors looked for other tools to help identify and protect against statements and promises that may have been made during the sales process.

In the 1980s and 1990s, for example, some franchisors made it a practice to audiotape or videotape franchise closings. A famous example of this is described in *Bonfield v. AAMCO Transmission*,<sup>76</sup> where an audiotaped recording of the AAMCO “Board of Review Hearing” was admissible to prove that certain statements made to Bonfield during the franchise sales process were not “material” to his purchase decision.

Specifically, during the process of buying an existing AAMCO center, Bonfield was told that he would have to assume responsibility for honoring warranties issued by the former owner of the center he was purchasing as well as those of other AAMCO franchisees. AAMCO and its franchisees referred to the honoring of those warranties as “come-backs.” Bonfield tried to quantify his potential liability for the “come-backs.” Bonfield’s Complaint alleged that AAMCO’s attorney, during the final stages of the acquisition, represented that \$5,000 would “be more than enough money” to cover those warranties,” and that AAMCO’s Manager of Franchise Administration also said that AAMCO “recommended” the \$5,000 figure.

The Complaint asserted that these statements, made during the franchise sales process, were material and false and, therefore, violated Section 706(1)(b) of the Illinois Franchise Disclosure Act of 1987 (now codified at Section 705(6)), which makes it

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<sup>74</sup> *Randall v. Lady of America Franchise Corp.*, 532 F. Supp.2d 1071, 1087 (D. Minn. 2007).

<sup>75</sup> For example, Section 31512 of the California Corporations Code provides that “[a]ny condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void.” The Maryland Franchise Registration and Disclosure Act of 1987 provides that “[a]s a condition of the sale of a franchise, franchisor may not require a prospective franchisee to agree to a release, assignment, novation, waiver, or estoppel that would relieve a person from liability under this subtitle.” Section 80C.21 of the Minnesota Franchises Law provides that “[a]ny condition, stipulation or provision, including any choice of law provision, purporting to bind any person who, at the time of acquiring a franchise is a resident of this state, or, in the case of a partnership or corporation, organized or incorporated under the laws of this state, or purporting to bind a person acquiring any franchise to be operated in this state, to waive compliance or which has the effect of waiving compliance with any provision of sections 80C.01 to 80C.22 or any rule or order thereunder is void.”

<sup>76</sup> 708 F. Supp. 867 (N.D. Ill. 1989).

unlawful for any person to ... “make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading....”

In granting summary judgment for AAMCO, the court held that Bonfield could not prove that the statements were material to Bonfield’s investment decision. In addition, the court held that “[a]s a matter of law Bonfield even apart from his being an experienced businessman and investor, from his own account to the Board of Review is foreclosed from contending the claimed misstatement, made during his investigation and negotiation of the Wheaton deal, affected his investment decision. That is so because during the Board of Review hearing AAMCO explicitly told Bonfield and he explicitly acknowledged that anything not contained in the Agreement or covered in that hearing could not be considered as a valid representation from AAMCO....”

Audio-taped and video-taped closings, though effective, posed both financial and logistic challenges for most franchisors. In the decades that followed, therefore, written questionnaires – covering essentially the same ground – replaced recorded interviews. By the early 2000s, franchise questionnaires were considered a quintessential part of the franchise agreement. In fact, most franchise questionnaires used today substantially mirror the exemplar attached to the 2004 International Franchise Association Legal Symposium written materials.<sup>77</sup>

While franchise questionnaires can help a franchisor identify misrepresentations by franchise sellers before it is too late, the use of franchise questionnaires to avoid or mitigate a franchisor’s risk of liability<sup>78</sup> contravenes the purpose of franchisee protection laws. Moreover, the industry’s ever-increasing reliance on technology (including the use of e-signature software, such as DocuSign) and desire to expedite franchise closings has led to the use of more streamlined versions of the questionnaire, which often deny franchisees the opportunity to answer truthfully or to qualify or explain their responses.

