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THORNY FDD DISCLOSURE ISSUES

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I. INTRODUCTION

The Federal Trade Commission's franchise rule, *Disclosure Requirements and Prohibitions Concerning Franchising* (the "FTC Rule") went into effect on October 21, 1979, as amended on January 22, 2007,[2] and establishes the disclosure requirements for the sale of franchises in the United States, including its territories. However, simply following the FTC Rule would not be sufficient to prepare a franchise disclosure document ("FDD"). The Federal Trade Commission ("FTC") has issued other essential resources, including the Compliance Guide,[3] the Statement of Basis and Purpose,[4] and the Frequently Asked Questions ("FAQs").[5] Further, the North American Securities Administrators Association ("NASAA") has adopted some essential resources, including the 2008 Franchise Registration and Disclosure Guidelines ("2008 NASAA Guidelines")[6] and related Commentary on 2008 Franchise Registration and Disclosure Guidelines ("2008 NASAA Commentary")[7], NASAA Franchise Commentary on Financial Performance Representations ("FPR Commentary")[8], and Multi-Unit Commentary[9]. While the NASAA resources are not law, they are just as important as the FTC Rule because, in reality, the state franchise examiners, not the FTC, review FDDs and interpret the disclosure requirements of the FTC Rule. State franchise examiners either approve or disapprove a state registration of an FDD based on their interpretations.

This paper will review select provisions of the FTC Rule, as interpreted by some of the FTC's and NASAA's guidelines. It will also discuss required timing under the FTC Rule and applicable states to amend the FDD upon the occurrence of a material change.

II. SELECT DISCLOSURE ISSUES

a. Cover Page

The FDD cover page requires disclosure of the total investment necessary to begin operation of the franchise. This estimate must be the total amount or range disclosed in Item 7. The cover page must then disclose the total amount payable to the franchisor or its affiliate. This includes not only the initial franchise

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[2] 16 C.F.R. § 436 (2007).

[3] The Franchise Compliance Guide ("Franchise Compliance Guide" or "Compliance Guide") was issued by the Federal Trade Commission in May 2008. The Compliance Guide can be found at https://www.ftc.gov/tips-advice/business-center/guidance/franchise-rule-compliance-guide.

[4] The Statement of Basis and Purpose (or "SBP") was released on January 23, 2007, 72 Fed. Reg. 15444-15492; CCH Bus. Guide Para. 6050.

[5] The Federal Trade Commission's Frequently Asked Questions (FAQs) can be found at https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs.

[6] The NASAA Guidelines can be found at http://www.nasaa.org/wp-content/uploads/2011/08/2008UFOC1.pdf.

[7] The NASAA Commentary can be found at http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf.

[8] The NASAA FPR Commentary can be found at http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf.

[9] http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf.

fee but also a total of all other fees identified in Item 5. Because the FTC Rule requires disclosure of the "total" amounts payable to franchisor and its affiliates, many state examiners will not permit additional disclosure providing a further breakdown of fees payable to the franchisor and its affiliates by the type of fee.

b. Item 1 (The Franchisor, and any Parents, Predecessors, and Affiliates)

i. Item 1 requires inclusion of disclosure of certain information relating to the following entities:

1. Parents. The definition of "parent" under the FTC Rule is "an entity that controls another entity directly, or indirectly through one of more subsidiaries"[10] The FTC has noted in the FAQs that in determining whether an entity is a parent, the focus should be on "control" rather than mere ownership and whether the parent shapes the franchisor's policies or control franchise operations or sales.[11] In completing the analysis for whether a parent needs to be included in Item 1, it is important to note that the term "parent" includes all parents in the chain of ownership, not just the "ultimate" parent. However, if a parent is required to be disclosed, the franchisor only needs to identify the name of the parents and provide their principal business address. The FTC Rule does not require disclosure of other information required in Item 1 for other affiliates and predecessors, such as their business background and involvement in other lines of business.[12] Finally, note that the definition of parent expressly limits the disclosure to an "entity" and not individuals. Franchisors do not need to disclose individual shareholders.

2. Predecessors. A predecessor under the FTC Rule is an entity from which the franchisor obtained a "major portion" of its assets.[13] Therefore, a franchisor that sells its franchise system to a company that already owns and franchises other franchise brands may not need to be disclosed as a predecessor in the post-acquisition FDD of the acquirer because the acquirer did not obtain a "major portion" of its assets from such franchisor. What if the acquirer only

[10] 16 C.F.R. § 436.1(m).
[11] FAQ #16 (last visited Apr. 19, 2018), *available at*: https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs.
[12] Franchise Compliance Guide, *supra* note 3 at 28-29, *available at* https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.
[13] 16 C.F.R. § 436.1(p).

