



RAISING THE BAR

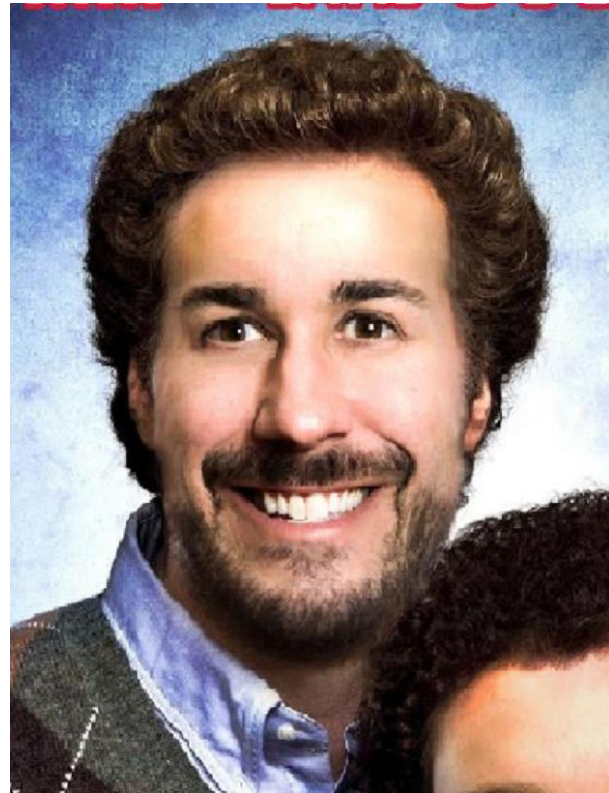
IFA LEGAL SYMPOSIUM
MAY 5-7, 2019 | WASHINGTON, DC



Unusual, Uncommon and Atypical Comments from State Examiners

- Mike Drumm - Drumm Law, LLC
- Matthew Kreutzer - Howard & Howard Attorneys PLLC
- John Moore - Husch Blackwell LLP

Meet the Team



Franchising



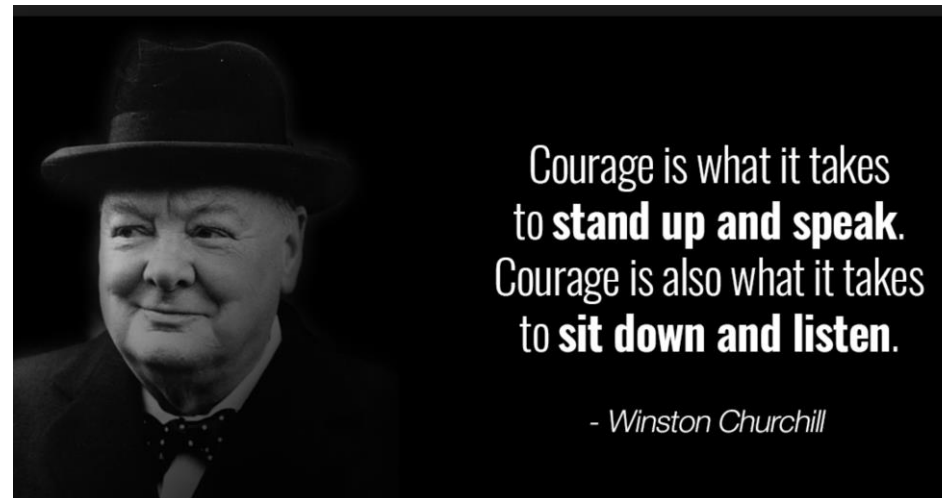
General Strategies

- Ensure the FDD is compliant with the NASAA Guidelines;
- Make the FDD compliant with applicable state law by reviewing each state's individual state laws, regulations, guidelines and commentary;
- Carefully review information to be incorporated into the FDD;
- Review the franchisor's financial statements to confirm the FDD contains the correct financial statements and that those financial statements are consistent with the information disclosed in the FDD;
- Confirm the accountant consent includes the prescribed statements;



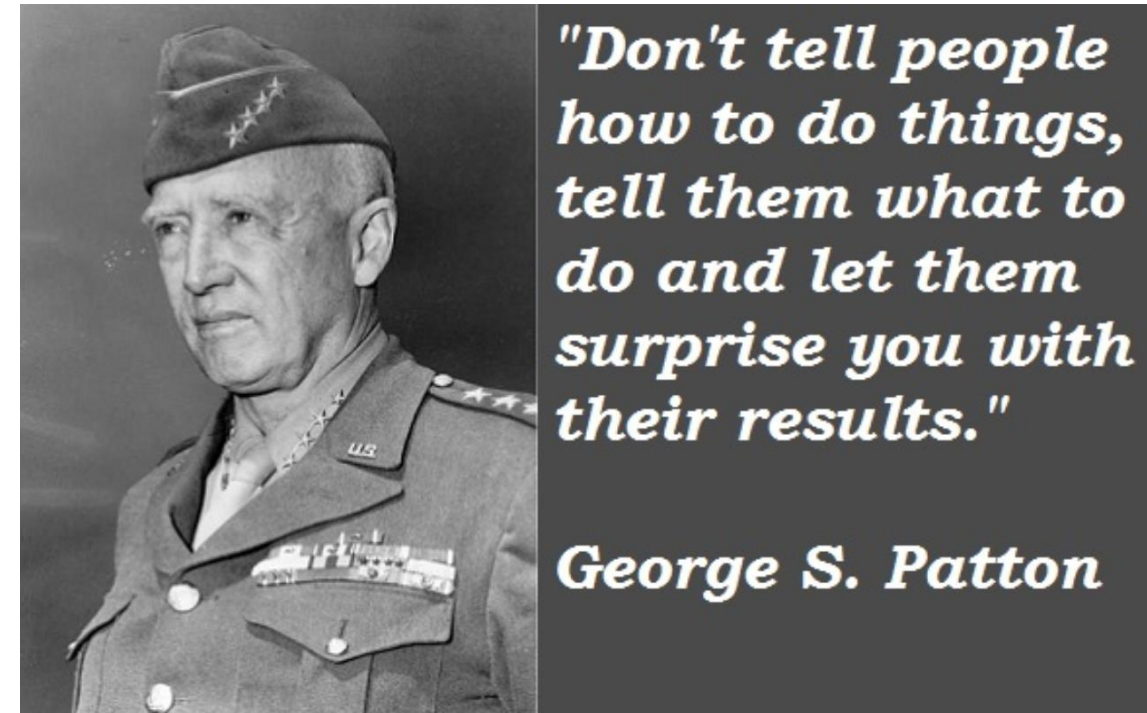
General Strategies

- Respond promptly and completely to all comment and deficiency letters and collect and review all information required to respond to each letter including any necessary references to the laws or regulations of that state;
- If any comment is unclear (or if the same comment is repeated in subsequent comment letters), contact the state administrator to seek clarification before responding to the letter;
- If two different state examiners make conflicting comments, provide details of the conflict to each examiner and ask each examiner to clarify so a potential resolution can be identified;
- Develop an understanding of each state's particular requirements for responses to comment or deficiency letters such as providing blacklined copies of the entire FDD versus only changed pages;



