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IN THE PUBLIC EYE – UNIQUE ISSUES FACING FRANCHISORS

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I. INTRODUCTION

For many companies, going public is a dream come true, and franchisors are no exception. However, becoming a publicly traded company requires the adoption of a whole new mindset – a mindset of accepting the life in the public eye – a life that involves public scrutiny, fiduciary duties, heightened political and public policy pressures, extensive new disclosure and reporting obligations, takeover risks and accountability to additional set of stakeholders. Although franchisors are not new to rigorous disclosure and registration requirements because of their obligation to comply with the franchise disclosure and registration laws and they understand how to effectively navigate the complex relationship with third-party franchisees under the state franchise relationship laws, they should know that becoming a public company presents a whole new ballgame. Franchisors that are traded on public exchanges must learn to navigate their new obligations under the Federal securities laws in the context of their existing obligations under the franchise laws – all in the public spotlight.

This paper previews the various legal and practical considerations that a private-company franchisor should be aware of before embarking on the rewarding, yet expensive and challenging life of a public company. This paper only touches on the topic of how a private-company franchisor may become a publicly traded company, as that journey itself warrants a presentation of its own. Instead, the authors focus on analyzing the interplay between the securities law and franchise law regimes after a franchisor becomes a public company. This paper compares and contrasts certain key obligations under each regime and describes functional methods of addressing the different yet overlapping legal requirements under each set of laws.

II. WHY FRANCHISORS GO PUBLIC

Franchisors may be incentivized to list their securities on a public stock exchange for various reasons, including increasing access to public debt and equity markets to accelerate growth potential or provide liquidity to existing owners. There are two customary methods of going public: (i) a traditional initial public offering ("IPO") where the company registers its offering with the Securities and Exchange Commission ("SEC") by filing a registration statement on Form S-1; or (ii) a reverse merger where the company merges with an existing public company, which may be a special purpose acquisition company ("SPAC"). The method of going public utilized depends on the franchisor's size, concerns, goals, financial capabilities, future vision and objectives.

Since 2014, the total number of businesses being operated by emerging franchise brands has been on the rise, and such growth contributes to the number of franchisors interested in the public market. According to a 2018 study done by FRANdata on emerging franchisors, "emerging franchise brands contributed an aggregate total of over 15,000 franchised and company owned businesses" to U.S. markets in 2016 and since then, the growth has been compounded by 75% annually to over 8,000 locations as of

2016.[1] The expansion efforts of these emerging franchise brands included strategic alliances and partnerships which led to some recent successful IPOs for the companies' founders. Some of the franchise brands that went public in the year 2021 include European Wax Center Inc. (which raised $180 million), Xponential Fitness (which raised $120 million), and the longstanding doughnut chain Krispy Kreme (which raised $500 million).

III. CONSEQUENCES OF BECOMING A PUBLIC COMPANY

The potential benefits of becoming a publicly listed franchisor must be weighed against the additional obligations imposed on the company. By listing on a public exchange, a franchisor must account for new shareholders, a broader audience with greater scrutiny and a more complex regulatory regime. Franchisors should weigh the advantages and obligations of listing on a public exchange as well as understand the ongoing legal considerations of being a publicly listed company.

A. Advantages of Becoming a Public Company

Listing on a public exchange can offer franchisors an opportunity to, among other things, finance their research and development, reduce their overall debt by increasing access to cash, and increase their capitalization. A company may access U.S. public markets and freely trade its securities in the secondary market by becoming publicly traded. The amount of capital raised by a company in an IPO is significant and can help transform such company faster than growth on private markets. This capital can assist franchisors to hire new employees, open more corporate locations, expand franchise development efforts, and even acquire additional brands, invest in new technologies for the franchise system, or expand the brand internationally. Going public also provides a significant exit opportunity for the existing owners by allowing them to sell their shares of the company on the open market, subject to such shares being registered with the SEC and any contractual restrictions agreed to by such shareholders. Further, franchisors are able to increase their brand exposure through the IPO process to engage with more prospective franchisees and customers who perceive a publicly listed company with positive publicity and credibility. Another important effect of an IPO is the company's greater access to cash via public equity and debt markets. Prior to going public, private companies customarily raise capital by receiving capital contributions from existing shareholders, incurring indebtedness through traditional credit facilities, or selling equity in private placements. Listing on a public exchange gives companies an additional option when raising capital, as public companies can initiate debt or equity offerings on the open market, which can result in shorter timelines, decreased costs and better financing terms.

[1] *See* NOWAKOWSKI ANYA, 2018 FRANCHISE SMALL BUSINESS REPORT, FRANdata: Franchise Market Research and Consulting, accessed February 17, 2022, available at https://www.frandata.com/downloading-research-analytics-and-the-emerging-franchise-market/.

B. Burdens of Becoming a Public Company

While an IPO can provide many benefits to a franchisor, there are also disadvantages and risks that accompany going public. Aside from the significant upfront costs (*e.g.*, fees for underwriters, registration, legal advisors, investment banks, and auditor) of becoming a public company, public companies incur additional ongoing compliance costs and obligations following an IPO. Public companies are subject to various federal and state reporting and anti-fraud laws, rules and regulation, including for senior executives, which can be difficult and expensive to manage for a newly public company. These reporting obligations are further complicated for franchisors because they already operate under a disclosure and registration regime under applicable franchise laws and going forward, they must navigate both regulatory regimes. Public companies must submit various current reports and periodic filings which require significant resources. Public company franchisors must carefully consider the contents and the timing of such filings in light of their disclosure and registration obligations under the franchise laws. Additionally, public companies must prepare their financial statements in accordance with certain accounting standards and must certify such financial statements to the SEC – the audited financial statement requirement is not new to franchisors; however, becoming a public company may mean that the franchisor now has multiple entities that must prepare and file audited financial statements.

The extensive regulatory burden, the significant costs and resources involved with the regulatory compliance as well as the public scrutiny that accompanies being listed on a public exchange place pressures on a public company, which may lead the company to eventually opt to delist its securities. A number of large and well known publicly-traded franchise companies like Rent-a-Center, Buffalo Wild Wings, Jamba Juice and Popeyes delisted their stock from stock exchanges and instead opted to raise capital through private channels. In addition to the ongoing costs of regulatory compliance, public companies are under heightened scrutiny regarding environmental, social, and governance ("ESG") initiatives and concerns from socially conscious investors and other stakeholders. As further described below, the public market is seeing an increased interest in investing in companies that adhere to heightened ESG standards, incentivizing publicly-listed companies to change their methods and operations to cater to these stakeholders. Such pressures present unique issues for franchisors, who must consider the challenges of imposing ESG requirements on their franchisees, who are independent third-party operators and, in many cases, small businesses without the resources of a public company.

IV. THE INTERPLAY OF U.S. SECURITIES LAWS AND FRANCHISE LAWS IN THE LIFE OF A PUBLIC COMPANY FRANCHISOR

A. Disclosure Based Systems

1. Securities Laws

The objective of U.S. securities laws, rules and regulations is to protect investors by providing reliable information regarding securities issuers' financial condition, products and markets, management, and competitive and regulatory climate. The primary sources of United Stated federal securities laws are the Securities Act of 1933, as amended (the "Securities Act"),[2] and the Securities and Exchange Act of 1934, as amended (the "Exchange Act").[3] The central government agency in charge of enforcing and implementing these federal securities laws in the United States is the SEC. The Securities Act primarily regulates the issuance of securities and requires that any offer or sale of securities in the United Stated be registered with the SEC unless an exemption applies. The Exchange Act generally governs transactions involving securities in the secondary market (*e.g.*, transactions post-issuance) and, among other things, requires certain issuers to file current and periodic reports with the SEC.