On March 13, 2019, the Federal Trade Commission published a Request for Public Comment on the Franchise Rule to explore, among other things, the Rule’s prohibitions against disclaimers. Several practitioners responded to the request, voicing concern over the use of franchisee questionnaires as part of the franchise sales process.

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<sup>77</sup> Andrew F. Perrin, Harold L. Kestenbaum, and Richard L. Rosen, *State-of-the-Art Franchise Agreements*, International Franchise Association Legal Symposium (May 23-25, 2004). A copy of the sample questionnaires attached to that paper are attached here as Exhibit B.

<sup>78</sup> At least one court has noted that the questionnaires can “effectively root out dishonest sales personnel and avoid sales secured by fraud.” *Emforce Corp. v. Blimpie Ass. Ltd.*, 860 N.Y.S.2d 12, 51 A.D.3d 434, 435 (2008) (finding court correctly dismissed plaintiff’s common law fraud claims because they were contained in a separate rider, which plaintiff’s principal read and initialed, stating she was not relying on any representations by defendants).

Attorney Peter Lagarias, who began his career in 1977 as a staff attorney with the Federal Trade Commission and, in 1979, became part of the team charged with enforcing the newly enacted Franchise Rule, characterized the use of franchise questionnaires as an “unfair or deceptive practice which should be prohibited by the Franchise Rule.” In a letter dated December 15, 2020, Lagarias described how questionnaires are actually used in practice:

The questionnaires are presented at the very end of the sales process, at the time of signing the franchise agreement. By then the potential franchisees have invested substantial time and money in proceeding. They have spent considerable time; attended discovery day, travelling there on their nickel; considered and explored a location; maybe even signed a lease or lined up a location; obtained, sometimes borrowed, the required investment; and may have resigned from gainful employment. Prospective franchisees know, or are coached in, how to complete these forms if they want to proceed, and they invariably want to proceed at this point.

We have represented franchisees who when they answered that yes, they had received additional representations, sometime [sic] financial representations were asked to complete another questionnaire and remove that answer. We have represented franchisees who have been coached how to answer the questionnaire, or who realized they needed to answer “no” to each question. But even the remainder simply regard this as a final boilerplate, and sign because they want to proceed.<sup>79</sup>

Attorney Howard Bundy, in a letter to the Federal Trade Commission dated December 17, 2020, shared similar concerns and characterized disclaimers as a “get of jail free” card. Rather than prohibiting disclaimers outright (which would not work because franchise lawyers will find creative ways to draft around any prohibition), Bundy advocated that a statement be added to the FTC Cover Page and to the Receipt Page substantially as follows:

The Federal Trade Commission prohibits any contract terms or statements that have the effect of limiting any franchisee’s right to rely on any information provided by or on behalf of the franchisor or that could be interpreted to limit the franchisee’s right to a remedy for fraud, deception or violation of any statute. Any such terms, to the extent that they might be interpreted to impose such limits, whether within the FDD or a separate document, are void and unenforceable and a violation of the FTC Franchise Rule.<sup>80</sup>

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<sup>79</sup> Letter from Peter C. Lagarias to April J. Tabor, Federal Trade Commission (Dec. 15, 2020).

<sup>80</sup> Letter from Howard E. Bundy to Federal Trade Commission (Dec. 17, 2020).

Attorney Mark Leitner wrote to the Federal Trade Commission, on behalf of himself and attorney Joseph Goode, to express agreement with Bundy's letter adding that, in their experience, "prospective franchisees who answered the questionnaires honestly by identifying statements that had been made to them in the pre-purchase phase by representatives of the franchisor were later instructed by franchisor sales personnel that their applications **would not be considered at all** unless they affirmatively represented that no such statements had been made to them."<sup>81</sup>