owned one single unit hotel and then acquired a franchise system with 100 hotels? Under those circumstances, the selling franchisor would likely be deemed a "predecessor" under the FTC Rule. A franchisor may want to compare the pre-transaction balance sheet of the company to the post-transaction balance sheet in order to make that decision. The FTC Rule requires disclosure of predecessors for the 10-year period before the end of the franchisor's last fiscal year.[14]

3. Affiliates. Item 1 requires disclosure of affiliates that offer franchises and affiliates that provide products or services to the franchisees of franchisor.[15] Note that affiliates are not limited to U.S. affiliates but may include foreign affiliates that offer franchises.[16]

c. Item 2 (Business Experience)

Item 2 requires disclosure of the 5-year business experience of not only the officers and directors, but also individuals with management responsibility relating to the sale or operation of the franchise offered.[17] It does not matter if the individual does not have a formal title, or if the individual is employed by a parent, affiliate or other entity. Rather than focusing on title, the decision as to whether an individual should be included in Item 2 should be based on whether an individual's involvement in either sales or operations is such that a franchisee would rely on his or her expertise, formulation of policy, or control of the system.

d. Item 3 (Litigation)

Item 3 requires disclosure of certain litigation involving the franchisor, a predecessor; a parent or affiliate who induces franchise sales by backing the franchisor financially or otherwise guarantees the franchisor's performance; an affiliate that offers franchises under the franchisor's principal trademark; and individuals disclosed in Item 2 (collectively referred to as "Disclosable Parties").[18] While Item 3 limits disclosure of litigation involving affiliates and parents to only a limited set of affiliates and parents, Item 3 requires disclosure of litigation involving all predecessors. Unlike Item 1, it does

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[14] 16 C.F.R. § 436.5(a)(2).
[15] 16 C.F.R. § 436.5(a)(1).
[16] NASAA Commentary *supra* note 7 at § 1.4 (last visited Apr. 19, 2018), *available at* http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf.
[17] 16 C.F.R. § 436.5(b).
[18] 16 C.F.R. § 436.5(c).

not limit disclosure of predecessors to predecessors of the parent in the 10-year period before the end of the franchisor's last fiscal year.

With respect to the Disclosable Parties, Item 3 requires disclosure of the following types of pending litigation:[19]

> 1. Administrative, criminal or material civil action alleging a violation of a franchise, antitrust or securities law, or alleging fraud, unfair or deceptive practices, or comparable allegations.
>
> 2. Other litigation which are material in light of the number of franchisees and the size, nature or financial condition of the franchise system or its business operations.
>
> Often, this "pending" litigation disclosure is what triggers the obligation to amend an FDD. What if a plaintiff franchisee files a lawsuit but does not serve the franchisor? However, the franchisor knows about the lawsuit and proceeds to enter into negotiations with the franchisee to settle the lawsuit. The analysis should be whether the allegations constitute "material" civil litigation, not whether the lawsuit has been served. If such lawsuit constitutes a material civil litigation, a franchisor would have to amend the FDD whether or not such complaint has been served.
>
> In addition, Item 3 requires disclosure of "other material civil action involving the franchise relationship in the last fiscal year."[20] Franchisors are required to disclose this type of litigation for all Disclosable Parties. If an Item 2 individual who started with the new franchisor employer in 2018 was involved in a material civil action involving a franchise relationship of another franchise system in 2017, would the new franchisor employer have to disclose this litigation in its FDD? The FTC Rule defines a "franchise relationship" to means "contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business."[21] Because the definition does not narrow "franchise business" to the franchise business offered under such FDD, the new franchisor employer must include such litigation if such litigation is otherwise "material."

Item 3 also requires disclosure of certain litigation matters that concluded within the last 10 years:[22]

> 1. Felony convictions or pleads of nolo contendere to a felony charge.
>
> 2. Litigation matters where a "Disclosable Party" was "held liable" in the type of litigation described in subsection 2 above. For purposes of Item 3, the FTC

[19] 16 C.F.R. § 436.5(c)(1)(i)-(ii).
[20] 16 C.F.R. § 436.5(c)(1)(ii).
[21] 16 C.F.R. § 436.5(c)(1)(ii).
[22] 16 C.F.R. § 436.5(c)(1)(iii); 16 C.F.R. § 436.5(c)(2).

Rule defines "held liable" to include settlements where the person must (a) pay money or other consideration, (b) reduce an indebtedness, (c) refrain from enforcing its rights, or (d)t take action adverse to its interest. For example, if a franchisor sues a franchisee seeking $500,000 in damages and the franchisee files a counterclaim seeking $500,000 in damages, and the parties settle by simply dismissing their claims and walking away from the damages sought, the franchisor has arguably refrained from "enforcing its rights."