The SEC places reporting obligations on companies in order to ensure investors have access to the information to make informed investment decisions. By listing itself on a public exchange, a company faces new potential liabilities under U.S. securities laws if it fails to disclose material information required to be disclosed under the reports required by the SEC. U.S. securities laws impose anti-fraud provisions to hold issuers liable for failing to disclose material information or making false or misleading statements of material nature to the public.[4] Action against violators of anti-fraud provisions can be brought: (i) federally by the SEC, who also imposes further penalties for material misstatements or omissions, or by the Department of Justice (the "DOJ"), (ii) on a state level by state prosecutors, or (iii) by private litigants in private derivative or class actions suits filed by a company's security holders. The federal securities laws do not recognize mitigating circumstances, so even the appearance of improper behaviors by a company could place a company under investigation or even adversely affect a franchisor's image in the public's eye. Therefore, it is important for a newly publicly-traded franchisor to comprehend its disclosure obligations under applicable securities laws, rules and regulations.

In addition to federal securities laws, certain states have enacted their own securities laws commonly referred to as "Blue Sky Laws" with a similar purpose of protecting in-state investors by regulating offerings or sales of securities in such states. Similar to federal securities laws, blue sky laws provide prescribed forms for various disclosure and reporting obligations on an issuer. Generally, issuers are required to

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[2] 15 U.S.C. §77a *et seq.*

[3] 15 U.S.C. §78a *et seq.*

[4] General anti-fraud provisions are mainly found in Rule 12b of the Exchange Act and Sections 18 and 10(b) of the Exchange Act. *See* 15 U.S.C. § 78j(b); *See also* 17 C.F.R. § 240.10b-5.

comply with the blue sky laws of each individual state in which they offer and/or sell securities, including state registration requirements, unless a state exemption applies. However, typically companies offering "covered securities" are preempted by federal securities laws and are not subject to state securities registration requirements. Covered securities include, among others, offerings of securities listed on a U.S. national securities exchange and private offerings conducted in compliance with Rule 506 of Regulation D under the Securities Act. Some states simply mirror federal securities laws while other states require notice filings in-state for covered securities.

2. Franchise Laws

Publicly traded franchisors face the additional challenge of navigating the securities laws' disclosure obligations alongside the disclosure requirements imposed on franchisors under the franchise laws. The Federal Trade Commission (the "FTC") promulgated the original Franchise Rule[5] on December 21, 1978, as a result of its finding that franchisors engaged in deceptive practices in connection with the sale of franchises. The FTC found that many franchise sellers failed to disclose material facts or materially misrepresented the franchise opportunities. As a result, the Franchise Rule mandated the pre-sale disclosure of material information to prospective franchisees based on the principle that an informed purchaser can better evaluate the franchise opportunity. The Franchise Rule was then amended in 2007 in order to, among other things, reduce inconsistencies with the state franchise disclosure laws and to update the Franchise Rule to address new technologies that were developed since the original Franchise Rule was promulgated.[6] In the Statement of Basis and Purpose issued in connection with the final amended Franchise Rule, the FTC reiterated that the purpose of the Franchise Rule is to prevent deceptive and unfair practices in the sale of franchises through pre-sale disclosure of material information necessary to make an informed purchasing decision and prohibition of specified misrepresentations. Based on the same concerns of deceptive and unfair practices, a number of states have also enacted franchise disclosure and registration laws, which laws co-exist alongside the Franchise Rule and are only preempted by the Franchise Rule to the extent they are inconsistent with the Franchise Rule.

Although the intent of the two disclosure regimes (securities and franchise) is similar, the categories of persons at which the protection of these laws is aimed are different – potential investors in the public company vs. prospective franchisees interested in purchasing the franchise opportunity. Therefore, the type of information required to be disclosed under each regime is somewhat different, although there is overlap, and so it is important for the disclosures under both regimes to be consistent.

Similar to the securities laws, the federal and state franchise laws prescribe the format and the contents of the required disclosures – in the form of a franchise disclosure document (the "FDD"), which sets forth 23 prescribed "Items" that disclose information

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[5] Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436. The Franchise Rule became effective on October 21, 1979, and was subsequently amended, effective July 1, 2007.

[6] Statement of Basis and Purpose for the Amended Franchise Rule, 72 FR 15444 (Mar. 30, 2007), at 15445.

regarding the franchisor, its parents, predecessors and certain affiliates, its management, certain litigation and bankruptcy matters, the franchisor's financial condition, the statistics of the openings, closings, transfers, terminations and non-renewals of franchised and company outlets, financial performance information regarding the franchise system and the terms and conditions of the franchise offering. While a franchisor may provide prospective franchisees with certain promotional or other materials outside of the FDD, no information or statements made, whether written or oral, may contradict the information included in the FDD.[7]

The Franchise Rule prohibits franchisors from including in the FDD any information that is not required or expressly permitted either by the Franchise Rule or by state franchise laws that are not preempted by the Franchise Rule.[8] For example, as the Franchise Rule Compliance Guide notes, franchisors may not include testimonials or promotional literature in their FDD.[9] Nor may they modify or expand on any of the prescribed statements specifically required by the Franchise Rule to be included in the FDD – these prescribed statements must be set forth in the FDD verbatim as specified in the Franchise Rule. As noted above, the Franchise Rule does not preempt state franchise laws, except to the extent of any inconsistency with the Franchise Rule, and state franchise law is not deemed inconsistent with the Franchise Rule if it provides a prospective franchisee with equal or greater protection than the Franchise Rule.[10]

While the federal franchise law, the Franchise Rule, is purely a disclosure law, the state franchise laws include a filing and registration component. Specifically, fourteen U.S. states (California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin) generally require a formal filing or registration before the offer of a franchise can be made in the state. In four of these states, the FDD becomes effective almost immediately (Indiana, Michigan, South Dakota and Wisconsin essentially require a "notice only" filing and ordinarily do not review the FDD) and so the franchisor can generally offer and sell franchises in these states without delay. In the remaining 10 franchise registration states, the franchise law administrators will review the FDD and they must approve the filing (including any FDD amendment filings) before the franchisor may resume its franchise sales activity in the state. Depending on the state and the timing of the filing, this review process may take several weeks to even a few months in some instances, during which time period (referred to as the "dark period") the franchisor may not use the FDD in the state, may not accept any money or other consideration from prospective franchisees or enter into any franchise (or other definitive) agreements with franchisees who are located in the state or whose franchise outlet is to be located in the state. Because prolonged dark periods disrupt the franchisor's franchise sales efforts, a public company franchisor will want to coordinate the timing of its securities and franchise law filings as much as

[7] 16 C.F.R. § 436.9(a).
[8] *FTC Franchise Rule Compliance Guide* at p. 122 (May 2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf ("Franchise Rule Compliance Guide").
[9] Franchise Rule Compliance Guide, *supra* note 8 at 122.
[10] 16 C.F.R. § 436.10.

possible to minimize the number of instances during which the franchisor must "go dark" under the franchise laws during any given year.

A franchisor's failure to properly disclose all required information could subject the franchisor to investigations, enforcement actions and fines by the FTC. While no private right of action exists under the federal Franchise Rule, franchisees who previously purchased franchises relying upon misleading or incomplete information may be able to bring common law claims (such as fraud claims) against the franchisor. In addition, a private right of action exists under the state franchise laws, business opportunity laws as well as state consumer protection /unfair trade practices laws (commonly referred to as the "Little FTC Acts"). The Little FTC Acts generally provide that a violation of the Federal Trade Commission Act and regulations promulgated thereunder (including the Franchise Rule) is a violation of the Little FTC Acts. The Little FTC Act claims are complex, with several hurdles for the franchisee to overcome and several potential defenses for the franchisor. As an example, in some states, a private right of action under the Little FTC Act is only available to a "consumer" and whether a franchisee is a "consumer" under the Little FTC Act is a state-by-state analysis. But the potential remedies available to the franchisee for franchisor's franchise law violations can be significant. While remedies vary by state, they may include injunctive relief, compensatory damages, attorneys' fees and costs, enhanced or trebled damages, and, in some states, even punitive damages.