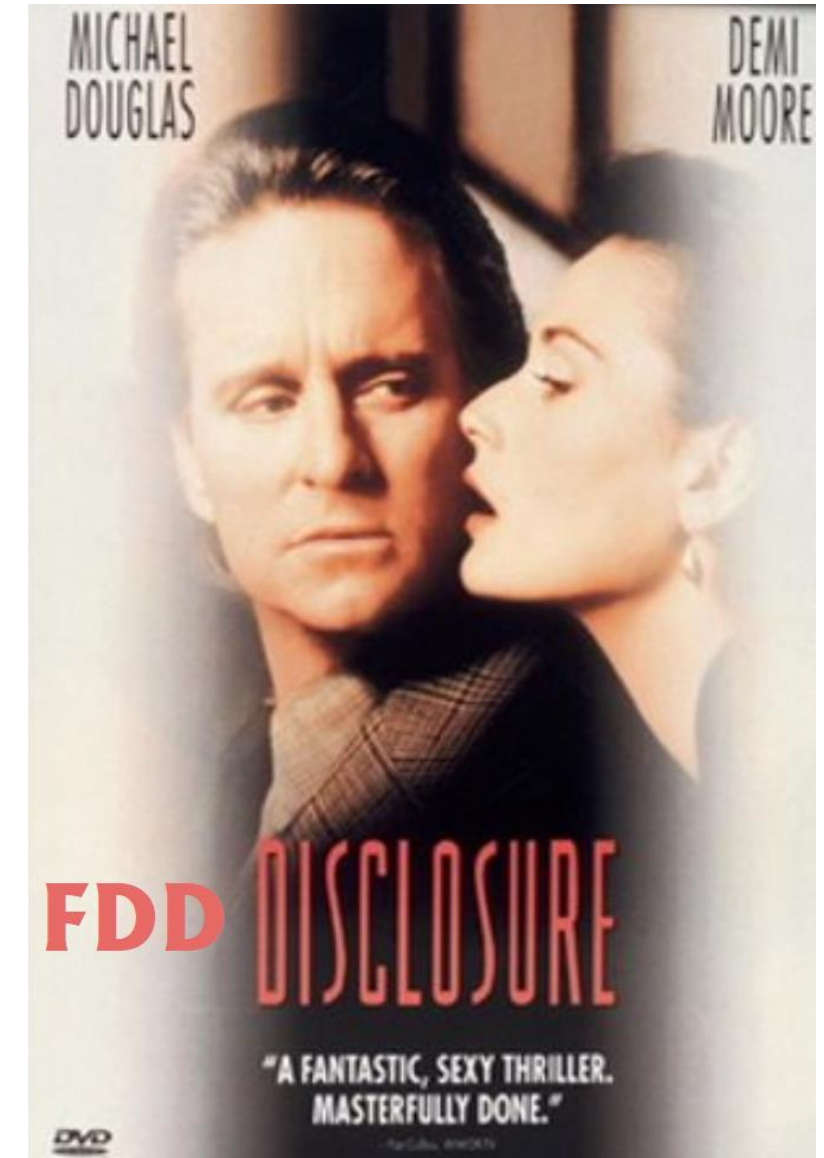
General Strategies

- Address state-specific requirements as completely as possible, even though some may appear to be trivial and inconsequential to you, they are not to the applicable state;
- Address all comments in a single response that creates an appropriate record of correspondence and adequately responds to the content of each comment in the form required by the state administrator;
- Respect the state regulators and they will respect you; and
- Choose your battles wisely.



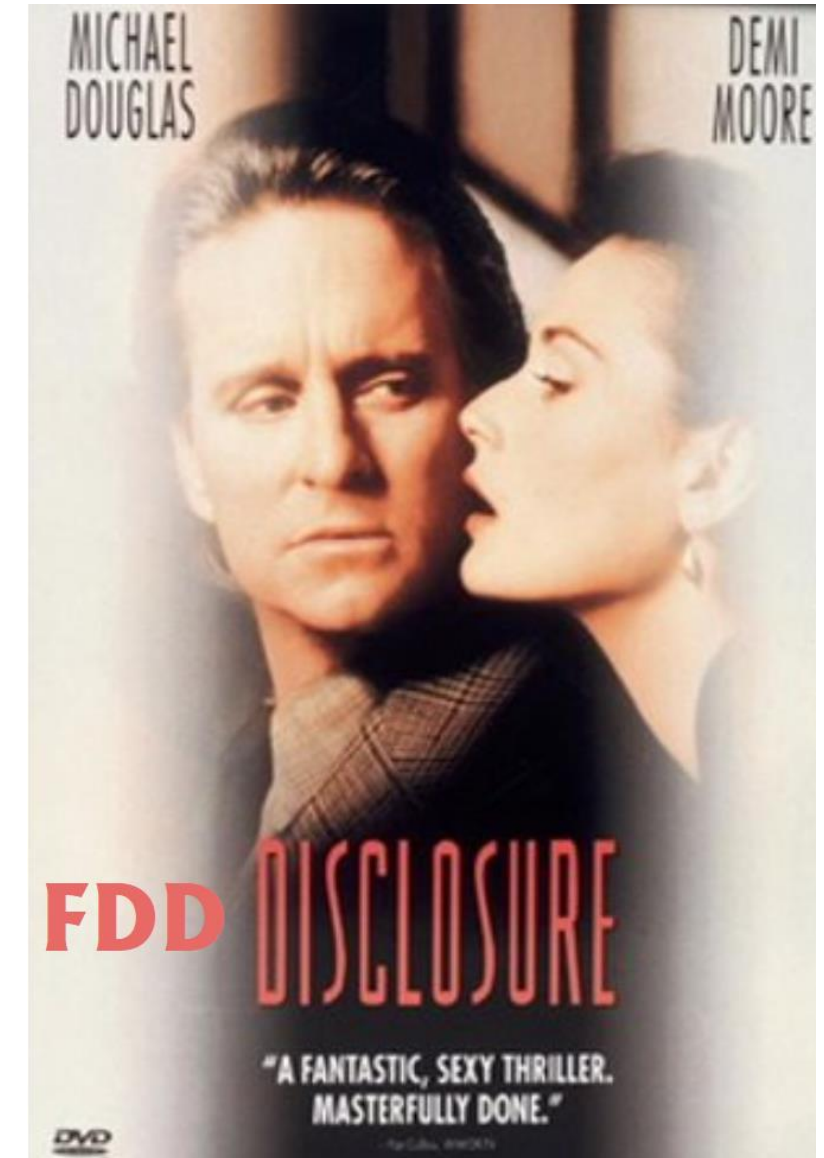
Common FDD Disclosure Items That Generate Comments and/or Delay Registration

- Include the correct “issuance date” on both the FTC cover page and receipt pages of the FDD.
- If the franchisee is required to make payments to the franchisor and/or one of its affiliates prior to opening for business, the amount of such payments must reconcile on the FTC Cover Page and Item 5.
- The amounts listed in the estimated initial investment table(s) in Item 7 must also reconcile with the FTC Cover Page.
- Modifications to the required paragraphs. See FTC’s FAQ #27.



Common FDD Disclosure Items That Generate Comments and/or Delay Registration

- Tables 1-4 in Item 20 must reconcile, so that net franchise and company-owned numbers in tables 3 and 4 match the numbers in table 1.
- The lists of current and former franchisees must match the disclosures in Tables 1, 2, and 3 of Item 20, and the list of franchisees that have purchased franchises but are not yet open must match the numbers disclosed in Table 5 of Item 20.
- If the franchisor does not have sufficient net worth and/or working capital to satisfy its pre-opening obligations to its franchisees based on the number of projected openings for the next fiscal year based on Item 21 financial information disclosures for the franchisor, the state regulators will likely require financial assurances such as deferral of fees, escrows, etc. Franchisors in this position should plan to include the financial assurance it is willing to provide in its initial filing to avoid comments on this issue that will delay registration, and specifically highlight the issue in the cover letter to the registration package.
- In Item 21, the audited financial statements must be listed in side-by-side format, so that the results of the most recent fiscal year are shown next to the results of the prior fiscal year.