In a December 17, 2020 letter to the Federal Trade Commission, Senators Dianne Feinstein (D-CA), Catherine Cortez Masto (D-NV), and Christopher S. Murphy (D-CT), and Representative Jan Schakowsky (D-IL) wrote to the Federal Trade Commission urging a ban on "questionnaires and disclaimers that are used by franchisors to avoid responsibility for contract disputes..." and stating that "[a]ny questionnaire or disclaimer should not be used to avoid a claim of deceptive practices of fraud."<sup>82</sup>

Nonetheless, responses to franchise questionnaires still provide an effective litigation tool. For example, in *Healy v. Carlson Travel Network Associates, Inc.*,<sup>83</sup> as part of the closing process, the franchisor gave the prospect a Franchise Closing Checklist, which was a one-page list of statements to initial. These included a statement that he had not been given, nor had he relied upon, any oral or written promises, representations, or assurances of any specific actual, projected or pro forma sales, profits, earnings or break-even point for his franchise or any other franchise outlet. The checklist stated in bold capital letters, "**DO NOT INITIAL ANY OF THE FOLLOWING STATEMENTS IF IT IS NOT TRUE!**" The franchisee claimed that although some of the statements he initialed were untrue, the sales representative urged him to initial all of them to complete the signing process. After his franchise closed one year after opening, he sued the franchisor. The court granted summary judgment to the franchisor on his claim for misrepresentation under the Illinois Franchise Disclosure Act for several reasons, including the fact that he had specifically disclaimed in the Closing Checklist that he had been given or relied on any oral or written statements.<sup>84</sup>

In *Fantasic Sams Salons Corporation v. PSTEVO, LLC*,<sup>85</sup> the court dismissed the franchisee's fraudulent misrepresentation claim based on one of the questions posed to the franchisee that stated: NO ORAL, WRITTEN OR VISUAL CLAIM OR REPRESENTATION WHICH STATED OR SUGGESTED ANY SALES, INCOME OR PROFIT LEVELS WAS MADE TO ME, EXCEPT: \_\_\_\_\_ (several additional lines for a written response). The franchisee wrote the word "none" and initialed his response. The

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<sup>81</sup> Letter from Mark M. Leitner to Federal Trade Commission (Dec. 17, 2020).

<sup>82</sup> Letter from Dianne Feinstein, U.S. Senator, Catherine Cortez Masto, U.S. Senator, Christopher S. Murphy, U.S. Senator, and U.S. Rep. Jan Schakowky, to Joseph J. Simons, Chairman, Federal Trade Commission (Dec. 17, 2003),

<sup>83</sup> 227 F. Supp.2d 1080 (D. Minn. 2002).

<sup>84</sup> *Id.* at 1083, 1091-92.

<sup>85</sup> Case No. 15 C 3008, 2016 WL 8856662 (N.D. Ill. Jan. 15, 2016).

court held that this statement expressly disclaimed representations regarding projected profitability, thus the claim was barred.<sup>86</sup>

In *Sherman v. Ben and Jerry's Franchising, Inc.*, the court examined application of the parol evidence rule in the context of acknowledgments and disclaimers when considering defendant's motion to dismiss plaintiffs' fraudulent inducement claims.<sup>87</sup> Although parol evidence of an oral agreement is not generally admissible to vary or contradict the terms of a written contract, the court noted that the parol evidence rule did not necessarily bar certain of plaintiffs' claims because proof of fraud in the inducement will defeat the parol evidence bar. The court dismissed plaintiffs' allegations that the franchisor made misrepresentations about earnings data in Item 19 of the disclosure document because there were express disclaimers about specific representations related to expected profits. On the other hand, the court denied defendant's motion to dismiss on other alleged misrepresentations, finding there was no specific disclaimer stating that plaintiffs did not rely on the alleged statements. Thus, the court would determine whether plaintiffs qualified for the parol evidence rule's fraud exception on a motion for summary judgment once the parties developed the factual record.<sup>88</sup>

In November 2020, the Federal Trade Commission held a series of online public workshops that explored several issues related to the Franchise Rule, including a workshop focused on "Disclaimers, Waivers, & Questionnaires."<sup>89</sup> The testimony provided at that workshop highlighted some of the very concerns that state regulators have regarding those documents. Regulators note that although franchise questionnaires have found themselves into most FDDs that regulators review, the documents are not required and were never contemplated to be part of the franchise sales process under any state or federal franchise disclosure law or guideline.