B. Regulation FD Under Securities Laws

Regulation Fair Disclosure (Regulation FD) was adopted by the SEC in 2000 in order to prevent selective disclosure by public companies and create a regulatory environment in which all investors gain access to the same information at the same time.[11] Regulation FD applies to a public company, or any person "acting on behalf" of such company.[12] Persons deemed "acting on behalf" of a company include the company's senior officials (*e.g.*, directors, executive officers), investor relations officials, public relations officials and others who regularly communicate with the general public or the securities market officials. Generally, Regulation FD prohibits issuers from selectively sharing certain information (especially information that would be indicative of changes in share price) to a subset of investors. Regulation FD further prohibits the disclosure of "material nonpublic information" in a private setting. Examples of information that would be considered material nonpublic information include, among others, information regarding earnings; mergers, tender offers, acquisitions; securities offerings; dividends, stock repurchases, stock splits; insider buying and selling; bankruptcy or litigations involving the company; and guidance about future performance of the company or meeting analysts' expectations for current or future financial periods.

Further, Regulation FD prohibits the disclosure of material, nonpublic information to certain "specified persons" such as sell and buy side analysts; institutional investment

[11] *See* U.S. SEC. AND EXCH. COMM., FINAL RULE: SELECTIVE DISCLOSURE AND INSIDER TRADING, available at https://www.sec.gov/rules/final/33-7881.htm, accessed February 15, 2021.
[12] *See generally* SEC CDIS, June 4, 2010, available at https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm.

managers; broker-dealers; investment advisers; investment companies; hedge funds; and any stockholder where it is reasonably foreseeable the person will trade on the information.[13] It is important to note that Regulation FD generally applies to information given to persons outside the publicly traded company. Thus, Regulation FD does not apply to the communication of confidential information to employees of the public company franchisor. Likewise, Regulation FD does not apply to the company's communications with its attorneys, auditors, accountants, investment bankers, and others who owe a duty of confidence to the company.

Lastly, if material nonpublic information regarding the public company franchisor or its securities is made in violation of Regulation FD, public disclosure of such information is required. Whether the selective disclosure was made *intentionally* or *non-intentionally* determines the timing required to make the information available to the general public. Intentionally disclosed information must be made public simultaneously and non-intentionally disclosed information must be made public promptly. Prompt disclosure means 'as soon as reasonably practicable' after a senior official is notified of the non-intentional disclosure, but in no event after the later of 24 hours or the beginning of the next trading day. A person discloses information intentionally if he or she knows or is reckless in not knowing that the disclosure includes material, nonpublic information.[14] To make a public disclosure, publicly traded companies typically file a Form 8-K with the SEC, issue a press release, or hold a publicly accessible conference in order to disseminate the material information.

1. Regulation FD: Franchisor Considerations

The obligations under Regulation FD present unique challenges for public company franchisors. As noted above, under the franchise laws, a franchisor must prepare, file with certain states, and provide to prospective franchisees, an FDD. Public company franchisors must ensure that any information included in the franchisor's FDD is consistent with the disclosures made by the franchisor or its affiliate under the securities laws and is made publicly available at the same time. To the extent the FDD includes information that would be deemed material under the securities laws, such information needs to be properly and timely included in the franchisor's or its affiliate's securities laws filings, and vice versa.

This becomes particularly challenging because of the different timing requirements for updating the FDD under the franchise laws and for making the required filings under the securities laws. Under the federal Franchise Rule, the information in the FDD must be current as of the end of the franchisor's most recent fiscal year. The franchisor has an obligation to prepare an updated (referred to as "renewal") FDD each year within 120 days of the end of the franchisor's fiscal year. So that the same information becomes publicly available at the same time, a public company franchisor needs to align the timing

[13] *See* U.S. SEC. AND EXCH. COMM., FINAL RULE: SELECTIVE DISCLOSURE AND INSIDER TRADING, available at https://www.sec.gov/rules/final/33-7881.htm, accessed February 15, 2021.
[14] *See generally* U.S. SEC. AND EXCH. COMM., SEC CDIS, June 4, 2010, available at https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm.

for its annual report on Form 10-K and the issuance of its renewal FDD as much as possible.

In addition to the annual update requirement, the Franchise Rule requires that within a "reasonable time" after the close of each quarter of the franchisor's fiscal year, the franchisor prepare revisions to the FDD to reflect any material changes to the disclosures included, or required to be included, in the FDD. Finally, the Franchise Rule imposes an ongoing obligation on the franchisor to provide a prospective franchisee with notice of any material changes to the financial performance representations included in Item 19 of the franchisor's FDD.

In most states with franchise registration and disclosure laws, the occurrence of an event requiring an amendment of a franchisor's FDD, or the annual amendment requirement imposed in connection with franchise registration renewal, require the franchisor to cease offering and selling franchises until the amended FDD is prepared and registered where necessary. The required timing of the FDD amendment filings due to material changes varies by state under the state franchise laws. For example, the California Franchise Investment Law and the Maryland franchise law require that a material change amendment be filed "promptly".[15] The Washington Franchise Investment Protection Act makes it clear that any further franchise sales must stop upon the occurrence of a material change, requiring the FDD amendment to be filed "as soon as reasonably possible and in any case, before the further sale of any franchise".[16] Other states, such as Virginia, prescribe more specific timing and require that a material change amendment be filed within 30 days.17

In the end, the significance of each new development or information, and the timing of the associated disclosure, are challenging factual questions that require careful case-by-case analysis by the franchisor. For example, if a public company franchisor or its affiliate acquires another franchise system, such event should be disclosed in the FDD as a material change and the franchisor should go dark with its franchise sales until the FDD amendment is issued (and approved by the various franchise registration states, as applicable), especially if the acquired system is a competing system and/or this is the first acquisition of another franchise system by the franchisor/its affiliates. On the other hand, if the public company owns 20 different franchise brands already, an acquisition of the 21st franchise brand may not be viewed as requiring an immediate FDD amendment, especially if the brand does not compete with the franchisor's/its affiliates' existing brands and the acquisition otherwise doesn't make any information in the FDD incorrect or misleading, and thus the franchisor may take the position that it may disclose the acquisition as part of its next regularly-scheduled quarterly FDD amendment. In addition, there is no bright-line rule under the franchise laws as to the point in time (in the acquisition timeline) at which such an acquisition that is a material change must be disclosed in the FDD – the possible logical points in time would be (i) upon the signing of a non-binding letter of intent, (ii) at the time the parties enter into the definitive agreement

[15] 79 Cal. Corp. Code §31123; MD. Code Regs. § 02.02.08.06.
[16] Revised Code of Washington § 19.100.070.
[17] 21 VA Admin. Code §5-110-40(A).

for the transaction, or (iii) at the time of the actual closing of the transaction. Most franchisors will take the position that at the signing of a nonbinding letter of intent, the transaction is still too uncertain to warrant a material change amendment of the FDD; however, at the time of signing of the definitive agreement, the transaction becomes sufficiently certain such that the franchisor should seriously evaluate whether, at a minimum, to go dark with franchise sales if it is not ready to disclose the transaction in its FDD. However, as soon as the transaction is disclosed under the securities laws, the information becomes publicly available, and so to the extent it constitutes a material change under the franchise laws, the franchisor should coordinate a simultaneous disclosure in its FDD or go dark until it is ready to issue the amended FDD.

The public company franchisor must balance the restrictions on nonpublic information disclosure under the securities laws with the competing practical need to share franchise system updates and developments with its existing franchisees. For example, a franchisor may wish to roll out a new proprietary software system to its franchise system. In connection with the roll-out, the franchisor may want to first evaluate and discuss the details of the roll out with its franchise advisory council ("FAC") and then it may wish to create and implement a test program under which a select group of franchisees will install the new software system and test the system so that the franchisor and the franchisees participating in the test program can work with the software system vendor to fix any bugs or other issues before the software system is implemented across the entire franchise network. Before requiring systemwide implementation, the franchisor will also need to amend its FDD to disclose this new software requirement to prospective franchisees. Similarly, the franchisor may wish to introduce additional products or services or modified products or services that franchisees will be required to offer to customers. Again, before publicly disclosing such material change to its franchise system, the franchisor may wish to evaluate the new or modified products or services through a test program and/or input from the FAC.