Common Mistakes To Avoid

- Failure to write the FDD in “plain English;”
- Including introductory paragraphs at the beginning of Item 2 and Item 6;
- Additional information in the business experience disclosure for franchisor’s personnel in Item 2. For example, “Mary Smith, our president, is active in her church and community and coaches her daughter’s little league team”
- Lists of franchisor-defined terms in specific Items;
- Franchisor’s opinion about the merits of a specific lawsuit being included in Item 3 without including an opinion of counsel;
- Revising the standard Item 12 disclosure regarding an exclusive territory, or failing to include the required language when the franchisor does not grant an exclusive territory;



Watch the Typos and Mind Your Rrammar



Common Mistakes To Avoid

- Including additional language about state-specific laws *after* the table in Item 17;
- Failing to include required disclosures about renewals in Item 17.b, or regarding state-specific franchise laws in Item 17.v;
- Using an “issuance date” of the FDD that is before the date of the audited financial statements, or that is different from the date on the franchisor’s certification page;
- Failing to provide interim financial statements that are dated within 90 or 120 days (depending on the state) of the date of the franchisor’s application for registration in that state; and
- Failing to include financial statements that are prepared in accordance with GAAP.

State-Specific Tips

Google autocomplete results:

“Why is [state] so...”



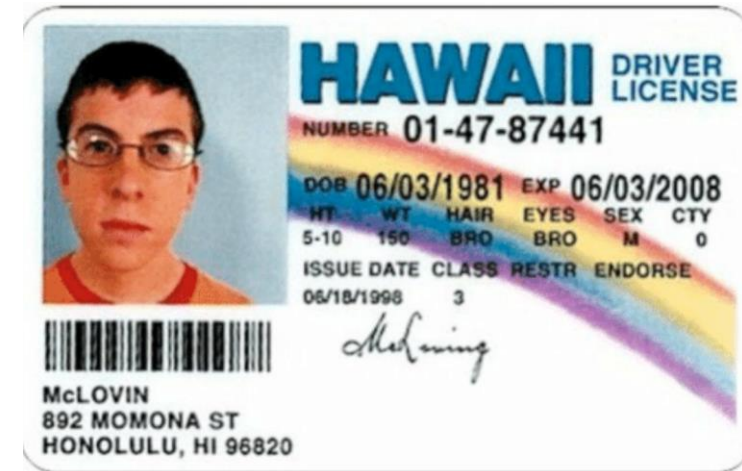
California

- Failure to include a Customer Authorization for Disclosure of Financial Records or Internet Advertising Exemption, which are forms unique to California.
- Failure to address in the cover letter for a renewal application whether the franchisor has complied with Cal. Corp. Code Section 31109.1 if it claims an exemption under that section for negotiated sales.
- For start-up franchisors, failure to include financial statements that have been audited or reviewed by a certified public accountant.
- Where the financial statements do not demonstrate that the franchisor has the ability to fulfill obligations to provide real estate, improvements, equipment, inventory, training or other items included in the offering, failure to provide sufficient financial assurance in the form of an escrow, initial fee deferral, surety bond, or parent guarantee.
- If the franchisor's legal entity is a California entity, failure to have filed with the DBO a form Notice of Transaction Pursuant to Cal. Corp. Code Section 25102(f) and have paid the applicable fee.



Hawaii

- Cover letter clearly stating the name of the applicant, the enclosed documents, the fiscal year of the applicant, and an acknowledgment that the franchise filing will “expire three months after the fiscal year end”;
- Filing Fee: \$250 (Checks must be made payable to Hawaii Commissioner of Securities);
- a copy of the FDD (clean and a marked (blackline) showing all changes from the most recent filing, which includes the franchisor’s audited financial statements for the most recent fiscal year;
- Uniform Franchise Registration Application (NASAA Form A or Hawaii State Specific Application for Filing of Franchise);
- Certification of the FDD signed by an authorized officer, manager or general partner of the franchisor;
- Franchisor’s Costs and Source of Funds (NASAA Form B)
- Uniform Consent to Service of Process (Hawaii state specific); and
- Consent of auditor (if franchisor is filing audited financials as part of the FDD)



Illinois

- Item 12: Exclusive/non-exclusive territories and franchisee/franchisor rights in territories
- Initial investment consistency between FTC Cover Page and Items 5 + 7 for 1 unit or multiple units. If the same numbers aren't used, revisions are required. No explanations or variations will be accepted by examiners.
- Approved/Required Suppliers disclosure in Item 8 + relevant info consistency through FDD
- Items 8 + 11 fiscal year end financial info + Item 20 franchise numbers
- Disclosure consistency between FDD + FA/ADA
- Complete disclosures responsive to FTC Franchise Rules for Items 8, 11, 12, 17, 20
- State laws governing agreements – Item 17, essentially addressed by State Addendum but that evolves
- Franchise/License sales. Term “license” triggers closer look at franchisor + filing. Looking for illegal franchise sales.
- Required financials – 3 fiscal years, interim financials, audited, GAAP basis + externally prepared for interim financials + fiscal year end financials for those new franchisors that haven't undergone an audit



Indiana

- The Securities Division does not review FDDs as part of the registration process.



Maryland

- Failure to include both a paper copy and CD of the FDD; and
- Failure to include a notarized acknowledgement certifying that the documents on the CD are identical to the paper documents.



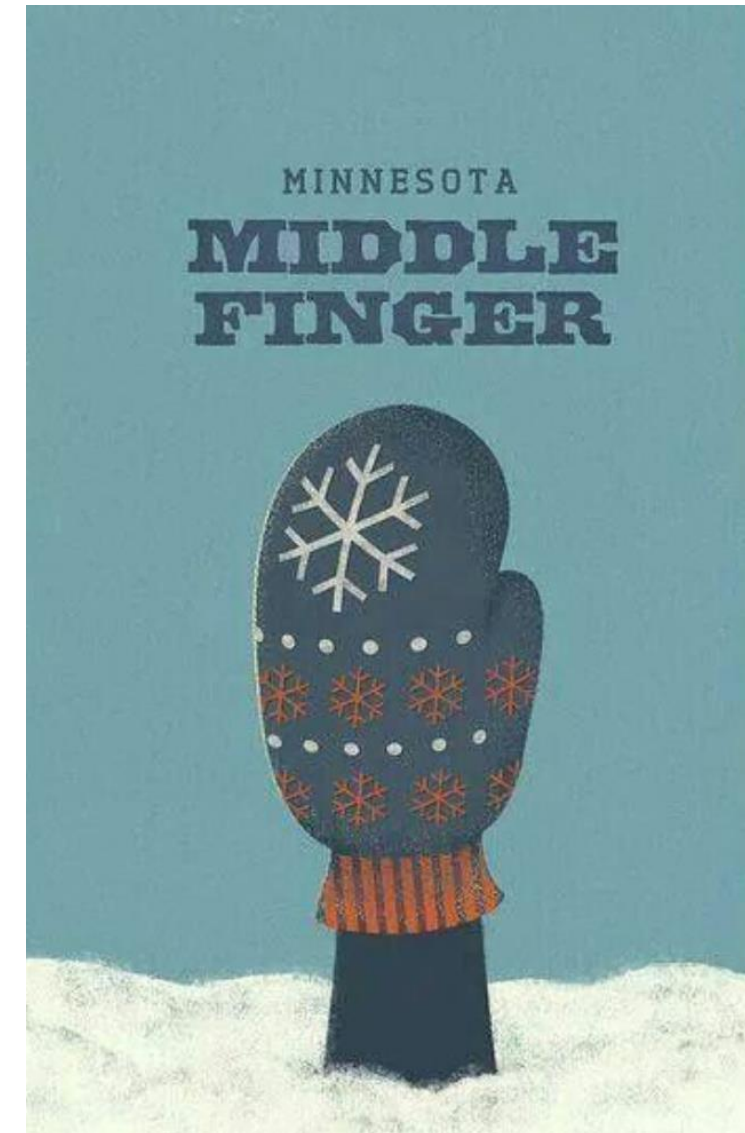
Michigan

- Michigan is a notice filing state. A franchisor is required only to file a notice with the Attorney General, in the required format, if it wishes to offer or sell franchises in the state. The Attorney General does not review FDDs as part of the registration process