As discussed during the Federal Trade Commission's November 2020 workshop, franchise questionnaires are included as part of the FDDs because franchisors require prospective franchisees to sign the documents, which makes them, arguably, a "proposed agreement required in connection with the franchise offering," which must be attached to the FDD under Item 22 of the FTC Franchise Rule.

Franchisor attorneys suggest that questionnaires are helpful to ensure that prospective franchisees had not received any unauthorized Financial Performance Representations during the sales process, and, if any franchisees did receive any unauthorized information, the questionnaire allows the franchisor the opportunity to stop a sale from going forward if a law violation has occurred. Franchisee advocates, however, have observed that franchisors also use these questionnaires as a vehicle to insulate

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<sup>86</sup> *Id.* at \*2.

<sup>87</sup> Case No. 1:08-CV-207, 2009 WL 2462539 (D. Vt. Aug. 10, 2009).

<sup>88</sup> *Sherman*, 2009 WL 2462539 at \*\*3-5.

<sup>89</sup> [https://www.ftc.gov/system/files/documents/videos/reviewing-franchise-rule-workshop-discussion-disclaimers-waivers-questionnaires/franchise\\_rule\\_workshop\\_transcript\\_-\\_discussion\\_of\\_disclaimers.pdf](https://www.ftc.gov/system/files/documents/videos/reviewing-franchise-rule-workshop-discussion-disclaimers-waivers-questionnaires/franchise_rule_workshop_transcript_-_discussion_of_disclaimers.pdf).

their clients from potential liability for franchise law violations. Most everyone agrees that franchisors should not be allowed to utilize questionnaires or any other type of disclaimer to avoid a claim of deceptive practices or fraud or to serve as a waiver or disclaimer against what could be a legitimate claim of misrepresentation, deceptive practices, and fraud in the offer or sale of a franchise.

State franchise regulators also have noted that many questionnaires currently found in some FDDs are replete with questions and representations that serve no legitimate purpose because they require franchisees to make acknowledgments or answer questions that are subjective, unreasonable, or repeat disclosures required to be stated in the body of an FDD. For example, some questionnaires require prospective franchisees to acknowledge, among other things, that the franchisee has read and understands all of the information in the FDD; that the franchisee understands or comprehends the risks associated with the purchase of the franchise; that, in deciding to purchase the franchise, that franchisee has relied solely on the FDD and not on any other information or representations or statements from other persons or sources.

Regardless of whether the FTC or NASAA takes any formal action relating to questionnaires, some state franchise regulators are taking a fresh look at these documents. Franchisors should look carefully at the wording of any questionnaires they include in their FDDs and omit any parts of those documents that do not serve a legitimate purpose, that replicate disclosures made in the FDD itself, or that serve to waive a franchisee's rights to pursue a claim under any applicable franchise law. Given their efficacy and potential for abuse, these questionnaires could become the subject of regulatory action in the future.

### **c. Ongoing Concern Over Franchisees as Employees**

Finally, states and franchisors continue to wrestle with increasingly expansive definitions of the employment relationship, and the potential impact on these expansive definitions on the franchise model.

In November 2020, the International Franchise Association filed a lawsuit, as lead plaintiff, in the United States District court for the Southern District of California seeking to enjoin the application of California's Assembly Bill 5 and Assembly Bill 2257 as they relate to legitimate franchise relationships.<sup>90</sup> Those bills are commonly known as California's "ABC test" for determining whether a worker is an employee or independent contractor. The IFA and the other plaintiffs ask the court to declare that application of California's ABC test to franchisors and franchisees, as defined by the FTC Franchise Rule, is preempted by federal law (including the FTC Franchise Rule). They also ask the court to enjoin the state and other defendants from enforcing the ABC test against franchisors and franchisees.<sup>91</sup>

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<sup>90</sup> *International Franchise Association v. State of California*, Case No. 3:20-cv-2243-BAS-DEB (S.D. Cal.).