Because of the various restrictions imposed by the securities laws on the franchisor's ability to share information, a public company franchisor should educate its franchisees on how such restrictions impact the franchisor's ability to manage, administer and evolve the franchise system, including restrictions on timing of sharing with the franchisees news and developments regarding the franchise system. Franchisees need to understand that they must strictly abide by their confidentiality obligations set forth in the franchise agreement with respect to any nonpublic information received from the franchisor (and they may be required to sign separate confidentiality agreements before being able to receive access to certain nonpublic information). At a minimum, the franchisor should always label all relevant nonpublic material as confidential, limit the number of recipients of such information as much as practical, and remind recipient-franchisees of their confidentiality obligation before disclosing such information to them. As noted above, ultimately, the public company franchisor must carefully balance the need to share information for legitimate business purposes with the legal obligation to avoid insider trading or Regulation FD issues.

C. Current and Periodic Reports Under the Exchange Act and Related Franchise Law Considerations

The Exchange Act regulates securities transactions in the secondary market (*e.g.*, transactions post-issuance) and its central aim is to ensure investors have access to updated information about a publicly traded company's performance. Hence, the Exchange Act imposes on-going reporting obligations on publicly traded companies.[18] Reporting duties are typically triggered when a franchisor becomes a "reporting" company by registering a public offering of its securities under the Securities Act or listing its securities on a U.S. securities exchange. Franchisors who become publicly traded are obligated to file their current and periodic reports with the SEC using the prescribed forms published by the SEC.[19] The most common types of such reports used are Form 8-K, Form 10-Q, and Form 10-K.

The quarterly and annual reports must be certified by a company's principal executive and principal financial officers as authorized by Section 302(a) of the Sarbanes-Oxley Act of 2002.[20] The required certification endorses the information disclosed on each report including any company financials. Additionally, the officers must certify that "they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation."[21] The SEC recommends companies establish procedures and internal communication systems to ensure effective and timely disclosures are made in adherence to the rules.

1. Current Reports on Form 8-K and Franchisor Considerations

Under Section 13(a)(1) of the Exchange Act, current reports on Form 8-K ("Form 8-K") filings are required upon the occurrence of certain triggering events such as entry into material definitive agreements, incurrence of indebtedness, changes in management, or the completion of an acquisition or disposition of assets.[22] With limited exceptions, Form 8-K reports are required to be filed or furnished within four business days after the occurrence of the underlying event. For instance, a Form 8-K filing to report the appointment of a new officer may be delayed until the date of the public announcement of the officer appointment if the announcement is to be made by another form.[23] A Form

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[18] 15 U.S. Code § 78m.
[19] *See* U.S. SEC. AND EXCH. COMM., FORMS LIST, available at https://www.sec.gov/forms.
[20] *See* U.S. SEC. AND EXCH. COMM., CERTIFICATION OF DISCLOSURE IN COMPANIES' QUARTERLY AND ANNUAL REPORTS, SEC Release No. 33-8124, available at https://www.sec.gov/rules/final/33-8124.htm.
[21] *Id.*
[22] A full list of the categories of items which are considered reportable events warranting a Form 8-K filing can be found on the Form 8-K's instructions as provided by the SEC, available at https://www.sec.gov/files/form8-k.pdf.
[23] *See* SEC CDIs on Exchange Act Form 8-K at Question 101.01, available at https://www.sec.gov/divisions/corpfin/guidance/8-kinterp.htm.

8-K filing may also be used as a corrective disclosure measure for previously reported information which requires updating or is no longer accurate. A late filing of Form 8-K may lead to the company losing its eligibility to file a short form registration statement, resulting in increased disclosure obligations and a longer timeline for any offerings by the company. The franchisor should also consider the public disclosure guidelines under applicable stock exchanges, such as NYSE or NASDAQ, in combination with the periodic reports filed with the SEC. The timing for filings with the SEC and a notification to a stock exchange may coincide, but may also be required at different times.

The franchisor will need to simultaneously evaluate whether the event triggering the filing of Form 8-K will be considered a material change to the franchisor's FDD. For example, as noted above, if the franchisor or its affiliate acquires another franchise system that competes with the franchisor's franchise system, such acquisition will be a material change under the FDD, requiring disclosures in item 1 and item 12 (disclosing how the two systems are competitive), as well as potentially updates to item 3 and 4 (with respect to litigation and bankruptcy disclosures, respectively, regarding the acquired system). The FDD will need to be amended or the franchisor will need to go dark (*i.e.*, stop using its FDD, not enter into any other franchise (or other binding) agreements with prospects and not accept any payments (or other consideration) from prospective franchisees) until the franchisor can issue an amended FDD disclosing the material changes resulting from the acquisition, and with respect to any franchise registration state, until the FDD becomes effective in the registration state.

2. Quarterly Reports on Form 10-Q and FDD Amendments

Sections 13(a)(1) and 15(d) of the Exchange Act[24] require public companies to file with the SEC quarterly reports on Form 10-Q ("Form 10-Q") to report the company's performance at the end of its first, second, and third fiscal quarters.[25] The filing due date for the Form 10-Q depends on the size of the company but ranges between 40 to 45 days after the end of the company's fiscal quarter.[26] Form 10-Q must include unaudited interim financial statements reviewed by an independent accountant. Other information to accompany Form 10-Q include material updates or events regarding the company from any previous filings, material market risks, any changes in securities or defaults, analysis of the company's financial condition and result of recent operations.[27]

The franchisor will need to evaluate whether the updates disclosed on Form 10-Q will be considered a material change under the FDD, requiring the filing of an FDD amendment. If so, the franchisor will want to align the timing of the Form 10-Q filing with any required FDD amendment issuance to minimize disruptions to its franchise sales process and to avoid inconsistencies or gaps in publicly available information. Depending

[24] 15 U.S. Code §§78m and 78o(d).
[25] Form 10-Q is filed pursuant to Rules 13a-13 or 15d-13. *See* 17 CFR § 240.13a-13; 17 CFR § 240.15d-13.
[26] *See* U.S. SEC. AND EXCH. COMM., Form 10-Q and its instructions as provided by the SEC, available at https://www.sec.gov/files/form10-q.pdf.
[27] A full list of the items to be included on Form 10-Q can be found on the SEC site, available at https://www.sec.gov/files/form10-q.pdf.

on the materiality of the update from a franchise law standpoint, the franchisor may have to make the filings well before the 45-day deadline imposed by the securities laws. Such FDD amendment should also include any other updates and changes that the franchisor wishes to make to its franchise system so as to again minimize the number of FDD amendments that the franchisor will have to issue in any year. To the extent the timing of any material event is within the franchisor's control, the franchisor will want to ensure that the timing of the material event allows for efficient disclosure under both securities laws and franchise laws – via Form 8-K, Form 10-Q, or Form 10-K that coincide with an FDD amendment or FDD renewal, respectively.

3. Annual Reports on Form 10-K and FDD Renewals

Under Section 13(a)(2) of the Exchange Act, public companies must file a Form 10-K within 60, 75, or 90 days (depending on the size of the issuer) of the end of each fiscal year. All public companies must file their Form 10-K annually to the SEC reporting overall conditions of the company's business and finances. Form 10-K is a document that discloses any material information, material risks to the company's business, defaults, and background information on the company, as well as two years of audited financial statements including an income statement, a balance sheet, and cash flow statement. The company may incorporate by reference information previously filed with the SEC, including the company's proxy statement, with each incorporation by reference clearly listing and identifying the referenced document.

As noted above, franchisors' obligation to comply with the disclosure and registration regime under both the franchise laws and the securities laws creates unique challenges because while the disclosure obligations under the two regimes are different, they must be consistent. As a general practice, the franchisor's securities legal team should be reviewing the draft renewal FDD and all draft FDD amendments and the franchisor's franchise legal team should be reviewing each draft Form 10-K, Form 10-Q and Form 8-K to ensure consistency between the disclosure documents and to prevent omissions of material information from any disclosure document. Both legal teams should understand to what extent the information required to be included in the two legal regimes' disclosure documents overlaps.