3. Where an officer identified in Item 2 is sued by a franchisee along with the franchisor, and the franchisor agrees to pay monetary consideration as part of the settlement, would the officer have to disclose such litigation if if the officer did not personally pay any monetary consideration? These are certainly all issues to consider when negotiating a settlement with a plaintiff. If the plaintiff agrees to acknowledge in the settlement agreement that the officer was not required to pay any consideration, would that be sufficient for the officer to take the position that it did not have to disclose the litigation in the FDD of its successor employer? Whereas if the settlement agreement provides that all defendants would pay the settlement amount, the officer would certainly not be able to take that position. A state examiner may take the position that such litigation has to be disclosed with respect to the officer, whether or not the officer personally paid any consideration.

4. Finally, Item 3 requires disclosure of whether a Disclosable Party is subject to a currently effective injunctive or restrictive order or decree resulting from a pending or concluded action brought by a public agency and relating to the franchise or to a federal, state or Canadian franchise, securities, antitrust, trade regulations or trade practice law.[23] Unlike the other disclosures of completed litigation matters, a franchisor may have to disclose a state injunctive order that was entered into 20 years ago if the franchisor is still under that order. The 10-year cut off may not apply. The 10-year cut off contained in Item 1 with respect to predecessors also does not apply. Therefore, a franchisor does have to ask itself whether it has any predecessors subject to a current effective injunctive or restrict order or decree. Further, for the purposes of this disclosure only, the franchisor must include any affiliate that has offered or sold franchises in any line of business within the last 10 years.

If a completed litigation matter must be disclosed in Item 3, the FTC Rule prescribes specific information that must be disclosed, including material settlement terms, whether or not the settlement agreement is subject to a confidentiality obligation. Many practitioners incorrectly take the position that settlement terms do not need to be disclosed if they are subject to confidentiality obligations. Practitioners should therefore advise the client of such disclosure requirements before finalizing the settlement so the client is not surprised later by such requirement. Further, if a pending litigation has been disclosed in the FDD, an analysis should be done as to whether a settlement constitutes a material change and necessitates an amendment to the FDD.

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[23] 16 C.F.R. § 436.5(c)(iii)(2).

If the disclosure is of franchisor initiated suits that are material civil action involving the franchise relationship in the last fiscal year, then the suits can be disclosed by listing individual suits under one common heading that will serve as the case summary.[24] For example, you can simply include the case citations for all suits against franchisees to enforce post-termination covenants under the heading "Suits to Collect Post-Termination Covenants." This summary format disclosure is not available for *all* suits involving the franchise relationship during the last fiscal year, just those initiated by the franchisor.

e. Item 4 (Bankruptcy)

i. As with Item 3, Item 4 requires disclosure relating to individuals disclosed in Item 2.[25] Therefore, in order to comply with its disclosure obligations, a franchisor must obtain that information from each individual disclosed in Item 2. Franchisors must not only obtain such information from individuals upon commencement of his or her employment, but must also advise such individuals to update the franchisor with any new information as required. Many franchisors fail to obtain such updated information. Failure to include up to date Item 3 and 4 information with respect to Item 2 individuals results in of the franchisor violating the FTC Rule and state laws.

ii. One of the most often forgotten disclosures is disclosure relating to bankruptcy of a company that either filed as a debtor under the Bankruptcy Code, or that obtained a discharge of its debts under the Bankruptcy Code while, or *within one year after*, an individual disclosed in Item 2 held a position as a principal officer or general partner in the company.[26] Again, a franchisor would not have this information unless it specifically asks each Item 2 individual for such information.

f. Item 6 (Other Fees)

Item 6 requires disclosure of fees, whether one time or recurring, payable to the franchisor or its affiliates in connection with a franchisee's operation of the franchised business.[27] If a franchisor collects fees on behalf of a third party, such fee is deemed to be payable to the franchisor or its affiliates and therefore required to be disclosed in

[24] 16 C.F.R. § 436.5(c)(4).
[25] 16 C.F.R. § 436.5(d)(1).
[26] 16 C.F.R. § 436.5(d).
[27] 16 C.F.R. § 436.5(F).

Item 6. It does not matter that the third party fees are just passing through the franchisor or its affiliate without a markup.

Conversely, Item 6 does not require disclosure of fees payable directly to third parties. Even if the fees represent a significant ongoing payment by the franchisee, such fees should not be disclosed in Item 6 unless they are payable to the franchisor or its affiliates.

Unlike Item 5, Item 6 does not require a franchisor to disclose whether it negotiated discounted fees during the last fiscal year. So while a discounted initial fee during the last fiscal year needs to be disclosed in Item 5, a discounted royalty does not need to be disclosed in Item 6[28]. However, a franchisor must disclose whether such Item 6 fees are applied uniformly.

g. Item 8 (Restrictions on Sources of Products and Services)

Item 8 explains the supply relationship between the franchisor (and any affiliated or third party suppliers) and its franchisees, whether the franchisor gets money from those supply relationships, and the amount of revenue the franchisor derives from them. In sum, Item 8 of the original FTC Rule required franchisors to disclose "obligatory purchases, restrictions on sources of products and services, and the amount of any revenue the franchisor may receive from required suppliers."[29] During the rule-making process leading up to the reveal of the current FTC Rule, the FTC opted to align the requisite Item 8 disclosures consistent with the "more detailed and extensive disclosures" in the then-current UFOC Guidelines.[30] It appeared to do so, in large part, in response to questions from franchisee advocates about the adequacy of the former Item 8.[31] As a result, the FTC Rule now requires franchisors to disclose in the FDD source restrictions and purchasing obligations.