<sup>91</sup> *Id.*

Meanwhile, some states are aggressively pursuing franchisors that they view as using the franchise model as a cover for low-wage jobs. The State of Washington recently filed a 51-page, 16-count consumer protection lawsuit against janitorial services company National Maintenance Contractors, alleging that the franchisor took advantage of immigrants with limited English proficiency (mainly native Spanish and Russian speakers) and promised them the independence of business ownership.<sup>92</sup>

The state alleges violations of the Washington Franchise Investment Protection Act and the state Consumer Protection Act in connection with the marketing, sale, and operation of janitorial franchises in Washington. Specifically, the state alleges that the company “lured hundreds of vulnerable, low-wage consumers into investing thousands of dollars in up-front and ongoing monthly fees to buy janitorial franchises based on false premises, including that they will be their own boss and can build a profitable business. To the contrary, many unsuspecting franchisees instead have come to discover that they paid a great deal of money – in some cases, their life savings – essentially to buy cleaning jobs for which they earn less than the minimum wage.”<sup>93</sup> For example, the state alleges that National offered an account to franchisees to clean a 1,700-square-foot office space six times a week. After National took its fees, the franchisee earned approximately \$6.59 per cleaning. The state also alleges that National grossly unbid for contracts, which created unrealistic demands on franchisees. For example, franchisees were allegedly required to perform a number of general kitchen cleaning tasks that National said they should perform in a total of 3 minutes. Franchisees were allegedly required to complete the tasks no matter how long it took them to actually complete the work. The state also alleges that National misled the franchisees, punished them for declining accounts, failed to deliver promised revenue, concealed client contract amounts, and charged unreasonable office fees. The lawsuit seeks restitution for National’s approximately 250 Washington franchisees, and civil penalties against National.

The abuses alleged in the Washington lawsuit are a further example of the type of abuses found in some janitorial franchises, which have caused disputes over employee classification (employee versus independent contractor) that could cause courts to apply the “ABC test” to the franchise business model. The abuses alleged in the Washington lawsuit are a bellwether that threatens the franchise model as we know it.

## 5. Conclusion

The franchise industry is dynamic. Change is the constant whether it is caused by outside forces like COVID-19 and FASB’s adoption of ASC 606 or from within as regulators reassess industry practices to ensure that state and federal franchise law

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<sup>92</sup> Press Release, Washington State Office of Attorney General, AG Ferguson files lawsuit against janitorial services company for exploiting mostly immigrant workers (April 6, 2021), available at <https://www.atg.wa.gov/news/news-releases/ag-ferguson-files-lawsuit-against-janitorial-services-company-exploiting-mostly>.

<sup>93</sup> *State of Washington v. National Maintenance Contractors, LLC*, Case No. 21-2-04554-1 SEA (King County Sup. Ct. April 6, 2021).

mandates are enforced. This includes adopting new online filing options, ADA compliance, franchise broker registration and more scrutiny of ubiquitous compliance questionnaires, acknowledgements and disclaimers to provide better access to disclosure documents and level the playing field.

**Exhibit A**  
**Hypotheticals for discussion**

1. Josephine's Pizza franchises enjoyed a record year of sales starting in March 2020 and continuing for the remainder of 2020. Josephine's Pizza restaurants have always focused primarily on take-out and delivery, so outlets have limited or no seating on premises. As a result, in most locations, the restaurants were perfectly positioned to prosper during the COVID-19 pandemic. In most locations, Josephine's Pizza restaurants enjoyed gross revenues in 2020 that were nearly double the revenues reported in 2019. Starting in the fourth quarter of 2020, however, overall system-wide sales began to lose steam. The franchisor's CEO has circulated to senior management a confidential memo that she expects that outlets will continue to experience percentage declines throughout the rest of 2021, and that average gross revenues this year will be closer to 2019 revenues than 2020 revenues, assuming the U.S. does not experience a significant resurgence in the pandemic.