To avoid inconsistencies between the securities laws and the franchise laws disclosures and to maximize efficiencies, the franchisor should aim to issue its FDD at the same time as it files its Form 10-K. Although under the Franchise Rule a franchisor must issue a renewal FDD within 120 days of its fiscal year end, there is nothing that prevents the franchisor from issuing its FDD prior to that deadline. In fact, filing earlier in certain states will be necessary, especially if the franchisor wishes to avoid having to include unaudited financial statements in its FDD. For example, the California franchise law requires franchisors to file a renewal FDD within 110 days of the end of the fiscal year.[28] Also, if a franchisor files its renewal FDD after 90 days of the end of its fiscal year, the Hawaii franchise administrators[29] will require the franchisor to add unaudited financial

[28] CAL. CODE OF REGS § 310.120.
[29] Haw. Code R. § 16-37-3(b).

statements in its FDD, which unaudited financials must be as of a date that is within the last 90 days of the FDD issuance date. The inclusion of unaudited financial statements in the FDD may present a challenge for a public company franchisor if such unaudited financial statements differ from those included in prior SEC filings.

D. Materiality Determination Under Each Regime

1. Securities Law Regime

Guidance under the various securities laws requires or prohibits certain disclosures by companies on the bases of the 'materiality' of the underlying event or act. For instance, the disclosure of "material" information pertaining to the company is *required* on periodic reports, and certain disclosure of "material nonpublic information" is *prohibited* by Regulation FD. The SEC provides guidance in its prescribed forms with instructions for specific circumstances of required disclosures. But much of the guidance relied on today for the definition of materiality stems from case law.[30] The U.S. Supreme Court has pointed out that the vague interpretations of materiality do not aid in establishing a clear test; the Court then decided to apply an objective test of materiality from a reasonable investor's point of view. The omission of a fact is material if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor. In other words, information is material if there is a substantial likelihood that a reasonable investor would consider it important for making an investment decision.

2. Franchise Law Regime

What change or development is considered material under the franchise laws? The original Franchise Rule included a definition of the terms "material," "material change" and "material fact", defining these as "any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or a prospective franchisee." However, such definition was eliminated from the Franchise Rule when the Franchise Rule was amended in 2007. In the FTC's Statement of Basis and Purpose for the Amended Franchise Rule (the "SBP"), the FTC noted that "materiality" should be evaluated through "long-established Commission jurisprudence. . . [because] materiality is a cornerstone concept of that jurisprudence." When interpreting Section 5 of the FTC Act, the FTC stated that it "regards a representation, omission or practice to be deceptive if: (1) it is likely to mislead consumers acting reasonably under the circumstances; and (2) it is material; that is likely to affect consumers' conduct or decisions with respect to the product at issue." Because violations of the Franchise Rule constitute violations of Section 5 of the FTC Act, the FTC concluded that "'materiality' is determined . . . in franchise matters, by the reasonable prospective franchisee standard."[31]

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[30] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); and *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).
[31] SBP at 15455.

Similarly, the "reasonable prospective franchisee" standard is generally applied under state franchise laws when interpreting materiality. For instance, under the Illinois Franchise Disclosure Act, "[a] statement or omission of fact is 'material' within the meaning of the Act if there is a substantial likelihood that a reasonable prospective franchisee would consider it significant in making a decision to purchase or not purchase the franchise."[32] Similarly, the Virginia franchise act defines a material change as "a fact, circumstance, or condition that would have a substantial likelihood of influencing a reasonable prospective franchisee in the making of a decision relating to the purchase of a franchise."[33] Therefore, the term "material" is interpreted consistently under the securities laws and the franchise laws, although it is applied for the benefit of a different stakeholder – a prospective investor vs. a prospective franchisee, respectively.

Examples of material changes that would trigger a franchisor's obligation to amend its FDD include: (a) a change of control or other significant change in the franchisor's corporate structure; (b) a significant change in the franchisor's management; (c) the commencement of litigation or arbitration alleging certain types of claims against franchisor, its predecessor, certain affiliates or its management; (d) a material change in the terms of the franchise offering; (e) termination or non-renewal of a substantial portion of the franchised outlets; or (f) a material adverse change in the franchisor's financial condition. At the same time, for example, ordinary updates to Item 20 of the FDD (which sets forth the 3-year statistics of the franchised and company-owned outlets, including the number of transfers, terminations, openings, closings and non-renewals) need not be updated more frequently than annually, unless, as noted above, the system experiences a significant number of closings, terminations and/or non-renewals. Therefore, for example, an ordinary course repurchase by the franchisor of several franchised outlets would generally not trigger an FDD amendment requirement; however, it may trigger a Form 8-K filing if the information is considered material, for example, due to the purchase price amount or if the transaction was not done on an arms-length basis. Similarly, the audited financial statements included in the FDD need not be updated more frequently than annually; however, if the franchisor's financial condition materially and adversely changes throughout the year, the franchisor must include interim unaudited financial statements in its FDD disclosing such material adverse change via an FDD amendment (similar to the interim unaudited financial statements required to be included in a public company's Form 10-Q).

E. Litigation Disclosures Under Each Regime

1. Securities Law Regime

Item 3 of Form 10-K and Item 1 of Form 10-Q require the disclosure of any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which a publicly traded franchisor or any of its subsidiaries is a party or of which any of

[32] 14 Ill. Admin. Code § 200.110.
[33] 21 VA Admin. Code § 5-110-10.

their property is the subject. No disclosure would be needed for any proceedings involving (i) negligence or other claims or actions if the business ordinarily results in such claims or actions, unless the claim or action departs from the normal kind of such claims or actions, or (ii) primarily a claim for damages if the amount involved, exclusive of interest and costs, does not exceed 10% of the current assets of the publicly traded franchisor and its subsidiaries on a consolidated basis; provided that, if any proceeding presents in large degree the same legal or factual issues as other proceedings pending or known to be contemplated, the amount involved in such other proceedings shall be included in computing such percentage.[34]

2. Franchise Law Regime

Under the franchise laws, there is no monetary threshold for disclosure of litigation. Instead, the Franchise Rule requires disclosure if the action involves certain types of claims and certain types of persons. The Franchise Rule defines "action" to include "complaints, cross claims, counterclaims, and third party complaints in a judicial action or proceeding, and their equivalents in an administrative action or arbitration.[35]" Under the Franchise Rule, certain types of pending and concluded actions need to be disclosed if they involve any of the following persons: (1) the franchisor, (2) any predecessor of the franchisor, (3) any parent or affiliate of the franchisor who guarantees the franchisor's performance, (4) any affiliate of the franchisor who offers franchises under the franchisor's principal trademark, or (5) any person disclosed in Item 2 of the FDD (*i.e.*, any director or principal officer of the franchisor or any person, regardless of title or position, who has management authority with respect to the sale or operation of franchises). With respect to pending actions, Item 3 of the FDD must disclose any pending (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, and (2) civil actions, other than ordinary routine litigation incidental to the business, which are material in the context of the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations. In addition, Item 3 of the FDD must identify any material civil actions involving the franchise relationship and filed in the last fiscal year. With respect to concluded actions, Item 3 of the FDD must disclose if, during the ten year period prior to the FDD's issuance date, any of the relevant persons referenced above have been convicted of or pleaded nolo contendere to a felony charge, or been held liable in a civil action involving an alleged violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations. The term "held liable" is defined by the Franchise Rule to mean that the applicable person must be required to pay money or other consideration, reduce an indebtedness by the amount of an award, is unable to enforce its rights, or otherwise must take action that is adverse to its interests.

Filing of an action against the franchisor or the other parties referenced above that requires disclosure in Item 3 of the FDD is considered a material change that triggers the franchisor's obligation to amend its FDD. However, franchisor-initiated lawsuits only need

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[34] 17 CFR 229.103(b).