The FTC opined that the Item 8 changes counterbalanced the need for franchisees to receive sufficient pre-sale disclose with franchisor compliance burdens, and noted that the requisite Item 8 disclosures work to effectively warn prospects about source restrictions, purchase obligations, and approval of alternative suppliers" without forcing franchisors to disclose "past practices" or "future intentions." Notably, the FTC observed that prospective franchisees sufficiently curious about supplier issues could talk to existing franchisees about the franchisor's history vis-à-vis supplier approval.[32]

[28] Practitioners should recall that any such negotiated changes are regulated as "negotiated sales" under California law. In sum, the franchisor has three ways to comply with the negotiated sales requirements: (1) Cal. Corp. Code § 31123 or (2) Cal. Corp. Code § 31109.1 and Cal. Code of Reg. Rule 310.100.4. or (3) Cal. Code of Reg. § 310.100.2.

[29] SBP, *supra* note 4 at 154448.

[30] *Id.* at 15487.

[31] *Id.*

[32] *Id.*

One could argue that the disclosure obligations in Item 8 are simple. Its core requirement isthat the franchisor describes all of the products and services that franchisees must purchase from specific sources, and the rebates the franchisor receives from those purchases. On the other hand, Item 8 has historically been one of the most frequently litigated items in the FDD. So, what's the disconnect? Prior to the FTC Rule amendment, franchisees cited lack of transparency in franchisors' disclosures regarding the pervasive extent of the supplier requirements. It is important that the prospective franchisee understand when it may be required to purchase even the most basic supplies from the franchisor, its affiliates, or approved or designated suppliers, and that the franchisor may generate money from that purchase.

A franchisor is required to disclose whether it or its affiliates "will or may derive revenue or other material consideration from required purchases or leases by franchisees."[33] It must describe the "precise basis" by which the franchisor or its affiliates "will or may derive that consideration."[34] Does this mean that the franchisor must provide detailed information about how rebates are calculated and paid to the franchisor? In a sense, yes. While the FTC Rule does not expressly define the phrase "precise basis," it says "(for example, specify a percentage or a flat amount)".[35] Further, the sample Item 8 disclosure provided in the Compliance Guide discloses the exact percentage of the rebate received by franchisor from franchisee purchases. Therefore, state examiners will often require disclosure of such exact percentage or amount per item purchased.

What if a supplier pays the franchisor for the right to have a booth at the system's annual convention? What if a supplier pays money to the franchisor that is earmarked for the marketing fund? What if that money is paid directly to the advertising fund coiffeurs, which are accounted for separately from the franchisor's funds? One way to answer these questions is to look at the transaction in question and determine who has the ability to control the expenditure. If the franchisor has the ability to control the funds, and the money is treated as income to the franchisor, then it should be disclosed in Item 8. To avoid any ambiguity, the franchisor should disclose that the amounts in question were used to pay for convention expenses or for marketing fund expenditures.

With respect to purchases from franchisors or its affiliates, Item 8 also requires the franchisor to disclose (i) the franchisor's total revenues, (ii) the franchisor's revenues from all required purchases and leases of products and services; (iii) the percentage of the franchisor's total revenues generated from those required purchases or leases, and (iv) if applicable, the franchisor's affiliates revenues from such purchases or leases.[36]

It is important to remember that Item 8 requires the franchisor to disclose its franchisees' obligation to purchase or lease such "goods, services, supplies, fixtures,

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[33] *Id.* at 15488.
[34] *Id.*
[35] 16 C.F.R. § 436.5(h)(8).
[36] SBP, *supra* note 4 at 154448.

equipment, inventory, computer hardware and software, real estate, or comparable items relating to establishing or operating the franchised business," *under the franchisor's specifications*.[37] If the franchisor's specifications state that the franchisee must use a certain type of ball point pen or 5-inch knives in the operation of the franchised business, those specified items must be included in the franchisee's estimated proportion of required purchases and leases and disclosed in Item 8.

h. Item 12 (Territory)

Franchisors must disclose in Item 12 details regarding "assigned territories and applicable sales restrictions", among other related topics[38]. During the FTC Rule review process, the Commission observed that some proponents for the FTC Rule thought it contained "a variety of post-sale franchise contract or relationship issues," and were ready to see the FTC Rule abolished if it did not address certain issues.[39] One of those issues was franchisee territory encroachment. The Commission rejected the opportunity to "promulgate" a franchise relationship law, but it did find that the FTC Rule review record supported including the following "warning of the consequences to a franchisee" where the franchisor does not offer an exclusive territory:[40]

> You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control[41].