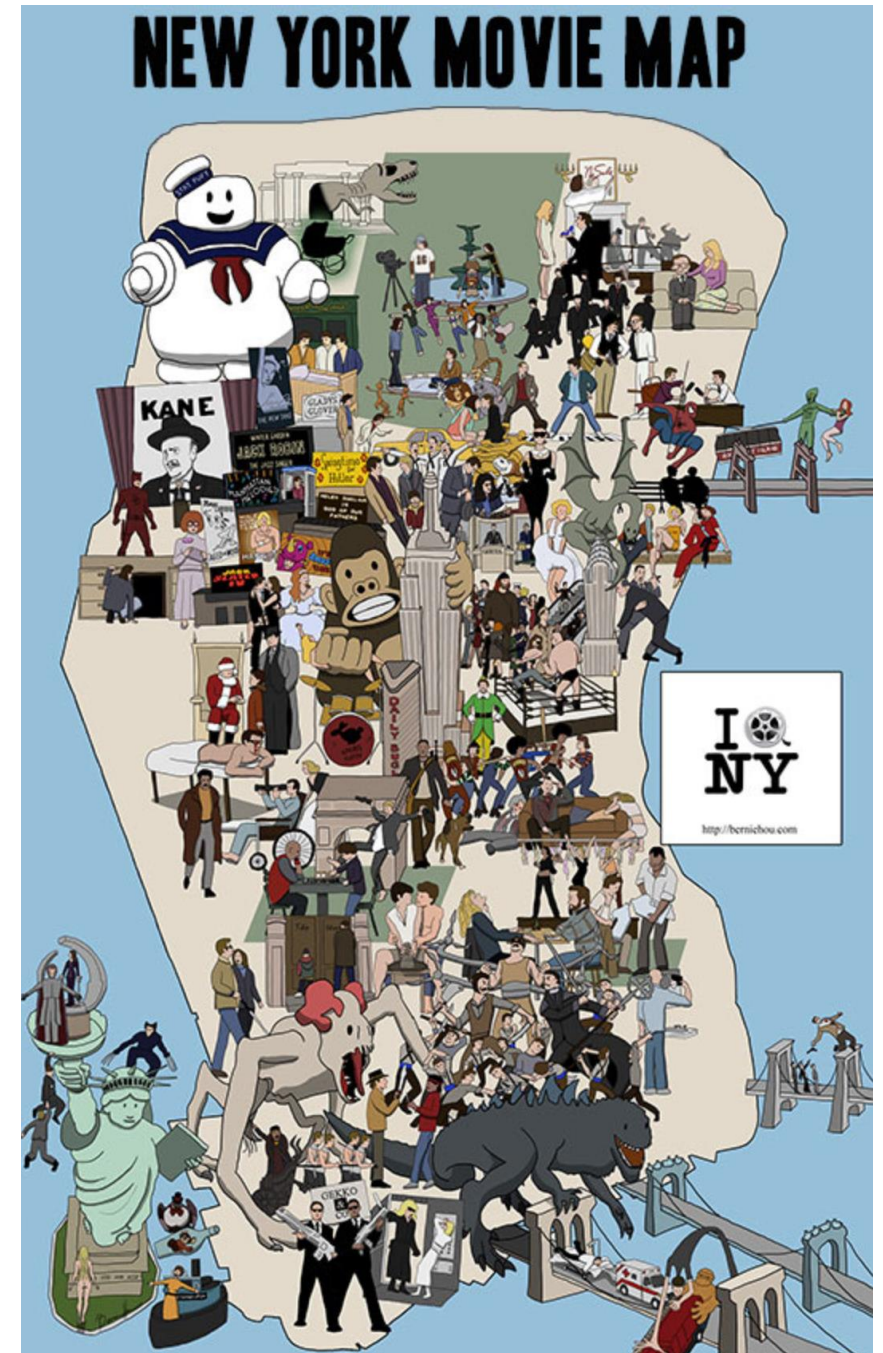
Minnesota

- Minnesota can and does send comment letters and most are about fee deferral and financial assurance. Occasionally, the state will send comment letter about other things (nothing too strange), but they are mostly looking at the financial statements to determine whether they will approve your application or not.



New York

- If a franchisor uses franchise brokers in the offer or sale of franchises in New York, those franchise brokers must be registered with the Department prior to the offer or sale of a franchise in any state so it is important to register brokers early with the state of New York.
- Be careful about calling the Department too often to ask about the status of a filing or the timing of a review because it may delay your registration; and
- Be sure you submit the proper form of marked blackline because the Department requires that your blackline reflect all changes that have been made to the version of the FDD that was last approved by the Department



North Dakota

- If the franchisor is a start-up and has submitted unaudited financial statements, failure to provide an accepted form of financial assurance.
- Failure to include a North Dakota addendum that addresses each of the state-specific issues in N.D.C.C. 51-19 et seq.



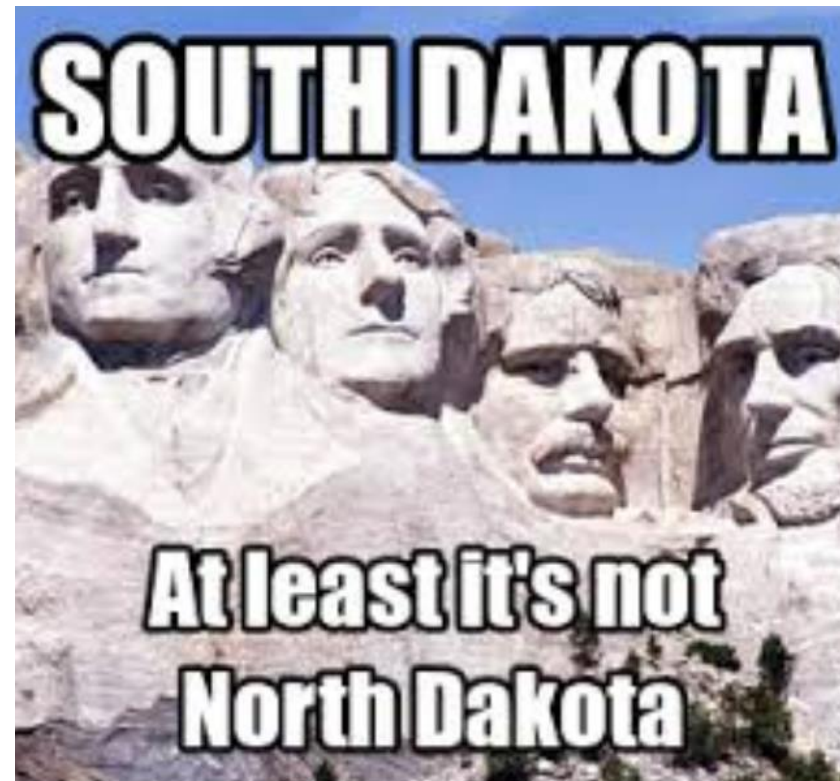
Rhode Island

- While Rhode Island will review your application and financial statements, they don't do as laborious of a review as other states. It is rare for them to send out a comment letter with any corrections.