[35] 16 CFR § 436.1.

to be updated in Item 3 on an annual basis – at renewal time -- unless the franchisee files a counter-claim against the franchisor alleging a claim that triggers a material change update to the FDD (for example, a counterclaim that alleges a violation of a franchise, antitrust or securities law, or fraud, unfair or deceptive practices or comparable allegations).

F. Bankruptcy Disclosures Under Each Regime

1. Securities Law Regime

Item 1.03 of Form 8-K requires a publicly listed franchisor to disclose if a receiver, fiscal agent or similar officer has been appointed for the publicly listed entity or its parent, in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the publicly listed entity or its parent, or if such jurisdiction has been assumed by leaving the existing directors and officers in possession but subject to the supervision and orders of a court or governmental authority.

2. Franchise Law Regime

The bankruptcy disclosure obligation under the franchise laws reaches a broader set of affiliates than the securities laws. Item 4 of the FDD requires the franchisor to disclose whether (1) the franchisor, any parent of the franchisor, (2) the franchisor's predecessor, (3) affiliate or (4) any officer or general partner of the franchisor, or any other individual with management responsibility relating to the sale or operation of franchises offered by the FDD, has, during the 10-year period immediately prior to the issuance date of the FDD (a) filed as debtor (or had filed against it) a petition under the U.S. Bankruptcy Code, (b) obtained a discharge of its debts under the Bankruptcy Code, or (c) been a principal officer or a general partner of a company that either filed as a debtor (or had filed against it) a petition under the Bankruptcy Code or obtained a discharge of its debts under the Bankruptcy Code while, or within one year after, the officer or general partner held the position in the company.

G. Financial Disclosures Under Franchise Laws

1. <u>Financial Statement Requirements Under Franchise Laws</u>

Under the Franchise Rule, a franchisor must include in its FDD audited, GAAP-compliant financial statements consisting of (a) a balance sheet for the previous two fiscal year-ends before the FDD issuance date and (b) statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years. Alternatively, the franchisor may include GAAP-compliant audited financial statements of any of its affiliates (including a parent) but then the affiliate must guarantee to assume the franchisor's duties and obligations under the franchise agreement. The guarantee must cover all of the franchisor's obligations to the franchisee, but it does not have to extend to third parties. The guarantee must be included in the FDD. The financial statements

included in the FDD must be prepared in accordance with U.S. GAAP "as revised by any future government mandated accounting principles, or as permitted by the Securities and Exchange Commission".[36] This language allows franchisors to look to the principles established by the SEC and to maintain consistency in preparation of the financial statements under both regulatory regimes. The financial statements included in the FDD must be audited using generally accepted U.S. auditing standards.

In addition, if any parent of the franchisor entity commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations, such parent's audited financial statements must also be included in the FDD. As explained in the Franchise Rule FAQ's, this requirement applies when the franchisor has an obligation to provide goods or services to the franchisees, and that obligation is guaranteed or assumed by the franchisor's parent. If the franchisor has no obligation to provide the goods or services to the franchisees but the parent simply happens to supply the goods or services to the franchisees, then the parent is similar to any other third-party supplier to the franchisees and its financials then need not be included in the FDD. On the other hand, if the franchisor accepts the responsibility to provide the goods or services to the franchisees and the parent assumes such obligation, or the franchisor arranges for the parent to supply the goods or services directly to franchisees on the franchisor's behalf, then the parent's financials need to be included in the FDD. Parent financial statements are required only when the parent commits to perform post-sale obligations for the direct benefit of franchisees, and so the parent's provision of administrative or other services for the franchisor's internal purposes does not trigger the parent financial statement disclosure obligation. Parent is defined by the Franchise Rule as any entity that controls another entity directly, or indirectly through one or more subsidiaries; the term "control" is not defined in the Franchise Rule.

The Franchise Rule requirement regarding parent audited financial statements may become especially burdensome for public company franchisors if the franchisor already has multiple entities that must prepare audited financial statements because of the securities laws' requirements. Therefore, before embarking on its initial public offering, a franchisor should carefully evaluate its existing corporate structure and potentially re-structure its corporate organization so that it minimizes the number of entities that would need to prepare annual audited financial statements under the securities laws and the franchise laws once the franchisor becomes a public company. For example, if the franchisor's affiliate provides services or products that franchisees are required to purchase or use in their franchised business, the franchisor should ensure that such affiliate is not a parent of the franchisor entity so that it can avoid having to audit and disclose in the FDD such affiliate's financial statements.

If for some reason the franchisor is unable to timely file its renewal FDD, the franchise registration states will require the inclusion in the FDD of unaudited financial statements as of a recent date (generally as of the last 90 to 120 days of the FDD issuance

[36] 16 CFR § 436.5.

date, depending on the state).[37] To comply with the requirements of Regulation FD, a publicly traded franchisor should consider filing these unaudited financial statements in a Form 8-K, unless the FDD can coincide with the filing of the company's Form 10-Q.

2. Franchisor's Net Worth and Availability of the "Large Franchisor" Exemption

From a franchise law perspective, the public company franchisor will want to take advantage of the large franchisor exemption that is available under the franchise laws of nine of the franchise registration states (California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, Virginia and Washington). This exemption is generally referred to as the large franchisor, experienced franchisor or seasoned franchisor exemption, and franchisors that qualify under this exemption receive the benefit of not having to file the FDD with several of these exemption states (*i.e.*, California, Illinois, Indiana, New York and Washington), generally receiving a faster review and exemption approval (as compared to an approval process for a standard franchise registration application), and not having to file any FDD amendments with several of the exemption states (*i.e.*, California, Illinois, Indiana, New York and Washington), which benefits generally allow the franchisor to shorten or even avoid a dark period in these states.

The specific qualifications for the exemption differ by state but generally the large franchisor exemption is available when (i) the franchisor and/or, depending on the corporate structure, its parent company, maintains a certain minimum net worth based on its most-recent audited financial statements, and (ii) the franchisor and/or, depending on the corporate structure, its parent company, possesses certain franchising and/or operating experience involving a minimum number of outlets over a certain period of time. The net worth threshold is $5 million, $10 million or $15 million, depending on the state, based on the franchisor's (or its parent's) most recent audited financial statements. If the franchisor is relying on its parent's audited financial statements to meet the exemption, the franchisor must still have a minimum net worth of $1 million and in several of the states (*e.g.*, Maryland, Rhode Island and Virginia) the parent must then also guarantee the franchisor's performance under the franchise agreement (and the guarantee must be included in the FDD). The parent entity must own at least 80% of the franchisor entity if the franchisor wishes to rely on the parent's financial statements and experience. The states that require the experience prong to qualify for the exemption (*i.e.*, all large franchisor exemption states except for Illinois and New York) generally require that the franchisor (or its parent, as applicable) have had either at least 25 franchised outlets in operation for at least the last five consecutive years, or in some states the franchisor may satisfy this requirement if it has itself (or its parent, as applicable) conducted the business that is the subject of the franchise for at least the last five consecutive years.

Therefore, when deciding on its corporate structure and on the entity or entities whose financial statements will be audited, the franchisor should also consider whether it can have a corporate organization that allows it to meet the large franchisor exemption requirements, including having the audited financial statements in support of the

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[37] Are there implications to consider under the securities laws for including unaudited financial statements in the FDD?

exemption. If a franchisor restructures its corporate organization in connection with going public, it should keep in mind that changing the franchisor entity (*e.g.*, creating a new franchisor entity as part of the restructuring) may result in the large franchisor exemption not being available right away in all states that provide for the exemption and that impose the 5-year experience requirement. In the states that impose the experience requirement as part of the exemption qualification, the franchisor may have to approach the state examiner to explain why substantively the newly formed franchisor entity should be considered as having met the experience prong of the exemption and thus qualify for the exemption post-restructuring/IPO filing.

3. Financial Performance Representations under Franchise Laws

A. General Media Financial Performance Representations

A financial performance representation (an "FPR") is defined by the Franchise Rule as any representation, including any oral, written or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits, including charts, tables or mathematical calculations that show possible results based on a combination of variables. The Franchise Rule provides that a franchisor making financial performance representations, whether historical or forecasted, must (1) have a reasonable basis for making such claims, (2) written substantiation for the representation at the time the representation is made and (3) provide written disclosure of such representation to a potential franchisee in Item 19 of its FDD.