Notably, the FTC Rule does not expressly define an "exclusive territory," which renders the term subject to interpretation. Because territorial exclusivity varies from system to system, it is important to understand what the term means. The FTC stated in FAQ 25 that an exclusive territory means "a geographic area granted to a franchisee within which the franchisor promises not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks."[42] Stated another way, a territory is exclusive if a franchisee has "all rights" within a particular area to use the franchisor's trademarks in connection with the goods or services provided under the franchise system.[43]

Therefore, according to the FTC, a franchisor may not state that it grants the prospective franchisee an exclusive territory if it reserves the right to open outlets (either company-owned or franchised) in non-traditional locations such as airports, military

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[37] 16 C.F.R. § 436.5(h).
[38] Compliance Guide at 72-73.
[39] SBP, *supra* note 4 at 15447.
[40] *Id.* at 15451.
[41] Compliance Guide at 73.
[42] FAQ 25, *available at* https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#25.
[43] Michael Gray & Julie Lusthaus, *Plowing New Ground Litigating Non-Traditional FDD Disclosure Issues*, American Bar Association (ABA) 39th Annual Forum on Franchising, W-5 at 34 (2016).

bases, schools and theme parks.[44] Any reservation of rights to open outlets in the franchisee's territory that sell the same goods or services under the same marks triggers the requirement that the franchisor include the disclaimer above[45]. Similarly, to the extent the exclusive territory does not include the right to service national account customers, that exclusion must be clearly identified in Item 12.

i. Item 19 (Financial Performance Representations)

Item 19 has earned its unofficial title of "thorniest" item in the FDD. Item 19 permits franchisors to make financial performance representations (formerly referred to as "earnings claims"), but under limited circumstances. We will not delve into Item 19 in this paper, because it is covered in detail as part of a separate paper and presentation in this year's Legal Symposium. It is worth noting, however, that Item 19 is the most "missed" or overlooked Item in the FDD in that franchisors frequently neglect to address the NASAA requirements outlined in the NASAA Guidelines, 2008 NASAA Commentary and now, the recently effective FPR Commentary.

j. Item 20 (Outlets)

In a change from both the original FTC Rule and the UFOC Guidelines, the FTC added a new requirement to Item 20 regarding confidentiality agreements. Specifically, if franchisees have signed a confidentiality clause in a franchise agreement, settlement agreement or any other contract with the franchisor during the franchisor's last three fiscal years, the franchisor must include the following statement in the FDD:

> In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees will be able to communicate with you.[46]

The FTC's rationale for requiring mandatory disclosure about the existence of these confidentiality agreements was, in large part, to counterbalance the need to inform prospective franchisees that certain franchisees in a system may not be able to discuss their experiences as a franchisee with the need to minimize franchisor's compliance burdens.[47] According to the Compliance Guide, the term "confidentiality agreement" includes "any contract, order, or settlement provision" that restricts a current

[44] FAQ 37, *available at* https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#37.
[45] *Id.*
[46] 16 C.F.R. § 436.5 (t)(7).
[47] SBP, *supra* note 4 at 15506.

or former franchisee from talking about his or her experience in the franchise system.[48] This disclosure requirement is narrowly tailored in that it is only concerned with confidentiality agreements that contain this limitation.

Expressly excluded from the definition of a confidentiality agreement are clauses that serve to protect the franchisor's trademarks or other proprietary information or agreements that prevent a franchisee from speaking with individuals other than a prospect of the system.[49]

k. Item 21 (Financial Statements)

Item 21 requires that franchisors disclose three years of audited financial statements prepared according to generally accepted accounting principles ("GAAP"), unless the franchisor is a start-up franchisor.[50] A franchisor must include its parent's financial statements if the parent has post-sale performance obligations or guarantees the franchisor's performance of its obligations.[51] What does "if the parent has post-sale performance obligations" mean? What if the parent company sells certain goods, services, inventory or equipment to franchisees? The FTC answered this question in FAQs 4 and 30. If the parent company merely provides certain goods or services to franchisees, but there is no "underlying obligation on the part of the franchisor" (and the parent does not guarantee the franchisor's performance) to supply those goods or services, the parent's financials need not be disclosed.[52] If, however, the franchisor is required to provide the underlying goods or services and the parent company has assumed this responsibility, or if the parent is required to provide those goods or services, the parent's financials must be disclosed.[53] Moreover, if the parent is the only supplier of goods or services that are essential to the franchise (i.e. the engine for the car or the battery for the iPhone), disclosure of the parent's financial statements is required, even where there is no express obligation in the franchise agreement for the franchisor's parent to provide the good or service.[54] Under this scenario, the parent's financial stability is a material fact that should be disclosed. If the parent supplies the widget vital to the operation of the franchised business, the prospective franchisee should be able to assess the parent's financial standing.