South Dakota

- The Division does not review the contents of the FDD, as a whole, but it will review the franchisor's financial statements as part of the registration process and may require financial assurance based on the financial condition of the franchisor. The Notice filing is effective upon receipt by Division and expires one year following the date of the Division's receipt of the application.



Virginia

- If the notes to the audited financials contain a “going concern” opinion (meaning that the auditor expresses doubt as to the franchisor’s ability to continue operating as a going concern), Virginia will refuse to register the franchisor.
- Failure to submit financial statements that are prepared according to GAAP.
- If the audited financials demonstrate that the equity of the shareholders in the franchisor is less than the franchisees’ total estimated investment, the franchisor must include a risk factor on the state cover page that says “THE FRANCHISEE WILL BE REQUIRED TO MAKE AN ESTIMATED INITIAL INVESTMENT RANGING FROM [low number] TO [high number]. THIS AMOUNT EXCEEDS THE FRANCHISOR’S STOCKHOLDERS EQUITY AS OF [end of last fiscal year], WHICH IS [amount].”
- If, in response to a comment letter, corrections to the FDD disturb the pagination from the version originally submitted to the state, the franchisor must submit a complete clean copy of the FDD on a CD-ROM in PDF format.
- If the franchisor’s audited financial statements reflect that a high percentage of the franchisor’s assets are intangible, the franchisor must include a risk factor on the state cover page that says “THE FRANCHISOR’S FINANCIAL CONDITION, AS REFLECTED IN ITS FINANCIAL STATEMENTS (SEE ITEM 21) CALLS INTO QUESTION THE FRANCHISOR’S FINANCIAL ABILITY TO PROVIDE SERVICES AND SUPPORT TO YOU.”



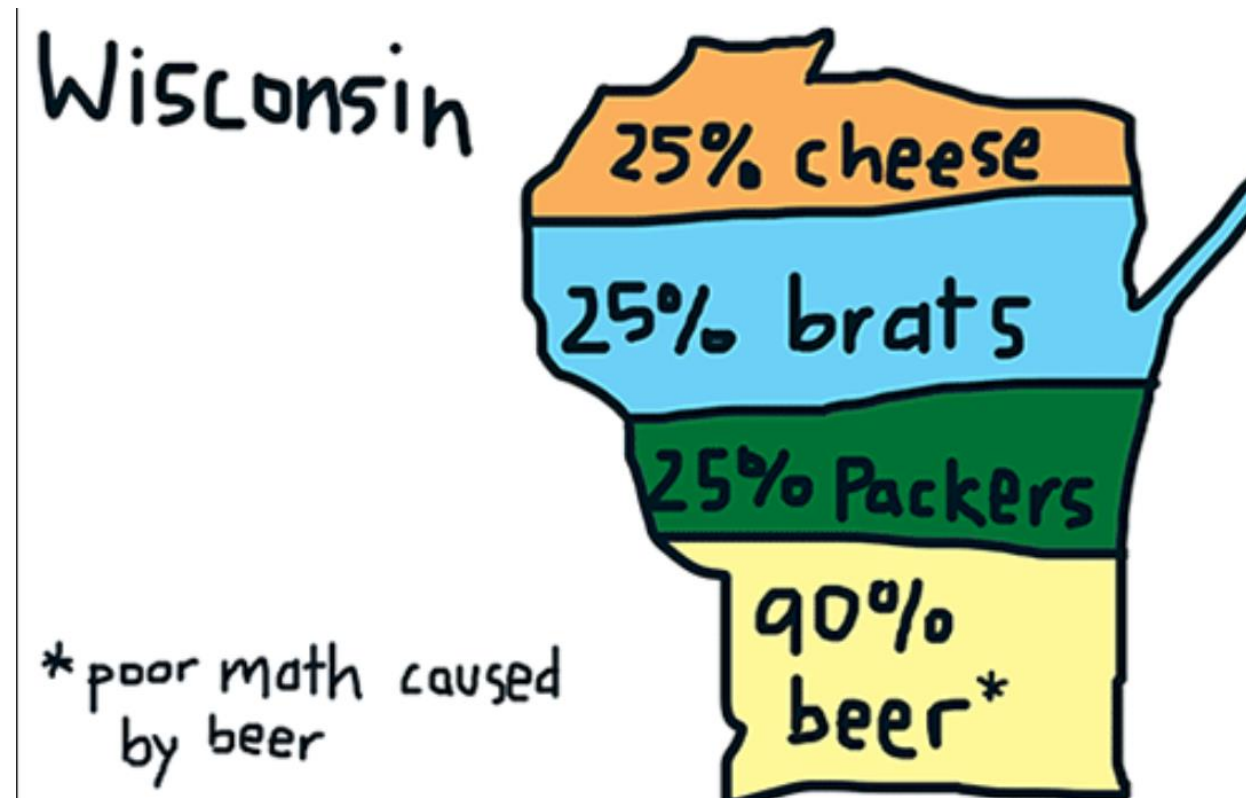
Washington

- The penalty for missing your renewal deadline is more than just the extra \$500 filing fee. It also means your FDD will be treated like a new application and will get a full review by an examining attorney. This adds several weeks/months to the process and pretty much guarantees you will receive a comment letter.
- Try to keep your changes from year-to-year at a minimum, especially Item 19. Renewals that are heavily blacklined are often referred to an examining attorney which (like missing the renewal deadline) will add a significant delay in the renewal and will likely lead to a comment letter.
- Unless you have a very compelling reason, don't call/email the examiners to ask them to speed up their review.
- Remember that April is the renewal season for state examiners as well. At any given time, an examiner may each have backlog of 40-60 FDDs to review. When you get a comment letter, it's very helpful to respond comment-by-comment in the order the comments were issued. If you change or fix something based on a comment, but don't explain to the examiner what you did, you are much more likely to get a response comment letter.



Wisconsin

- Once you file your application online, your registration is effective immediately. It would be very rare for you to receive a comment letter from Wisconsin.



Fine Print

- To any regulators in the audience, we love you and appreciate what you do. If any part of this presentation is offensive, it is the fault of the franchise lawyers not present here today (you know, the bad ones).

WARNING

If you are reading this then this warning is for you. Every word you read of this useless fine print is another second of your life. Don't you have other things to do? Is your life so empty that you honestly can't think of a better way to spend these moments? or are you so impressed with authority that you give respect and credence to all who claim it? Do you read everything you're supposed to read? Do you think everything you're supposed to think? Buy what you're told you should want? Get out of your apartment. Meet a member of the opposite sex. Stop the excessive shopping . Quit your job. Start a fight. Prove you're alive. If you don't claim your humanity you will become a statistic. You have been warnedTyler