Because the Franchise Rule's definition of financial performance representations covers representations made in general media, public company franchisors need to be careful how they disclose and use financial performance information. The Franchise Rule Compliance Guide explicitly states that a public franchisor's financial performance information included in its SEC filings is not deemed general media FPR under the Franchise Rule.[38] Similarly, any communications by the franchisor to financial journals or to the trade press made in connection with bona fide news stories will not be considered general media FPRs.[39] As noted in the Franchise Rule Compliance Guide, typically, statements in speeches and press releases will not be deemed general media financial performance representations "unless they are specifically directed at members of the public interested in purchasing a franchise."[40] Therefore, an FPR included in the investors section of a public company franchisor's website will not be considered a general media FPR because it is not necessarily intended for prospective franchisees.[41] Just because a prospective franchisee may come across such information while researching about the franchise opportunity on the internet does not make such

[38] Franchise Rule Compliance Guide, *supra* note 8 at 133.
[39] *Id*. at 133.
[40] Franchise Rule Compliance Guide, *supra* note 8 at 132.
[41] *Id.*

information a general media FPR under the Franchise Rule. However, if the franchisor then includes the financial performance information in the franchise section of its website or in other franchise sales materials, then such information would be deemed an FPR and would have to comply with the Franchise Rule requirements on FPRs.[42] As another example, if the franchisor references in its franchise marketing materials the general financial information on its website, or otherwise uses the general financial information to attract potential franchisee candidates (for example, if the franchisor's representative discusses such information during a meeting with prospective franchisees), then such information will be considered general media FPRs.[43]

To the extent a franchisor makes financial performance representations (as defined by the Franchise Rule) in the general media, then such representations, like all FPRs, must be true and have a reasonable basis and be substantiated by written information the franchisor possesses when the representations are made. In addition, general media financial performance representations must include the following information (which requirement also applies to all FPRs): (1) the number and percentage of outlets from which supporting data for the FPR were gathered that actually attained or surpassed the represented level of financial performance; (2) the time period when the performance results were achieved; and (3) a clear and conspicuous admonition that a new franchisee's results may differ from the represented performance. Finally, the full FPR, including all material basis and assumptions, must also be included in Item 19 of the franchisor's FDD.[44]

B. Financial Projections

When making financial projections, a public company franchisor should ensure that the projections are not used in a way that would make them financial performance representations as defined under the Franchise Rule - *i.e.*, make sure that they are not directed at prospective franchisees and are not used to attract prospective franchisees. Otherwise, the financial projections would have to be included in Item 19 of the FDD and would have to comply with the Franchise Rule. With respect to financial projections that are considered FPRs under the Franchise Rule, the Franchise Rule requires that financial projections be based on historical financial performance data of the franchised outlets that are substantially similar to the type of franchised outlet offered under the FDD.[45] The Franchise Rule Compliance Guide notes that when preparing financial projections, the franchisor should consult with the current standards for projections issued by professional organizations such as the American Institute of Certified Public Accountants ("AICPA").[46] The Franchise Rule Compliance Guide lists the following considerations that a franchisor

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[42] *Id.*
[43] *Id.*
[44] Franchise Rule Compliance Guide, *supra* note 8 at 133.
[45] 2017 NASAA Commentary on Financial Performance Representations, Use of Forecasts and Projections, questions and answers no. 19.19 and 19.20.
[46] Franchise Rule Compliance Guide, *supra* note 8 at 135.

should take into account when preparing financial forecasts: (1) the financial forecasts should be prepared in good faith, with appropriate care by qualified personnel, using appropriate accounting principles; (2) the information used in preparing the forecasts should be consistent with the plans of the company; (3) key factors should be identified as a basis for the assumptions; (4) assumptions used should be appropriate; and (5) the process used to develop the financial forecasts should (i) provide for seeking out the best information reasonably available at the time, (ii) provide the means to determine the relative effect of variations in the major underlying assumptions, (iii) include adequate documentation of both the financial forecasts and the process used, (iv) include, where appropriate, comparison of the financial forecasts with achieved results; and (v) include adequate review and approval by the responsible party with appropriate levels of authority.[47] The Franchise Rule Compliance Guide notes that these considerations are not the complete test for whether there exists a reasonable basis for a financial performance projection, although in the FTC staff's view, projections made in accordance with the AICPA standards are presumed to have a reasonable basis.[48][49]

H. Financial Disclosures Under Securities Laws

Similar to the Franchise Rule, the securities laws require a public company to prepare its financial statements in accordance with certain accounting standards and regulations, and the company must include in each Form 10-K a certification of the audited financial statements by a public accounting firm. Section 13(b)(2)(B) of the Exchange Act requires public reporting companies to develop and maintain internal accounting systems which provide reasonable guarantees that the information recorded is sufficient for use in a company's preparation of financial statements.[50] Non-GAAP compliant financials may be used in the franchisor's disclosure measures but not without limitations. Regulation G and Item 10(e) of Regulation S-K place specific limitations for non-GAAP compliant financials which must not be misleading and "must present the most directly comparable GAAP measure with equal or greater prominence."[51]

I. Duty to Correct Misstatements or Omissions

Under Section 10(b) of the Exchange Act, a public issuer could be found liable for failing to correct or update materially misleading statements previously supplied to the public.[52] A public company has a duty to correct and update previously shared material statements or information when the company discovers it to be incomplete, false, or misleading. The company must update and correct the material information within a reasonable amount of time, and the determination of what is reasonable is fact-specific.

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[47] *Id.* at 135.
[48] *Id.* at 136.
[49] NTD: Jim, what do public companies typically do with respect to the financial projections? Do they file them with an 8-K for Reg FD purposes?
[50] 15 U.S.C. §78m(b)(2)(B).
[51] *See* U.S. SEC. AND EXCH. COMM., NON-GAAP FINANCIAL MEASURES, Question 102.10, updated April 4, 2018, available at https://www.sec.gov/corpfin/non-gaap-financial-measures.
[52] 15 U.S.C. § 78j(b).

Although under the Franchise Rule there is no explicit duty to correct misstatements or omissions, it is an unfair or deceptive act or practice in violation of Section 5 of the FTC Act for any franchisor to fail to include the information and follow the instructions for preparing FDDs that are set forth in the Franchise Rule.[53] It is also an unfair or deceptive act or practice for any franchisor to make any claim or representation, orally, visually, or in writing, that contradicts the information required to be disclosed by the Franchise Rule.[54] Finally, as discussed above, a franchisor has an affirmative obligation to update its FDD for any material changes. Therefore, if a franchisor discovers a material misstatement or omission in its FDD, it should correct such misstatement or omission as soon as possible via an FDD amendment.

In addition to requiring the preparation, registration, and delivery of an FDD, state franchise registration and disclosure statutes prohibit illegal or fraudulent conduct, including: (1) making any untrue statement of a material fact in an FDD (or any application or other document submitted to the state in connection with the FDD); and (2) engaging in any act or course of conduct that operates as a fraud or deceit upon any person. These statutes also prohibit a franchisor from requiring a franchisee to waive and, in some instances, to release the franchisor's compliance with all obligations imposed by such state statutes in connection with the offer or sale of a franchise. Therefore, a material misstatement or omission may expose a franchisor to liability under the state franchise laws. Again, a franchisor should correct a material misstatement or omission via an FDD amendment filing with the applicable franchise registration states as soon as possible upon discovery.

J. Annual Proxy Statement Under Securities Act

Pursuant to Section 14(a) of the Exchange Act, the SEC requires registered companies to send a proxy statement to its shareholders prior to the annual shareholders meeting. The purpose of a proxy statement is to inform the shareholders of any upcoming business of the company and most importantly, inform the shareholders of the matters requiring shareholder vote such as the election of directors of the public company. Additionally, a proxy statement updates shareholders on certain management members, their compensation and their ownership stake in the company. Schedule 14A provides the information required in a proxy statement which includes information regarding a merger, consolidation, acquisition of a company, or proposed dispositions of all or substantially all of the company's assets.[55] The information within the proxy statement must be filed with the SEC before soliciting shareholders' votes.