Another commonly overlooked requirement is where the franchisor engages subfranchisors (master franchisees) for particular territories. According to the FTC, a "subfranchisor" is any party that "steps into" the franchisor's shoes to sell and perform

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[48] Compliance Guide, *supra* note 3 at 108.
[49] *Id*.
[50] 16 C.F.R. § 436.5(u)(2).
[51] *Id.* at (u)(1)(v).
[52] FAQ 4, *available at* https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#4.
[53] *Id.*
[54] FAQ 30, *available at* https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#30.

post-sale obligations.[55] The franchisor must include in Item 21 separate financial statements for the subfranchisor.

I. Item 22 (Contracts)

To comply with Item 22, franchisors must attach to their FDDs a copy of all proposed agreements regarding the franchise offering. This includes the franchise agreement, development agreements, non-competes, personal guarantees, leases or options.[56] On its face, Item 22 does not seem particularly thorny, but how exhaustive is this requirement? What if the terms of the franchise agreement provide for automatic renewal upon execution of a renewal addendum? If the franchisor has a standard form of renewal addendum that it requires all renewing franchisees to sign, the renewal addendum may need to be attached to the FDD.

III. SELECT REGISTRATION ISSUES

a. Material Changes and Amendments

We would be remiss if we did not address select thorny state registration issues. Under federal and state law franchisors must update their disclosure documents on a periodic basis and whenever there has been a material change in any of the information previously disclosed in the FDD. The Compliance Guide notes that a material change includes "such events as the recent filing of a bankruptcy petition or the filing against the franchisor of a legal action that may have a negative effect on its financial condition."[57] Whether a change is "material," is not always an easy assessment to make. The inquiry ultimately turns on whether the change would have a substantial likelihood of influencing a reasonable prospective franchisee's decision to purchase a franchise. However, under various state laws whether a change is material can turn on what some might deem minor changes. Six of the registration states provide examples of material changes that trigger FDD updating (and amended filing) requirements as follows:

Hawaii[58]

A "material change" includes:

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[55] SBP, *supra* note 4 at 15511.
[56] 16 C.F.R. § 436.5(v).
[57] Compliance Guide, *supra* note 3 at 126.
[58]Haw R. Code § 16-31-1 (1981); Terrence M. Dunn, *Material Changes and the FDD: Amending and Going Dark*, Franchise Law Journal, 34(4) (2015).

- the termination, closing, or failure to renew during any three-month period of (a) the greater of one percent or five perfect of all franchises of a franchisor or subfranchisor regardless of location or (b) the lesser of fifteen percent or two percent of the franchises of a franchisor or subfranchisor located in Hawaii;
- any change in control, corporate name, or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor or subfranchisor is a subsidiary, is required to file reports under the Securities Exchange Act;
- the purchase by the franchisor in excess of five percent of its existing franchises during any three-month period on a continuous basis; or
- the commencement of any new product, service, or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis.

Illinois[59]

Examples of "material change" include:

- any increase or decrease in the initial or continuing fees charged by the franchisor;
- a change of more than fifteen percent in the number of requests for refund or rescission or other mode of termination or cancellation of business opportunities sold which were received by the seller in the most recent quarter since the effective date of the current disclosure document;
- a change in the franchisor's management;
- a change in the seller's or purchaser's obligations under the contract or agreement of sale or related agreements;
- a decrease in the seller's income or net worth of more than twenty-five percent; or
- additional litigation or a significant change in the status of litigation, including, without limitation (a) the filing of a complaint, or

[59] Ill. Admin. Code tit. 14 § 135.353 (2015); Dunn, *supra* note 57 at 537-38.

amendment thereto, alleging or involving violations of any business opportunity or franchise law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property or breach of contract, (b) the entry of any injunctive or restrictive order relating to any business opportunity; or the entry of any injunction under any federal, state, Canadian or Mexican business opportunity, franchise, securities, anti-trust trade regulation or trade practice law, and (c) the entry of a judgment that has or would have any significant financial impact on the franchisor (15% or more of the current assets).

Maryland[60]

In the Old Line State, a "material change" includes:

- the termination, in any manner, of more than ten percent of the franchises of the franchisor that are located in Maryland during any three-month period or the termination, in any manner, of more than five percent of all franchises of the franchisor regardless of location during any three-month period;

- a reorganization of the franchisor or a change in control, corporate name, or state of incorporation of the franchisor;

- the commencement of any new product, service, or model line requiring, directly or indirectly, additional investment by any franchisee; or

- the discontinuation or modification of the marketing plan or system of any product or service of the franchisor which accounts for at least twenty percent of the franchisor's annual gross sales.