Unusual, Uncommon, or Atypical Comments

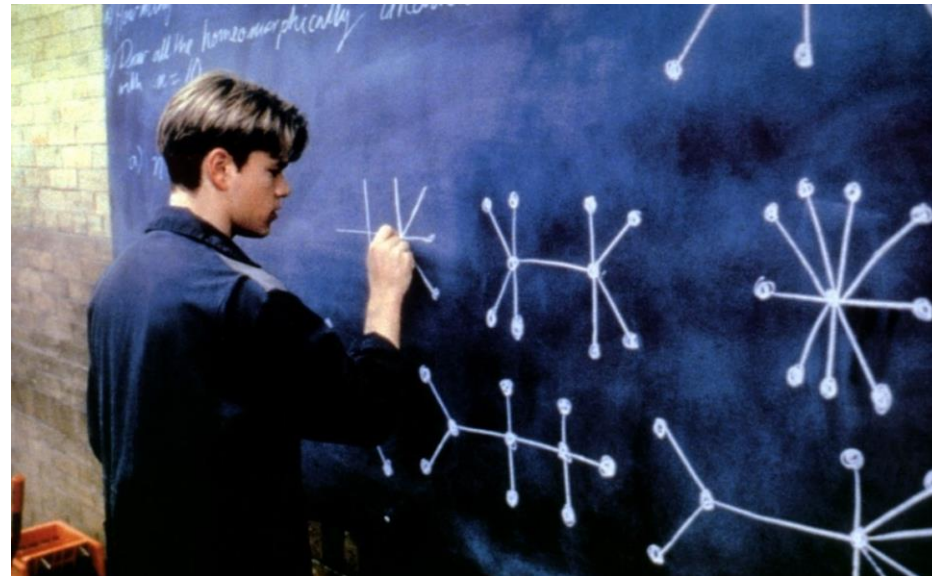


Failure to Communicate



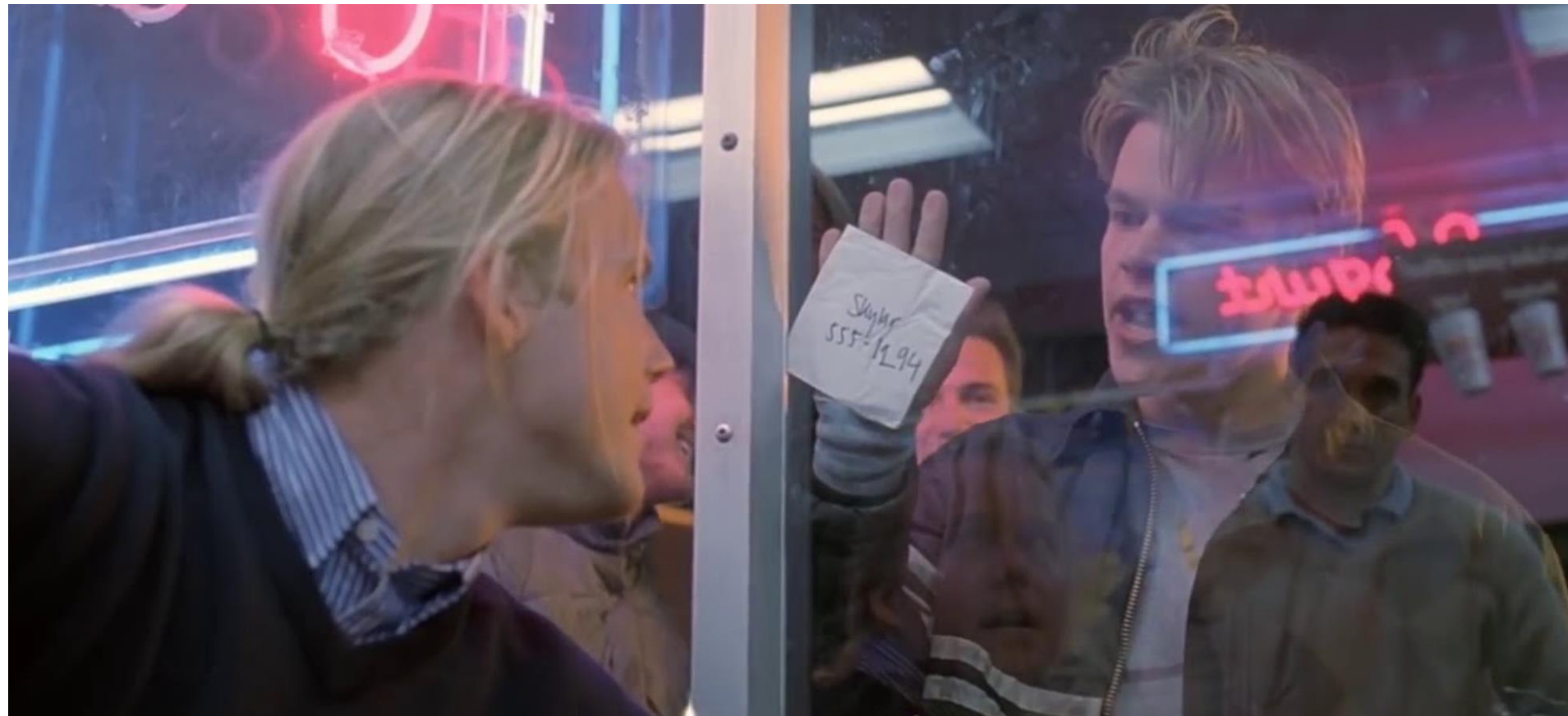
Lawyers and Math

As of / / , the franchisor had only \$ in current assets and had \$ in current liabilities. This means that for every dollar of liabilities due within one year, the franchisor has only \$ (divide current assets by current liab.) in current assets. Since its inception, the franchisor has lost \$ (deficit accumulated during the development stage / or look for a column heading: Cumulative for the Period from Inception- put in Net Loss) **** (Retained Earning) **** causing it to have a deficit net worth of \$ **** (Stockholders Equity) **** . Franchisors working capital is \$. (Subtract total current liabilities from total current assets)



Lawyers and Math

We are requesting you can waive this requirement as I think the risk factor is misleading and confusing. For example, you are requesting that I state that a franchisor has lost \$____ since Inception based on members deficit from one year's set of financial statements. I appreciate your reconsideration of this request. Thanks.



We are Family

I routinely make this request so that if it is a family business prospective franchisees know this. As you know I have authority to add to the FTC Guidelines and I do not think this request is over reaching when several people have the same last name. Just add a line as to how each person is related.

I reserve the right, as always to use my discretion to clarify disclosure. The Guidelines in California afford me this discretion.

I would like the disclosure in Item 2 to clarify what should be an obvious relation and the issue should be resolved where the question arises.

In Item 2, please disclose how all the Smiths are related.

Do not place this clarification in the CA state addendum.



NASAA ≠ FTC Compliance Guide



- Footnote in Item 9 of FTC Compliance Guide regarding guarantee must be removed from FDD approved by state

I'm On a Boat

Also, please state amenities of the vessels.



I'm On a Boat

Am/fm radio.....



Footnotes – Items 9 and 17

- Multiple states have directed deletion of footnotes or other explanatory notes under tables in Items 9 and 17.

Don't Call it a "Receipt!"



California: refused to register an FDD where the franchisor included documents that had “receipt” in the title.

Examiner: “I will require that you rename Exhibit L [named “Receipt for Completed Documents”] to something that doesn’t reference a ‘receipt,’ as this is confusing.”

How many sets of tables?



- Comment requiring two sets of Item 20 tables be provided for a franchisor that had both (a) new franchisees and (b) existing licensees who were in the process of converting to franchisees by signing franchise agreements

Back to the Future

8) Regarding my Comment #32, I am reissuing my Comment:

32) In Item 16, it states “You must sell or offer for sale all types of services and products specified by us. We may change or add to our required services and products at our discretion with prior notice to you. (See Item 8).”

Please state how long a Franchisee would have to comply with changes or additions to the required services and products.

Also, please state the Amount a Franchisee would have to pay per year to comply with the changes to the required services and products.



