

2018 IFA

LEGAL SYMPOSIUM

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Thorny FDD Disclosure Issues

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

- Predecessors – A person from whom the franchisor acquired, directly or indirectly, the major portion of the franchisor’s assets.
 - During the 10-year period immediately before the close of the most recent fiscal year
- Affiliates – An entity controlled by, controlling, or under common control with, another entity.
 - Not all affiliates need to be disclosed in Item 1

Item 2 (Business Experience)

- Who has “management responsibility”?
- Does not matter if not “employed” by the franchisor
- Do area representatives have “management responsibility”?

Item 3 (Litigation)

- Not all parents and affiliates
- Predecessors – no time limitation
- How do you get information from Item 2 individuals?

Item 3 (Litigation)

- Complaints filed but not served
- Confidential settlements
- Pending
 - violation of franchise, antitrust or securities laws, or alleging fraud, unfair or deceptive practices or comparable allegations
 - civil actions material in the context of the number of franchisees and the size, nature or financial condition of the franchise system or its business operations
- “Franchise relationship” – contractual obligations between the franchisor and franchisee directly relating to the operation of the franchise business

Item 4 (Bankruptcy)

- Obtained a discharge of debts under the Bankruptcy Code during the last 10-year period
- Principal officer of a company or general partner in a partnership – during or within one year after the individual held the position

Item 8 (Restrictions on Sources of Products and Services)

- Requires disclosure of (i) required purchases, (ii) required and approved suppliers, (iii) approval of alternative suppliers, (iv) revenue from franchisee purchases; and (v) purchasing coops, negotiated pricing, or material benefits
- What are “revenues or other material consideration” from required purchases and leases”
- Franchisors must disclose any franchisee obligations to purchase products *under the franchisor’s specifications*.
What does that mean?

Item 8 (Restrictions on Sources of Products and Services)

- Also requires disclosure of the estimated proportion of required purchases and leases by the franchisee to all purchases and leases of goods and services in establishing and operating the franchise business
- Are franchisors required to disclose names of suppliers?
- What's a rebate?
 - Contributions to marketing fund?
 - Contributions to franchise convention?

Item 12 (Territory)

- Franchisors must disclose: (i) specific location or location to be approved, (ii) any minimum territory granted, (iii) conditions for approval of relocation or establishment of additional outlets, (iv) any options, rights of first refusal or similar rights, (v) exclusive territory or not exclusive, (vi) other restrictions
- Required disclaimer:
 - *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*

Item 19 (Financial Performance Representations)



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- Most “missed” Item in the FDD
- Don’t forget the NASAA FPR Commentary

Item 20 (Outlets)

- Don't forget to count and recount outlet totals, helpful to explain any discrepancies in existing franchisee lists and list of franchisees that left the system
- Provide, among other information:
 - Disclosure regarding existence of confidentiality agreements that restrict a current or former franchisee from discussing the franchisee's *personal experience as a franchisee in the system*

Item 21 (Financial Statements)

- Franchisors must provide three years of audited financial statements (unless a start-up, in which case you may phase-in audited financials), audited in accordance with GAAP
- Parent's financials must also be disclosed if the parent (i) commits to perform post-sale obligations for the franchisor or (ii) guarantees the franchisor's obligations
- Affiliate's financials permitted if the affiliate guarantees to assume the franchisor's obligations under the franchise agreement
- Subfranchisor's financials must be disclosed if it engages in pre-sale activities and performs post-sale obligations

Item 22 (Contracts)



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- Franchisors must provide a copy of **all** proposed agreements “relating to the franchise offering” that the franchisor provides, or for which the franchisor makes arrangements.

Updating Requirements and Material Changes

- FTC Franchise Rule requires that FDDs be updated (i) annually, (2) quarterly, and (3) where there has been any material change to the FPR
- Most of the registration states require amendments to be filed pretty quickly after the occurrence of any “material change”

Updating Requirements and Material Changes

- What constitutes a “material change”?



State Addenda and Anti-Waiver Provisions

- State addenda are also often overlooked
- Require the inclusion of anti-waiver provisions if the Franchise Agreement provides for jurisdiction or venue outside of the state or has a foreign choice of law provision
 - *see, e.g.* CA, IL, MD, MI, MN, RI, SD, WA, WI

State Addenda and Anti-Waiver Provisions

- *Dickey's Barbecue* (MD)
 - Least desirable result (bifurcated proceedings)
 - Raised questions about FAA preemption
- *How do we approach this particularly thorny issue, or is it not really thorny at all?*