Minnesota[61]

Examples of "material change" include:

- the termination, closing, or failure to renew by the franchisor during any consecutive three-month period after registration of ten percent of all franchises of the franchisor, regardless of location, or ten percent of the franchises of the franchisor located in the state of Minnesota;

- any change in control, corporate name, or state of incorporation, or reorganization of the franchisor;

[60] MD. Code Regs. 02.02.08.01(9) (2015); COMAR 02.02.08.01 (9) (2015); Dunn, *supra* note 57 at 537-38.
[61] Minn. R. Code 2860.2400 (2015); Dunn, *supra* note 57 at 537-38.

- the purchase by the franchisor during any consecutive three-month period after registration of ten percent of its existing franchises, regardless of location, or ten percent of its existing franchises in the state of Minnesota;

- the commencement of any new product, service, or model line involving, directly or indirectly, an additional investment in excess of twenty percent of the current average investment made by all franchises or the discontinuation or modification of the marketing plan or marketing system of any product or service of the franchisor where the average total sales from such product or service exceed twenty percent of the average gross sales of the existing franchisees on an annual basis;

- any change in the franchise fees charged by the franchisor; or

- any significant change in: a. the obligations of the franchisee to purchase items from the franchisor or its designated sources; b. the limitations or restrictions on the goods or services which the franchisee may offer to a customer; c. the obligations to be performed by the franchisor; or d. the franchise contract or agreement, including all amendments.

New York[62]

Examples of "material change" include:

- the termination, closing, or failure to renew, during a three-month period, of the lesser of ten or ten percent of the franchises of a franchisor, regardless of location;

- a purchase by the franchisor in excess of five percent of its existing franchises during six consecutive months;

- a change in the franchise fees charged by the franchisor;

- any significant adverse change in the business condition of the franchisor or in any of the following: (a) the obligations of the franchisee to purchase items from the franchisor or its designated sources; (b) limitations or restrictions on the goods or services which the franchisee may offer to its customers; (c) the obligations to be performed by the franchisor; (d) the franchise contract or agreements, including amendments thereto; (e) the franchisor's accounting system resulting in a five percent or greater change in

[62] N.Y. Comp. Codes R. & Reg. tit. 13 § 200.5(b) (1981); Dunn, *supra* note 57 at 537-38.

its net profit or loss in any six month period; or (f) the service, product, or model line; or

- the issuance of audited financial statements of a fiscal year subsequent to the one in the FDD.

Wisconsin[63]

Examples of "material change" include:

- the termination, closing or failure to renew during any three-month period of (a) the greater of one percent or five percent of all franchises of a franchisor regardless of location or (b) the lesser of fifteen percent or two percent of the franchises of a franchisor located in the state of Wisconsin;

- any change in control, corporate name or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor is a subsidiary, is required to file reports under the Securities Exchange Act;

- the purchase by the franchisor of in excess of five percent of its existing franchises during any three-month period on a running basis;

- the commencement of any new product, service or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis; or

- an adverse financial development involving the franchisor or the franchisor's parent company, controlling person or guarantor of the franchisor's obligations. The term adverse financial development includes, but is not limited to (a) the filing of a petition under federal or state bankruptcy or receivership laws or (b) a default in payment of principal, interest, or sinking fund installment on indebtedness that exceeds five percent of total assets which is not cured within thirty days of the default.

These examples demonstrate that a change can be as simple or small as the franchisor changing its corporate designation to significant adverse changes in the franchisor's financials.

[63] Wis. Admin Code § 31.01(2)(a)-(e) (2008); Dunn, *supra* note 57 at 537-38.

While the FTC Rule only requires quarterly amendments (in the form of an addendum), the franchise registration and filing states require the FDD to be updated, and amendments to be filed, pretty quickly after a material change has been identified[64]. In some states like California, Maryland, Michigan, New York, North Dakota and Rhode Island, the amendment must be promptly filed. In Illinois, Virginia and Wisconsin, the filing must occur within a 30-day period from a triggering event. In Hawaii, it must occur before any additional sales are made in the state, and in Washington, the filing must be made as soon as reasonably possible, but before any additional sales occur.[65] These nuances underscore the importance of understanding when a change is material thus triggering updating of and, if applicable, amending the FDD. The chart in Exhibit A reflects these timing requirements.

b. Choice of Law, Venue and Other Dispute Resolution Considerations

Relatively recent jurisprudence has highlighted a particularly thorny issue with respect to the dispute resolution provisions in a franchisor's FDD and franchise agreement. Many of the state franchise laws have anti-waiver clauses voiding franchise agreement provisions mandating a foreign governing law, venue or forum. So, what should a franchisor do when its standard form of franchise agreements requires binding arbitration, but a state addendum has an anti-waiver provision requiring dispute resolution in state court? That is a snapshot of the underlying dispute in *Dickey's Barbecue*. That case offered an interesting challenge to Federal Arbitration Act's (FAA) preemption in light of state anti-waiver statutes.