Back to the Future

We may change or add to our required services and products at our discretion with prior notice to you. (See Item 8). If we change or add to our required services and products, the changes or additions will remain in permanent effect, unless we specify otherwise. The amount you must pay for the changes or additions will be dependent upon the nature and type of changes or additions



Dude, Where's the Car?



Illinois: for home-based business that did not require the franchisee to travel, examiner required franchisor to include the cost of a vehicle in Item 7.

“Reasonable” LDs

- Comment requiring evidence that Liquidated Damages provision bears “reasonable relation” to franchisor’s potential damages



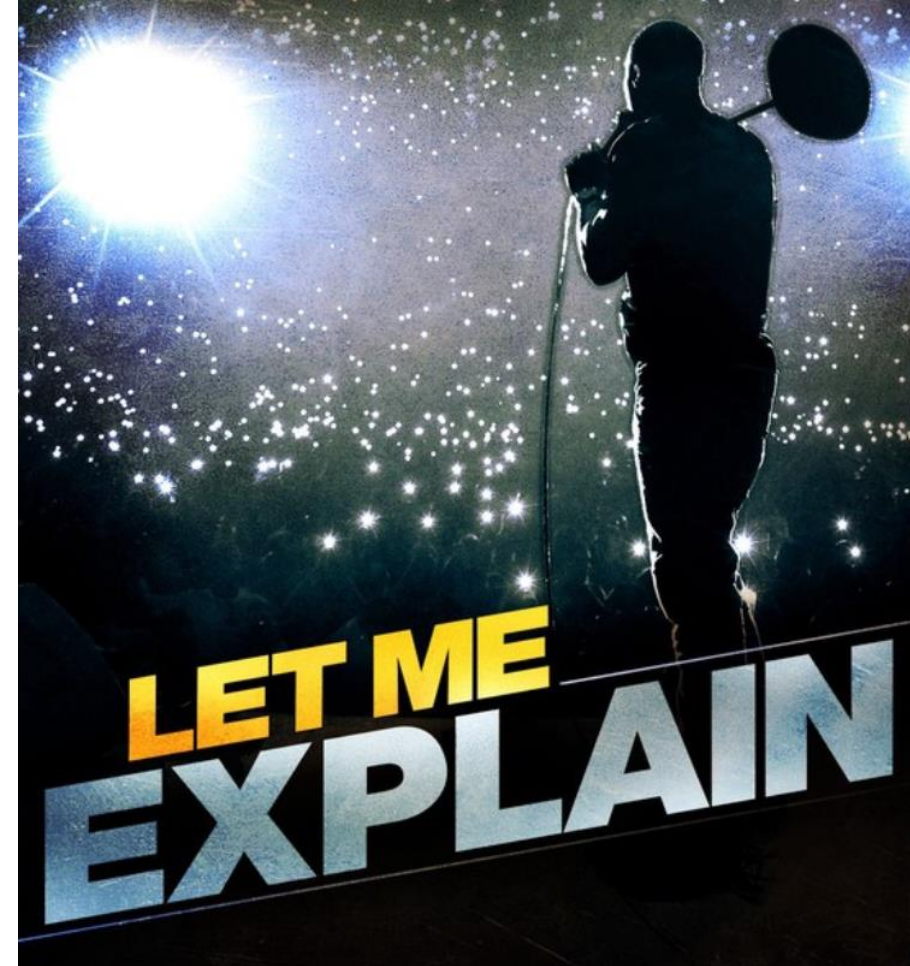
Rejected

Item 22 is **rejected**, as the entire franchise agreement is lined. Submit a copy of the franchise agreement that indicates the additions and deletions from the one that was previously registered by this State



Rejected

As previously explained, when applicant hired us as their counsel, we switched applicant to our form of documents which, we believe, are written in a more plain English style in compliance with the amended guidelines. We utilize workshare compare software which is an industry leading software for document comparison (<http://www.workshare.com>). As we switched to a completely new style of writing in this new template, most of the document has been revised. I have enclosed two redlines for your review. One shows the recent changes that were made in response to this comment letter. The other redline shows the last registered FDD and FA in Maryland compared to the latest version being submitted with this response. I have printed this entire redline in color for you so you are able to see the revisions. Any text that remained black was leftover from the original document (for example, item headings and most of Item 10). Any text in red shows where a section or words were deleted. Any text in blue shows the addition of words. Any text in green shows phrases that existed in the original but have now been moved to a new location in the document. Once again, most of this redline will show a majority of deletions of entire sections in red and entire additions in blue. Also, as you will see, some (very little) of the original text remains (see cover page and Item 10 for example) and certain phrases such as “Initial training classes are scheduled as needed according to demand, typically 6-8 times per year. Training sessions are held at franchise locations as approved by franchisor” remain in the document but have moved to a new location. As such, this is a valid redline which meets the requirements under Maryland law for a renewal filing because it is a copy that has been marked to show any changes, updates and deletions you have made to the last Franchise Disclosure Document you filed.” As such, the Item 22 rejection of the blackline is invalid.



N/A Means.... What?



New York: cannot use the abbreviation “N/A;” must write out “not applicable.”

Where's the Form?



California: If the franchisor is a California entity, it must file with the DBO a form Notice of Transaction Pursuant to Cal. Corp. Code Section 25102(f) and have paid the applicable fee.

English! Do You Speak It?



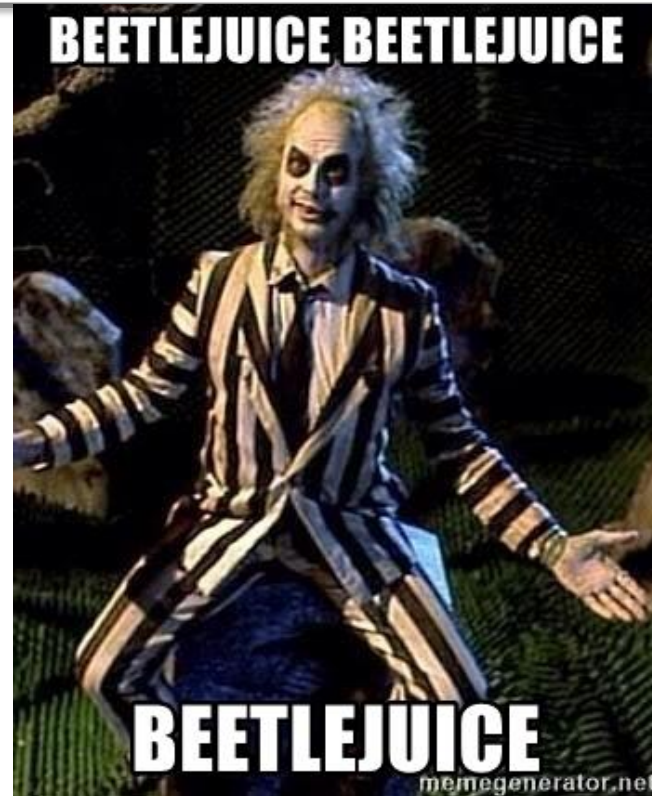
Maryland: “shall,” “set forth above,” “set forth below,” and “foregoing” are not plain English.

This Is a Job for Ethan Hunt



Maryland: First, add two risk factors to the state cover page. Second, put the state cover page entirely in 12-point type. Third, put the entire cover on a single page.

Say That Again



California: In Item 1, you state, “Terms used in this Disclosure Document have the same meaning as they do in the Franchise Agreement attached as Exhibit B to this Disclosure Document.” The FDD must stand alone with terms used clearly defined in the FDD in plain English. Do not cross-reference to the Franchise Agreement. Revise the FDD as necessary to comply.

How Old Are You?