Josephine's Pizza wants to include in its 2021 franchise renewal an FPR that reports average gross revenues from 2020 for its 4 company-owned outlets and its 150 operational franchise outlets. Can it? If so, how?

2. Specialty Learning Annex ("SLA") is a relatively new educational franchise with 2 company owned outlets. Its revenues were significantly impacted by the COVID-19 pandemic. Gross revenues collected in 2020 were \$350,000. In 2020, SLA also received \$65,000 in Paycheck Protection Program ("PPP") loan funds that it will not have to repay.

SLA is preparing its FDD, and it wants to include an FPR that reports total revenues received by its two affiliate-owned outlets in 2020. How should it report the PPP loan funds?

EXHIBIT B

SAMPLE QUESTIONNAIRE

(1) FRANCHISEE COMPLIANCE CERTIFICATION

As you know, \_\_\_\_\_ (the "Franchisor") and you are preparing to enter into a franchise agreement (the "Franchise Agreement") for the establishment and operation of a \_\_\_\_\_ Restaurant. The purpose of this Questionnaire is to determine whether any statements or promises were made to you by employees or authorized representatives of the Franchisor, that have not been authorized, or that were not disclosed in the Uniform Franchise Offering Circular or that may be untrue, inaccurate or misleading.

In the event that you are intending to purchase an existing \_\_\_\_\_ Restaurant from an existing Franchisee, you may have received information from the transferring Franchisee, who are not employees or representatives of the Franchisor. The questions below do not apply to any communications that you had with the transferring Franchisee. Please review each of the following questions and statements carefully and provide honest and complete responses to each.

1. Are you seeking to enter into the Franchise Agreement in connection with a purchase or transfer of an existing \_\_\_\_\_ Restaurant from an existing Franchisee?

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

2. I had my first face-to-face meeting with a Franchisor representative on \_\_\_\_\_, 20\_\_.

3. Have you received and personally reviewed the Franchise Agreement, each addendum, and/or related agreement provided to you?

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

4. Do you understand all of the information contained in the Franchise Agreement, each addendum, and/or related agreement provided to you?

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

If no, what parts of the Franchise Agreement, any Addendum, and/or related agreement do you not understand? (Attach additional pages, if necessary.)

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5. Have you received and personally reviewed the Franchisor's Uniform Franchise Offering Circular ("UFOC") that was provided to you?

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

Witness Initial: \_\_\_\_\_ (Franchisee) Initial: \_\_\_\_\_

6. Did you sign a receipt for the UFOC indicating the date you received it?

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

7. Do you understand all of the information contained in the UFOC and any state-specific Addendum to the UFOC?

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

If No, what parts of the UFOC and/or Addendum do you not understand? (Attach additional pages, if necessary.)

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8. Have you discussed the benefits and risks of establishing and operating a \_\_\_\_\_ Restaurant with an attorney, accountant, or other professional advisor?

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

If No, do you wish to have more time to do so?

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

9. Do you understand that the success or failure of your \_\_\_\_\_ Restaurant will depend in large part upon your skills and abilities, competition from other businesses, interest rates, inflation, labor and supply costs, location, lease terms, your management capabilities and other economic, and business factors?

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

10. Has any employee of Franchisor or other person speaking on behalf of the Franchisor made any statement or promise concerning the actual or potential revenues, profits or operating costs of any particular \_\_\_\_\_ Restaurant operated by the Franchisor or its franchisees (or of any group of such businesses), that is contrary to or different from the information contained in the UFOC?