In sum, Dickey's, a Texas-based barbecue restaurant franchisor opened arbitration proceedings in Texas against two sets of Maryland franchisees (the "Maryland Franchisees") after the parties' breached the terms of their franchise agreement. The Maryland Franchisees filed complaints in Maryland seeking to enjoin the Texas arbitration and asserting affirmative claims for relief under the Maryland Franchise Law. A Maryland district court consolidated the lawsuits to rule on the preliminary motions and ordered that the Texas arbitrations be stayed while the court ruled on the motions.

The franchise agreements contained a dispute resolution provision requiring arbitration in Texas and a "Maryland" provision which stated that Maryland law would "govern and control any contrary or inconsistent provisions" of the franchise Agreements. The Fourth Circuit noted that the Maryland provision was similar to Section 02.02.08.16(L)(3) of the Code of Maryland Regulations which states that "a franchisor violates the Maryland Franchise Law if it requires a franchisee to '[w]aive the franchisee's right to file a lawsuit alleging a cause of action arising under the Maryland Franchise Law in any court of competent jurisdiction" in Maryland.

The district court held that the franchise agreements were ambiguous because both parties' offered plausible interpretations of the contract. But the Fourth Circuit

[64] *Id.*
[65] *Id.*

disagreed holding that the clear language of the parties' agreement obligated the parties to resolve common law claims in arbitration and the Maryland franchise law claims in state district court.

One of the most compelling arguments that Dickey's lodged was that the FAA preempted the Maryland provision as an invalid prohibition on arbitration. Despite its head-scratching acknowledgement of the potentially conflicting results, the court determined that the purpose of the FAA is to give effect to the parties' arbitration agreement, even if it results in piecemeal litigation such as this case.. The court observed that that if the parties wanted to agree on a single forum for all of their claims, they could have formalized the agreement to do so.

The result in Dickey's is likely an outlier case, considering the robust precedence of FAA preemption. However, it is instructive in that state mandated anti-waiver provisions do have real world impact on the terms of the parties' franchise agreements. One practical solution is to draft the dispute resolution provision as permissive as opposed to mandatory. Instead of requiring that disputes be arbitrated in an out-of-state proceeding the dispute resolution provision in the franchise agreement can give the party the right – but not the obligation – to do so. This "protects" a franchisee's right to litigate in the franchisee's state, but does not otherwise render the legitimate arbitration provision invalid. However, though unlikely, this could result in the franchisee electing to arbitrate certain claims and litigating certain claims[66].

IV. CONCLUSION

It has been more than 10 years since the FTC amended the FTC Rule. While the interpretive guidelines provided that the FTC and NASAA give practitioners guidance on FTC Rule compliance, some of the questions raised in this paper suggests that, despite the guidance, franchisors and their counsel often still have to use their best judgment as to how to interpret the FTC Rule. Further, it is important not to forget the state specific requirements, whether they relate to specific disclosures or timing of amendments.

[66] Another option is to revise the addendum with the following provision or similar language: "In light of the Federal Arbitration Act, there is some dispute as to whether this forum selection requirement is legally enforceable." This language presumably preserves the franchisor's right to fight another day in court or arbitration about the enforceability of the anti-waiver provision in light of FAA preemption.

Exhibit A

State Timing Requirements (Amendments)

State	Requirement To Amend Registration; Timeliness Of Filing	Applicable Statute
CA	Amendments must be made promptly upon the occurrence of any material change	California Franchise Investment Law § 31123
HI	Amendments must be made before any further sales of the franchise	Hawaii Franchise Investment Law § 482E-3(b)
IL	Amendments must be made within 30 days after the close of each fiscal quarter	Illinois Franchise Disclosure Act of 1987 815 ILCS 705/11
IN	No amendment filing requirement	N/A
MD	Amendments must be made promptly upon the occurrence of any material change	Maryland Franchise Registration and Disclosure Law § 14-220
MI	The franchisor must promptly notify the state in writing of any change in the information contained in the notice as originally submitted or amended	Michigan Franchise Investment Law § 445.1519
MN	Amendments must be filed within 30 days after the occurrence of any material change	Minnesota Franchise Law § 80C.07
NY	Amendments must be made promptly upon the occurrence of any material change	New York General Business Law § 683.9
ND	Amendments must be made promptly upon the occurrence of any material change	North Dakota Franchise Investment Law § 51-19-07(6)(a)
RI	Amendments must be made promptly upon the occurrence of any material change	Rhode Island Franchise Investment Act § 19-28.1-11
SD	Amendments must be made within a reasonable time after the end of each quarter to reflect any material change. However, no filing with the division required.	South Dakota Franchise Investment Law § 37-5B-7(2)
VA	Amendments must be made within 30 days after the occurrence of a material change	Virginia Administrative Code 21VAC5-110-40
WA	Amendments must be made as soon as reasonably possible after the occurrence of any material change, but in any case before any further franchise sales	Washington Franchise Investment Protection Act § 19.100.70(3)
WI	Amendments must be made within 30 days after the occurrence of any material change	Wisconsin Franchise Investment Law § 553.31(1)