Generally, any addition or removal of directors or "named executive officers" (which are largely determined based on their respective responsibilities and compensation) will require a filing of a Form 8-K under applicable Federal securities laws.[56] Depending on the corporate structure of the franchisor and its affiliates, to the

[53] 16 CFR § 436.6.
[54] 16 CFR § 436.9.
[55] 17 CFR § 240.14a-101.
[56] *See* Item 5.02 of Form 8-K.

extent there are changes to the directors, officers or management personnel, such changes may trigger a requirement to update the FDD. Often, the franchisor entity will be a subsidiary of the public company, rather than the public company itself, and the two entities will, to some extent, have different officers and/or management. If any of the public company directors or "named executive officers" included in the securities filings are also either directors or principal officers of the franchisor entity or have management responsibility related to the sale or operation of the franchises, they will also be included in Item 2 of the FDD, and thus changes in such public company directors or "named executive officers" will trigger an FDD amendment. Typically, Item 2 of the FDD will include more individuals than the directors and "named executive officers" listed in the securities filings. Item 2 of the FDD requires disclosure of the 5-year business experience for all directors, trustees, general partners, principal officers of the franchisor and for any other individuals (regardless of title and employer) who will have management responsibility relating to the sale or operation of franchises offered by the FDD[57]. This Item 2 "bio" needs to disclose each such person's title, his or her employer's name, the city and state for the location of each position, and the start and end month and year for each position, for each principal position held by such individual in the last 5 years. Any changes to the individuals listed in Item 2 of the FDD will generally trigger the need for an FDD amendment.[58]

K. Disclosures Under Stock Exchange Rules

The complex intersection of the reporting requirements by federal and state securities laws as well as federal and state franchise laws warrants special attention by a newly-public franchisor as to when to make public disclosures. In addition to these laws, companies with securities listed on a securities exchange in the United States are also subject to listing, disclosure, reporting and corporate governance requirements of their relevant exchange. The most common U.S. exchanges are the New York Stock Exchange LLC ("NYSE") and the National Association of Securities Dealers Automated Quotations ("NASDAQ"). A company listed on one of these exchanges should carefully review correspondences and monitor annual letters provided by the exchange because such communications likely provide vital information regarding reporting requirements. For instance, NYSE customarily releases an annual letter containing a summary of the cumulative changes in listing standards for that particular year.

While both exchanges perform similar tasks and require disclosure reports (which are generally not public), there are some major differences between NYSE and NASDAQ. A company listed on NASDAQ "must make prompt disclosure to the public of any material information that would reasonably be expected to affect the value of its securities or

[57] 16 CFR § 436.5.

[58] Any change to director or "named executive officer" will require a Form 8-K filing under the securities laws as well.

influence investors' decisions."[59] NASDAQ's publicity guidelines require advance notification to be given to NASDAQ's MarketWatch Department prior to a filing with the SEC at times. NYSE, on the other hand, requests telephonic or written notifications depending on the type of announcement to be released by the company.[60] NYSE also relies on a company's transfer agent to report share numbers and details no later than the 10th day after the end of each calendar quarter. A public company franchisor will again need to evaluate the contents and the timing of these disclosures to the exchange in light of its disclosure obligations under the franchise laws.

L. Heightened Focus on Environmental, Social and Governance Issues

The recent focus on a company's ESG strategies and awareness has created heightened pressures on public companies to maintain and attract a new wave of socially conscious investors. With the COVID-19 pandemic and the rise of politically and racially charged movements starting in late 2019, many investors developed an interest in educating themselves and evaluating where their capital is being invested [partially based on ESG interests]. Among other things, investors are demanding more socially and environmentally aware companies; this new-found ESG awareness is often called "sustainable investing."

The hyper focus on companies' effort to address ESG issues has made reporting on ESG matters difficult and non-uniform. Currently, assessment on a company's ESG performance often involves considering a company's energy consumption, water and waste use, treatment of soil and animals, and natural resources' conservation. Investors often look to a company's relationships with business partners and others in its field.[61] The recent collaboration between Sustainability Accounting Standards Board ("SASB") and the Global Reporting Initiative ("GRI") and recent SEC rule proposals may lead to a more uniform system of assessing companies on ESG issues.[62] In 2020, these two entities have started an initiative to develop basic ESG reporting standards that would allow for a standardized analysis.[63] The outcome of the SASB/GRI standards is yet to be tested, but the efforts surrounding ESG issues communicate the amplified emphasis on ESG matters for any new public company, including franchisors.

There are currently no specific legal requirements regarding ESG matters under the franchise laws. However, franchisors may elect to implement various programs and incentives that address ESG issues and that franchisee may participate in. Most likely such programs would not be disclosed in the franchisor's FDD but instead would be implemented by the franchisor via franchise system communications to franchisees and/or via additions and/or revisions to the franchisor's franchise operations manual. Generally, the franchisor retains a general right and discretion under its franchise

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[59] *See* NASDAQ RuleBook: Disclosure Requirements, available at https://listingcenter.nasdaq.com/assets/rulebook/nasdaq/rules/Issuer_Alert_2007-005A.pdf.

[60] *See* Sections 202.05, 202.06 and 204 of the NYSE Listed Company Manual, and its amendments.

[61] ALFREDO B. D. SILVA AND WILL TALCOTT CARTER, MORRISON & FOERSTER LLP, Key ESG Disclosure Considerations for Public Companies, current as of June 23, 2021.

[62] *Id.*

[63] *Id.*

agreement to evolve and change its franchise system over time and as part of that right and discretion, to implement new or modify existing programs in which franchisees may (or may be required to, as determined by the franchisor) participate. Such programs may trigger disclosure in the FDD if the programs include components that are otherwise required to be disclosed in the FDD – for example, if franchisees are required to purchase certain products or services from designated suppliers or from the franchisor or its affiliates in connection with participating in such programs. When implementing ESG programs, however, franchisors need to be careful not to mandate any employment-related practices to franchisees so that they do not create joint-employer or vicarious liability exposure for themselves. In addition, franchisors must consider the practical challenges of imposing ESG requirements on their franchisees, who are often small businesses without the financial resources that a public company may have available. Franchisors must evaluate what initiatives are feasible at the unit level versus what initiatives can or should be implemented at the corporate (franchisor) level – for example, the franchisor may be able to implement certain ESG initiatives through changes to its supply chain program or its marketing fund administration. To the extent the initiatives require new equipment or other significant purchases by franchisees, the franchisor should consider the timing of requiring franchisees to make such investments – for example, can some of those investments be implemented as part of the franchise renewal process? The franchisor may also consider offering certain incentives to franchisees that may lessen the financial burden of implementing ESG initiatives while motivating franchisees to participate in the initiatives.

V. CONCLUSION

Becoming a publicly traded company is a very exciting milestone in the life of any business, including a franchisor. It presents an incredible opportunity for accelerated growth of the franchise system, but it is not without its challenges and costs. The disclosure obligations and public filings that a private-company franchisor is used to under the franchise laws become more challenging to navigate when they have to align with the new disclosure and reporting obligations under the securities laws. Auditing only a single entity's financial statements may become a luxury of the past. The franchisor's already-complex relationships with franchisees and prospective franchisees become even more complicated under the additional burdens of fiduciary duties and other obligations of a public company. Being a public company is expensive – not only in terms of the financial costs and resources tied to legal compliance but also due to the loss of "privacy" that a life in the spotlight means – a new set of stakeholders and an enhanced public scrutiny that most private-company franchisors, no matter how famous their brand may be, are simply not prepared for. This certainly doesn't mean that a public company life isn't worth it for franchisors – it means that franchisors must weigh these costs and burdens carefully against the opportunities and the benefits presented, and must understand and accept the new realities of a life "in the public eye" -- in order to succeed.