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

11. Has any employee of Franchisor or other person speaking on behalf of the Franchisor made any statement or promise regarding the amount of money you may earn in operating the franchised business that is contrary to or different from the information contained in the UFOC?

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

Witness Initial: \_\_\_\_\_ (Franchisee) Initial: \_\_\_\_\_

12. Has any employee of Franchisor or other person speaking on behalf of the Franchisor made any statement or promise concerning the total amount of revenue the \_\_\_\_\_ Restaurant will generate, that is contrary to or different from the information contained in the UFOC?  
 Yes \_\_\_\_\_ No \_\_\_\_\_
13. Has any employee of Franchisor or other person speaking on behalf of the Franchisor made any statement or promise regarding the costs you may incur in operating the \_\_\_\_\_ Restaurant that is contrary to or different from the information contained in the UFOC?  
 Yes \_\_\_\_\_ No \_\_\_\_\_
14. Has any employee of Franchisor or other person speaking on behalf of the Franchisor made any statement or promise concerning the likelihood of success that you should or might expect to achieve from operating a \_\_\_\_\_ Restaurant?  
 Yes \_\_\_\_\_ No \_\_\_\_\_
15. Has any employee of Franchisor or other person speaking on behalf of the Franchisor made any statement, promise or agreement concerning the advertising, marketing, training, support service or assistance that the Franchisor will furnish to you that is contrary to, or different from, the information contained in the UFOC or franchise agreement?  
 Yes \_\_\_\_\_ No \_\_\_\_\_
16. Have you entered into any binding agreement with the Franchisor concerning the purchase of this franchise prior to today?  
 Yes \_\_\_\_\_ No \_\_\_\_\_
17. Have you paid any money to the Franchisor concerning the purchase of this franchise prior to today?  
 Yes \_\_\_\_\_ No \_\_\_\_\_
18. Have you spoken to any other franchisee(s) of this system before deciding to purchase this franchise? If so, who? \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

If you have answered No to question 9, or Yes to any one of questions 10-17, please provide a full explanation of each answer in the following blank lines. (Attach additional pages, if necessary, and refer to them below.) If you have answered Yes to question 9, and No to each of questions 10-17, please leave the following lines blank.

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

Witness Initial: \_\_\_\_\_ (Franchisee) Initial: \_\_\_\_\_

I signed the Franchise Agreement and Addendum (if any) on \_\_\_\_\_, 20\_\_\_\_, and acknowledge that no Agreement or Addendum is effective until signed and dated by the Franchisor.

Please understand that your responses to these questions are important to us and that we will rely on them. By signing this Questionnaire, you are representing that you have responded truthfully to the above questions.

FRANCHISEE APPLICANT

\_\_\_\_\_  
Witness

\_\_\_\_\_  
Signed

\_\_\_\_\_  
Dated

Witness Initial: \_\_\_\_\_ (Franchisee) Initial: \_\_\_\_\_

**SAMPLE QUESTIONNAIRE**

**STATEMENT OF FRANCHISEE**

**[Note: Dates and Answers Must be Completed  
in the Prospective Franchisee's Own Handwriting]**

In order to make sure that no misunderstanding exists between you, the Franchisee, and us, \_\_\_\_\_ ("FRANCHISOR" or "we") and to make sure that no violations of law might have occurred, and understanding that we are relying on the statements you make in this document, you assure us as follows:

A. The following dates are true and correct:

- | Date            | Initials |  |
|-----------------|----------|--|
| 1. _____, 200__ | _____    | The date on which I received a Franchise Offering Circular on the _____ Business.                                      |
| 2. _____, 200__ | _____    | The date of my first face-to-face meeting with the _____ to discuss a possible purchase of a _____ Business.           |
| 3. _____, 200__ | _____    | The date on which I received a completed copy (other than signatures) of the Franchise Agreement which I later signed. |
| 4. _____, 200__ | _____    | The date on which I signed the Franchise Agreement.  |
| 5. _____, 200__ | _____    | The earliest date on which I delivered cash, check or other consideration to the FRANCHISOR.                           |