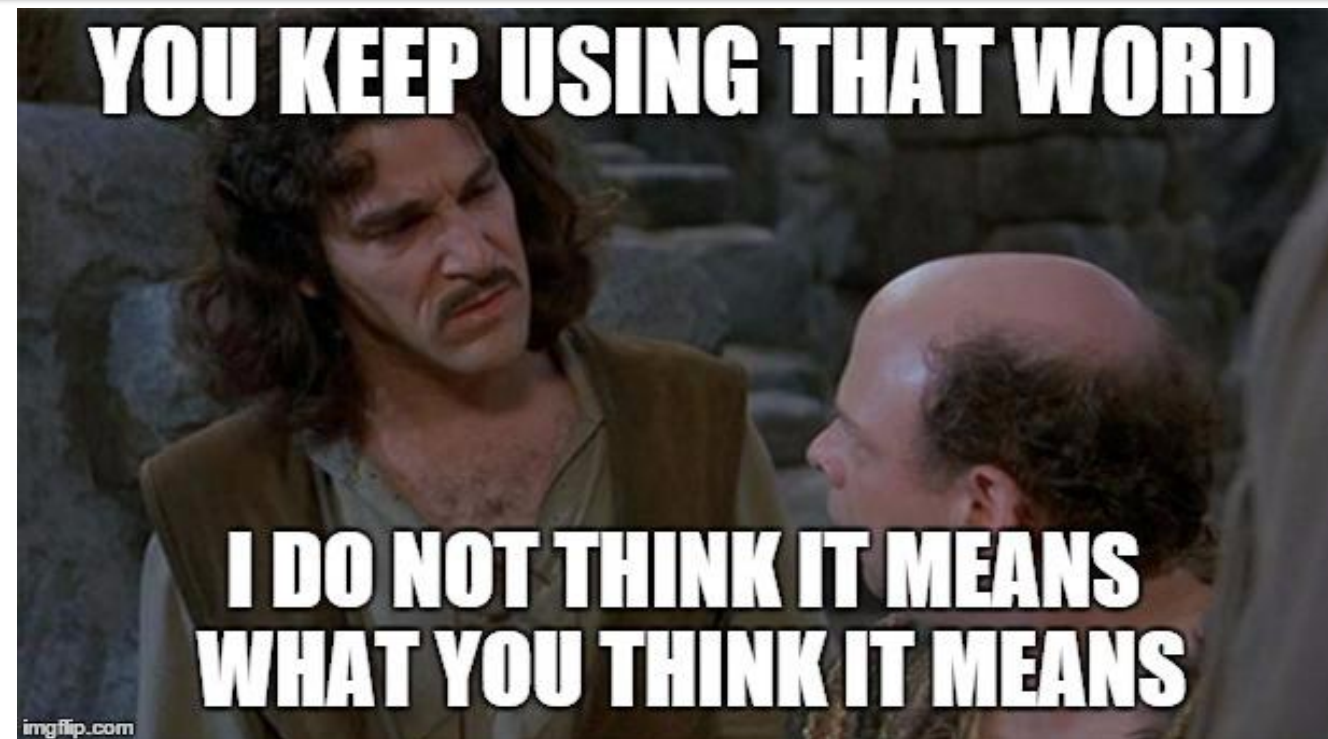
Washington: For start-ups and young franchisors, add the risk factor: “THE FRANCHISOR IS AT AN EARLY STAGE OF DEVELOPMENT AND HAS A LIMITED OPERATING HISTORY. THIS FRANCHISE IS LIKELY TO BE A RISKIER INVESTMENT THAN A FRANCHISE IN A SYSTEM WITH A LONGER OPERATING HISTORY.”

What Are You Trying to Sell Me?



Washington: “On the State Cover Page, we note the Franchisor states its intent to use the services of franchise brokers to assist it in selling franchises. If you intend to use any franchise brokers in Washington, please verify that they are properly registered in Washington and submit Franchise Broker Appointment Pages for each franchise broker.”

You Keep Using That Word



FTC Franchise Rule in Item 8 says to “Disclose the franchisee’s obligations to purchase or lease goods, services . . . or comparable items related to establishing or operating the franchised business either from the franchisor, its *designee*, or suppliers.” FDD says “We have the right to require you to purchase or lease all goods, services . . . either from us or our *designee*, or from suppliers approved by us.”

New York: explain in Item 8 what “designee” means.

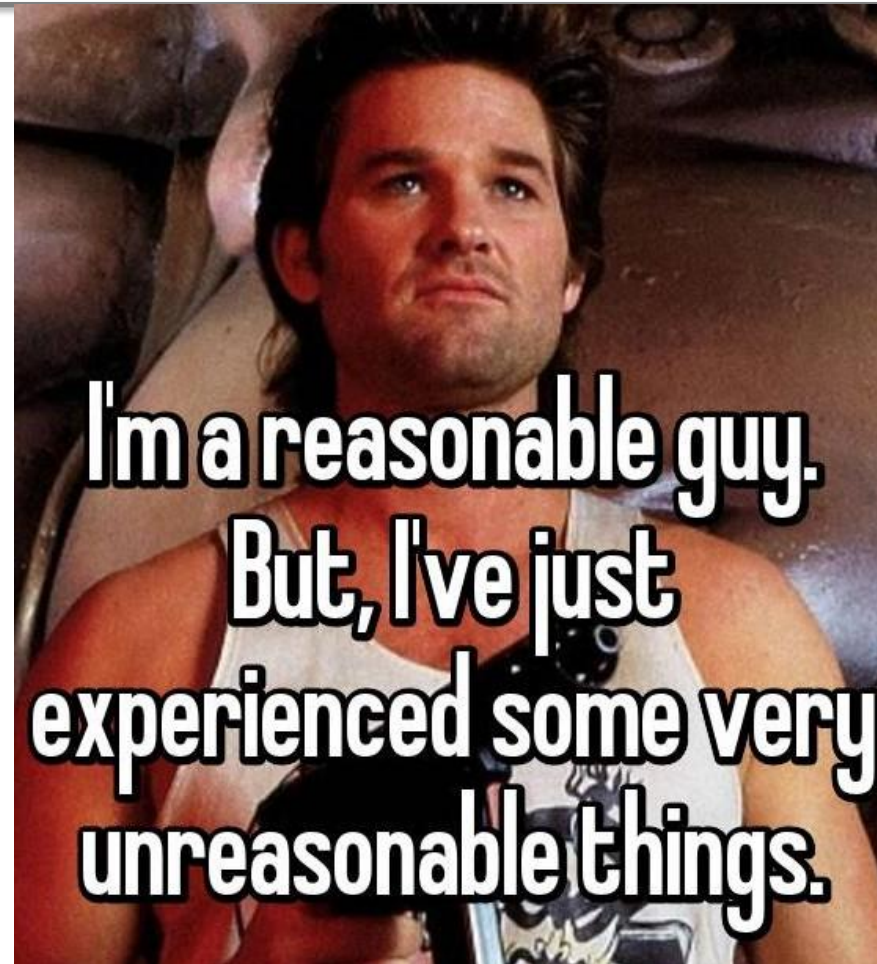
But it doesn't exist!



Franchisor allows franchisees to purchase 1, 2, or 3 territories. If a franchisee wants multiple territories, franchise will sign 2 or 3 unit franchise agreements simultaneously. But no area development / multi-unit agreement exists.

Maryland and Washington: disclose the multi-unit agreement and amend Item 17 to reference its provisions.

What do you mean by “reasonable?”



Virginia: in Item 6, remove the words “reasonable” and “reasonably,” or give more definition.

Alternative Solution