B. Representations.

1. No oral, written, visual or other promises, agreements, commitments, representations, understandings, "side agreements," options, right-of-first-refusal or otherwise have been made to or with me with respect to any matter (including but not limited to advertising, marketing, site location, operational, marketing or administrative assistance, exclusive rights or exclusive or protected territory or otherwise), nor have I relied in any way on same, except as expressly set forth in the Franchise Agreement or an attached written Addendum signed by me and the Franchisor, except as follows: \_\_\_\_\_

\_\_\_\_\_ (If blank, then the answer is "None")

2. No oral, written, visual or other promises, agreements, commitments, representation, understandings, "side agreements" or otherwise which expanded upon or were inconsistent with the Offering Circular or the Franchise Agreement or any attached written addendum signed by me and an officer of the Franchisor, were made to me by any person or entity, nor have I relied in any way on same, except as follows: \_\_\_\_\_

(If blank, then the answer is "None")

3. No oral, written, visual or other claim or representation (including but not limited to charts, tables, spreadsheets or mathematical calculations to demonstrate actual or possible results based on a combination of variables, such as multiples of price and quantity to reflect gross sales, or otherwise,) which stated or suggested a specific level or range of actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise (or from which such items might be ascertained) from the \_\_\_\_\_ Businesses, was made to me by any person or entity, nor have I relied in any way on any such, except as follows: \_\_\_\_\_

(If blank, then the answer is "None".)

4. No contingency, prerequisite, reservation or otherwise exists with respect to any matter (including but not limited to my obtaining financing, or my fully performing any of my obligations), nor have I relied in any way on same, except as expressly set forth in the Franchise Agreement or any attached written Addendum signed by me and the Franchisor: \_\_\_\_\_

(If blank, then the answer is "None")

5. The individuals signing for me constitute all of the executive officers, partners, shareholders, investors and/or principals. Each of such individuals has reviewed the Franchise Offering Circular and all exhibits and carefully read, discussed, understands and agrees to the Franchise Agreement, each attached written Addendum and any Personal Guaranties.

6. I have had an opportunity to consult with an independent professional advisor, such as an attorney or accountant, prior to signing any binding documents or paying any sums, and the Franchisor has strongly recommended that I obtain such independent advice. I have also been strongly advised by the Franchisor to discuss my proposed purchase of a \_\_\_\_\_ Business with any existing \_\_\_\_\_ franchisees prior to signing any binding documents or paying any sums.

7. I understand that a) entry into any business venture necessarily involves some unavoidable risk or loss or failure; b) while the purchase of a franchise may improve the chances for success, the purchase of a \_\_\_\_\_-Business or any other franchise is a speculative investment; c) investment beyond that outlined in the Offering Circular may be required to succeed; d) there exists no guaranty against possible loss or failure in this or any other business; and e) the most important factors in the success of any \_\_\_\_\_ Business, including the one to be operated by me, are my personal business skills, which include marketing, sales, and management, and require sound judgment and extremely hard work.

If there are any matters inconsistent with the statements in this document or if anyone has suggested that you sign this document without all of its statements being true, correct and complete, immediately inform the President of the Franchisor at \_\_\_\_\_.

You understand and agree that, except as set forth in Item 19 of the Offering Circular, we do not furnish, or authorize our salespersons, brokers or others to furnish, any oral or written information concerning actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise (or information from which such items might be ascertained), from franchise or non-franchised units, that no such results can be assured or estimated, and that actual results will vary from unit to unit.

You understand and agree to all of the foregoing and represent and warrant that all of the above statements are true, correct and complete.

PROSPECTIVE FRANCHISEE:

\_\_\_\_\_

\_\_\_\_\_  
Date

Reviewed by FRANCHISOR

By: \_\_\_\_\_

\_\_\_\_\_  
Date

Its: \_\_\_\_\_

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